What You Need to Know about Economics to Be Happier

By

Víctor Saltero

Freeditorial

There are two subjects that should be taught to the world's children before they reach puberty. One is fluency of spoken expression, and the other is economics, as both will be pivotal to their development in their future lives.

A high level of ability in language use opens a lot of doors because it facilitates communication with others, allowing people to express their thoughts, feelings and desires effectively. This in turn facilitates the integration of young people into society. Language unites us. I am sure that just about everyone will agree with this idea.

However, in the case of economics, no doubt there will be less consensus. I suspect that many readers have furrowed their brows, wondering whether to continue reading, because they believe economics is a boring subject for specialists, which ordinary people will never understand.

This impression is false. It is very easy to understand, and it is knowledge that is extremely useful because your whole life, from cradle to grave—and even afterwards—is affected by economics.

For example, social stability, which is so essential to your wellbeing, is the product of a stable economy. When governments make bad decisions in this area—or in any other area connected with it, such as the financial sector—they can end up ruining a whole country, although the consequences of their acts may take years to materialize, dragging you along with the disaster, and much of your happiness with it.

An understanding of economics is essential because it will help us to make better personal decisions. It will enable us to take the right approach to buying a home or a car; it will help us to decide whether we should take out a loan; and it will be very useful when we want to start up a business. And it will even allow us to work out whether the politicians we're going to vote for are making feasible promises, or merely spouting populist nonsense that would end up dragging society down and the wellbeing of our family with it.

A good knowledge of this subject gives us a clearer understanding of the world we live in, as its principles are the same in every country; conversely, without such knowledge we will walk through life blindly, with a greater risk of stumbling and falling.

Perhaps the first question that needs to be answered is: if economics is so important, why isn't it taught at school? The answer is simple: because nobody—our politicians least of all—has the slightest interest in ensuring that you know anything about this subject. They prefer to fill the curriculum with subjects like history, which is manipulated in keeping with the interests of the government of the day, or chemistry or math, which, beyond their basic rules, will generally not have the slightest relevance to our children's lives, and other subjects that make no attempt to transmit useful knowledge, but only convey the appearance of knowledge.

The political elite understand that a knowledge of economics would be a threat to their power. That is why they are not especially keen on letting citizens learn too much about it... not to mention the fact that they don't know much about it themselves, because not even in the universities where this science is studied do they teach it effectively. What is generally taught is the particular jargon used by each economic sector: the financial sector, the industrial sector, the trade sector, etc. In short, the particular features of the different sectors, but no global understanding of the economy.

Indeed, we tend to take for granted that somebody who understands the financial sector, for example, knows all about economics. This is a mistake. The only knowledge that this person would usually have of this subject is how to manage that part of the economy and the particular features of that specific sector, but not how it interrelates with the rest. Nevertheless, we tend to assume that they are experts in economics because we hear them use financial jargon that we don't understand, although they probably don't know anything more about economics than you do.

And how did they manage to keep you and your children so indifferent to this subject? By creating a halo of complexity around it that it doesn't have—as will be shown below—and turning it into a boring and supposedly specialist topic.

Without further ado, let's take a closer look at the subject.

We'll begin by defining exactly what economics is. Economics is simply the science that studies every act of production and exchange of goods and services to meet any kind of need or want that people may have.

It has always been around. Cavemen offered any surplus goods they had to neighboring tribes in exchange for others they were short on. Such exchanges were their way of trading, in an age before the invention of money when this bartering process was the only means available to them. But it is a very limited economic system, and would be quite useless today with more than six billion people on the planet.

Money was created more than 3,000 years ago, and since then economic concepts began evolving into their current form.

Let's move forward to our times.

In human nature, there is a desire to possess things, which is born out of the most powerful of our instincts: the survival instinct. This is why we buy food, housing, clothing and all kinds of goods that become more numerous and varied the more developed a society is, particularly as we move further beyond the simple economics of survival.

This is the origin of the phenomenon called the economy, which comes into operation naturally whenever somebody needs something he doesn't have, because he will always find somebody else ready to provide it. And this is how the different economic sectors come into being: production, transportation, storage, sales; and, if necessary, financing. Coexisting simultaneously with these different agents is the State, which becomes an economic sector of its own, taking a percentage of this movement of goods and services in the form of taxes.

These sectors are all mutually interdependent, and collectively they constitute the economy.

As noted above, the economy comes into operation when someone seeks a good or service, as this creates natural demand and that's where it all begins.

To facilitate understanding I have outlined a simple formula that explains and regulates all the rules governing the economy, and that can be applied universally.

The formula is: Demand = production + trade = labor. And by extension: labor = more demand + more production + more trade = more labor.

And so it goes on in an endless cycle.

Conversely, the absence of natural demand—a term I will make use of repeatedly—has a negative impact on the other factors, resulting in unemployment and poverty.

In short, when someone seeks something he wants (demand), somebody else will provide it by making it and selling it to him, having to create employment to produce what he has been asked for. These new workers will also need and want goods which, in turn, others will provide, for which they will also have to create work to meet this demand, and so on. But if demand is cut, whatever the circumstances may be, unemployment and poverty will ensue.

This is what this Formula means, and therein lies all the principles of the economy in a nutshell. The Formula also explains the reasons for the greatest economic successes, and likewise, the biggest economic disasters of all time.

