Unit 6 Economics

BOOM AND BUST

In this unit, you will

- read about economic bubbles, including a rather unusual one that occurred hundreds of years ago.
- learn language for describing trends.
- learn language for summarizing.
- increase your understanding of the target academic words for this unit:

accurate	compound	estate	infrastructure	specify
attitude	denote	file	norm	trend
commodity	dispose	ideology	secure	underlie

SELF-ASSESSMENT OF TARGET WORDS

Think carefully about how well you know each target word in this unit. Then, write it in the appropriate column in the chart. When you've finished this unit, come back and reassess your knowledge of the target words.

I have never seen the word before.	I have seen the word but am not sure what it means.	I understand the word when I see or hear it in a sentence.	I have tried to use the word, but I am not sure I am using it correctly.	I use the word with confidence in either speaking *or* writing.	I use the word with confidence, both in speaking *and* writing.

READING 1

BEFORE YOU READ

Read these questions. Discuss your answers in small groups.

1. People sometimes buy collectible items such as paintings or comic books because they hope to "make a killing"—or earn a lot of money—by reselling them when the price goes up. Can you think of any collectible items where that has been the case? Can you think of any cases where collectors "lost their shirts"—or lost all the money they invested?
2. Are there any investments that are "sure things"—ones that are safe and usually make money?
3. Here are several popular sayings that could relate to buying and selling. Discuss the possible meanings of these sayings. Are they good advice?

   Don't count your chickens before they hatch.

   A fool and his money are soon parted.

   Don't look a gift horse in the mouth.

   The early bird gets the worm.

   Nothing ventured, nothing gained.

   Don't throw good money after bad.

MORE WORDS YOU'LL NEED

asset: something with monetary value that a person or organization controls such as buildings, machinery, stocks, cash, or inventory

momentum: an object has momentum if its current speed will carry it farther even if no more force is applied. Prices and popular ideas are also said to have momentum.

speculator: someone who buys and sells things at increased risk in hopes of making a greater profit

READ

This article explains the phenomenon of economic bubbles and what causes them to burst.

Economic Bubbles

An economic bubble occurs when speculation in **commodities** (such as oil), **securities** (such as stocks and bonds), real **estate**, or collectibles drives up prices well beyond the item's intrinsic value. The end result of this *boom* in price is a *crash* or *bust*. The price falls sharply once it becomes clear that it is far beyond the purchasing power of potential customers.

Speculators risk money in such investments because they hope that price of an asset they purchased will quickly increase. Since most speculators are nervous about where they invest their money, bubbles are by no means the **norm**. After all, speculators face the danger that the item is already overpriced. They also know that rising prices will encourage either greater production of a commodity or greater willingness of current owners to sell. Either of these conditions can serve as a "negative feedback" mechanism that adjusts prices downward. In economic situations, negative feedback works a bit like your eyes do. As the light gets brighter, your pupils get smaller and let in less light. But what if your eyes worked as a "positive feedback" mechanism? In sunlight, your pupils would open wide and damage the retina.

Economic bubbles occur when prices **trending** sharply upward serve as a positive, rather than a negative, feedback mechanism. For whatever reason (fear of shortages, greed, an excessively optimistic **attitude** toward the future, or misinformation about an asset's **underlying** value), buyers believe that the value of the asset will continue to rise well beyond the current price. If the price rises, exuberant speculators buy more, or those who missed out on the lower price want to buy before the price rises any higher. Some economists offer the "greater fool theory" to explain this: Buyers justify the high price they pay by assuring themselves that they will find "a greater fool" who will pay even more. Or buyers assume that a rising trend has a momentum that will surely carry it higher. Under the right conditions, prices can reach dizzying heights before falling. One famous example of this phenomenon is the tulip-buying bubble centered in Amsterdam in the 1630s when a single tulip bulb could cost a year's salary (see Reading 2).

Most bubbles cause little or no economic damage. The losers (the "greater fools") are a bit wiser, and the winners (the sellers) are a lot richer. But the effects of a bubble might be felt more widely if the holders of the overpriced asset feel rich and spend foolishly. Imagine this: You buy a house for $200,000 for which you borrowed $160,000. At this point, you have $40,000 in equity in the house (the difference between the price of the house and what you owe). The market value rises to $500,000 over a 5-year period. Now you have $340,000 in equity ($500,000 – $160,000), so you borrow another $240,000 from a bank using this equity to secure the loan. You suddenly feel much wealthier. You control assets worth half a million dollars. You still have $100,000 in equity in your home, and you have $240,000 to spend. And you do—a down payment on a vacation home, your daughter's freshman year at an expensive private college, a new car, and luxurious home furnishings.

The market holds long enough for you to spend the money. Then it crashes and the value of your home falls to $325,000. Now you have negative equity and owe the bank almost $400,000. You ask yourself why you should be paying $400,000 for a $325,000 house, so you stop paying your loan and give your house, car, and vacation home to the bank. Depending on how this plays out, the bank or you or both will take a huge loss. If this situation is widespread, banks can fail and less money is available for the investments and purchases necessary to "grow" the economy.

Besides real estate bubbles, there are stock market bubbles. In a normal market, investors buy stock in a company (also called "buying shares") because they anticipate that future profits will be distributed to shareholders, or because they believe that the value of the company's assets will increase. The share price depends on how certain investors are that these gains will materialize—and uncertainty usually is enough to keep prices within reason. Sometimes, though, a "herd mentality[1]" sets in and too many investors rush to buy, driving prices to levels that prove unrealistic. Eventually, the price collapses. When this happens to many companies simultaneously, it is called a stock market crash, with panicked investors selling so much stock that the market can drop a staggering amount in a single day.

[1] *herd mentality*: idiom; compares people to a herd (group) of animals that thoughtlessly follows a leader

A recent stock market bubble was the "dot-com" bubble in the United States which lasted from the mid 1990s to 2001. Excitement about the economic possibilities of the Internet encouraged investors to fund the creation of many dot-com companies—too many it turns out. For several years, instant wealth seemed within reach of any business with a website. Dot-com companies used expensive TV commercials to attract investors, sometimes without indicating what product they were selling. Many companies, to increase "market share,"[2] purposely sold products at a loss, a scheme they believed would increase the company's customer base and lead to future profits. Instead on March 10, 2000, the dot-com boom reached its peak when the NASDAQ Composite Index[3] (a number that reflects the value of stocks traded on the technology-heavy NASDAQ stock exchange[4]) hit 5,132.52. Over the next two and a half years, the index dropped to as low as 1,108. Most of the dot-coms were out of business, **filing** for bankruptcy[5] or selling off their assets to healthier companies. Particularly hard-hit were communication companies that invested heavily in a high-speed communications **infrastructure** that greatly exceeded demand.

Bubbles are not limited to real estate or glamorous "get rich" stock offerings. In 1996, a series of stuffed animal toys called Ty Beanie Babies™ became such a fad that speculators bought up large quantities, assuming that their value as collectibles would rise greatly in future years. Did anyone make money on that fad? Maybe, but why not see for yourself? Check out the price of Beanie Babies in an online auction site and decide if any of these sellers have struck it rich.

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[2] *market share*: the percentage of a market that one company controls

[3] The NASDAQ Composite Index shows the relative stock market value of over 3000 companies listed on the NASDAQ stock exchange. This exchange includes many technology companies.

[4] *stock exchange*: a place where stocks and bonds are bought and sold

[5] *bankruptcy*: the legal condition of being unable to pay off debts; financial ruin

READING COMPREHENSION

Mark each sentence as *T* (true) or *F* (false) according to the information in Reading 1. Use the dictionary to help you understand new words.

.... **1.** The reading implies that economic bubbles can seriously alter one's attitude about spending money.

.... **2.** According to the reading, economic bubbles are the norm in a market-based economy.

.... **3.** The reading implies that in the end no one makes money as the result of an economic "bubble."

.... **4.** The reading says that the dot-com bubble led to widespread economic disaster.

.... **5.** We can infer from the reading that under normal conditions speculators tend to invest cautiously.

.... **6.** The reading suggests that selling items below cost in order to gain market share is a poor business model.

READING STRATEGY: Describing Trends

A *trend* is an increase or decrease in a behavior over a period of time. Here is a list of verbs useful for describing trends:

climb	drop	increase	reach
decline	fall	pass	rise
decrease	grow	peak at	top

This paragraph provides a more detailed description of the NASDAQ stock market bubble described in Reading 1. First, scan the paragraph to get a sense of the direction of the trends. Then, complete each sentence with an appropriate verb in the correct form. The same verb may be used more than once.

The NASDAQ Composite Index (1) .... and fell sharply between 1995 and 2003. On July 17, 1995, the index (2) .... 1,000 for the first time. Over the next four years, the market (3) .... steadily, (4) .... to over 2200 by January 1999. Over the next 15 months, it (5) .... even more rapidly, more than doubling its value. Finally, on March 10, 2000, it (6) .... 5,132. And then the bubble burst. Over the next two and a half years, the NASDAQ (7) .... dramatically to less than one-fourth of its peak value. On October 10, 2002, it (8) .... its lowest point since passing the 1,000 mark, (9) .... to 1,108.

VOCABULARY ACTIVITIES

Noun	Verb	Adjective	Adverb
attitude	....	attitudinal	attitudinally
commodity	....	....	....
estate	....	....	....
file	file	....	....
infrastructure	....	....	....
norm	....	....	....
security insecurity	secure	secure insecure	securely
trend	trend	trendy	....

A. Read these comments on investing. Fill in the blanks with a target word from the chart on page 85 that completes the sentence in a grammatical and meaningful way. Be sure to use the correct form.

1. Organizations can borrow money by issuing bonds, a kind of .... A bond is a borrower's promise to repay the principal with interest at a future date.
2. Cities or states often issue *municipal bonds* to raise money for .... improvements, such as new highways, schools, or other public projects.
3. The amount of interest a bond pays depends mainly on the risk the investor faces. The higher the risk, the higher the interest rate. Municipal bonds are relatively ....; thus they tend to pay a lower interest rate.
4. Investors have different .... toward risk. To help investors assess risk, bonds are rated from AAA, the most secure, to D, the least secure.
5. Investing in bonds issued by a corporation is somewhat safer than buying stock in the corporation. If the corporation must .... for bankruptcy, bond holders are paid first, before the stockholders.
6. Today, one of the .... investments is a "hedge fund." These rather mysterious funds make risky investments for small groups of wealthy investors.
7. Hedge funds invest very widely in stocks, bonds, currencies, real ...., and .... such as wheat or oil.

B. Circle the word that best captures the meaning of the bold target word in each sentence.

1. The state board of education established new **norms** for children studying the language arts.
   a. usual behavior **b.** standards to meet
2. The bookshelf was **secured** firmly to the wall.
   a. fastened **b.** made safe
3. They **filed** the legal papers necessary for starting a corporation.
   a. stored documents **b.** registered to begin a process
4. The legal battle over who would inherit her **estate** went on for many years.
   a. house and land **b.** money and property