As will be shown below, these disasters are invariably the product of erroneous decisions by certain professional sectors involved in the economy that upset the harmonious balance of factors involved in the Formula.

Normally, they are mistaken decisions made by governments or by the financial world, which are the two economic sectors with the biggest influence on the economy, both for good and for ill.

The best way to explain this is to consider some real-life cases, which I will offer below.

The reason for the economic (and, therefore, social) failure of Africa is that there is no organized demand beyond what is necessary for mere survival; as a result, there is minimal production, trade and labor.

The main factor behind the failure of the USSR was that the government decided what should be produced and purchased—private companies were legally banned—and thus its economy was not governed by the natural demand of its citizens; rather, it was governed by the demand created and manipulated by the Soviet State, which ended up collapsing with a resounding crash because it was producing tanks and missiles in its factories when what the people wanted (natural demand) was bread, milk, clothes, and housing. In other words, production was not operating in harmony with demand. So the Soviet state fell apart, after its citizens had suffered greatly. Today North Korea is doing exactly the same thing, and is headed in the same direction.

The Chinese learned from the Soviet failure and at once took to applying the Formula described above, and with its effective implementation they have turned their country in the world's second biggest economic power.

The secret of the economic success of the United States lies in the vitality of its natural and organized demand, which created and maintains a large middle class, which is, in turn, what creates much of the demand on which many of us around the world live.

As can be seen in these actual examples, in the negative cases the factors of the Formula are upset by manipulation or absence of demand, while the positive cases are the result of the effective application of that Formula.

In Africa, if there is no organized and natural demand, they cannot create employment that would in turn generate further demand and more employment.

In the former USSR, the State directed and manipulated demand by controlling industry, which only produced what the government instructed, not what the citizens wanted. As a logical consequence, none of the factors of the Formula could operate. In short, they were unable to get the economy operating.

The United States, and now also China, have the largest middle classes in the world because they create a free yet organized and natural demand. In other words, both countries apply the Formula effectively, although sometimes they also make mistakes that end up affecting all of us.

Frequently asked questions about economics

Below is a list of the questions I have been asked most often in recent years on this subject, although I have already answered some of them in other written works published previously.

What caused the global financial crisis of 2008?

At the end of the last century there were two basic types of institutions in the financial sector: traditional banks and investment banks. Both are to money what a riverbed is to water. If you make changes to the riverbed that aren't well planned, you may cause the river to dry up or, conversely, to overflow. In the case of this crisis, poor decisions resulted in an initial overflow of money that led to a subsequent monetary drought. This dried up credit, which in turn dried up demand.

Why did this happen? The role of traditional banks was to act as a depository of the people's money and, with a profit margin from interest, to loan it to anyone who needed it with the due guarantees, since it was other people's money they were lending. The central banks of each country supposedly supervised these banks to ensure they didn't do anything outlandish that would put the money of their depositors at risk.

Meanwhile, investment banks sought capital from others and invested it in high-risk transactions, with the aim of increasing profits for their clients, and for themselves, if these transactions proved successful. These banks were, along with pension funds, the big investors in stock markets around the world.

Then, at the end of the 1990s, US President Clinton lifted the restrictions on traditional banks related to stock market investment, while allowing other financial institutions to act as traditional banks as well. Many other countries imitated this initiative.

The result was a massive injection of money into stock markets around the world, thereby creating artificial demand. Thus began a problem whose consequences would be felt years later.

At the beginning of this century, banks and financial institutions began granting huge loan packages, mostly for housing but also to purchase other goods. They gave out more loans than businesses and the public needed for their usual demand, and these loans encouraged people to spend beyond the real possibilities of return.

The financial sector was delighted because, on paper, it was making a lot of money. With these theoretical profits, it distributed generous dividends to its stakeholders. As will be shown below, these lavish profits led to huge losses, which we all ended up having to pay for.

The lending institutions had already granted loans to people who were able to pay it back, so they began lowering the requirements in order to provide loans to less solvent borrowers.

The borrowers receiving this money assumed that the experts knew what they were doing, and thought: “If the banks are prepared to give me money, it must be because I can afford it.” So they bought bigger houses or new cars they neither needed nor were really able to pay for.

The banks and financial institutions knew that these were high-risk mortgages and lending operations. And so to control this risk, they took out default insurance with various insurers (especially with the company AIG). If someone defaulted on a mortgage or a loan, these insurers would have to cover the cost. In this way, the banks wrote off their risks and were able to seek new loans to continue operating, and as a result they went further and further into debt. The insurers assumed this risk on a global scale, convinced that the housing market would continue to boom.

But this conviction was far from logical. Having inflated demand with so much credit, housing prices ended up falling due to a supply surplus because too much housing had been built; more than what people needed. Mortgages were foreclosed and the insurers had to pay for the defaults. All of them, all over the world, and at the same time. They couldn’t pay. So the banks took massive losses all on the same day, because responsibility for the defaults ultimately fell to them, and as a result they went under and took the financial system with them.

These were the reasons for the financial crisis that began in 2008, the consequences of which are still being felt today in many countries.

As you can see, it was a flagrant violation of the Formula outlined above, as it created artificial demand. This produced a bubble that came close to bringing down the global economy.

Financial institutions, with the support of governments, were the ones who created this disaster, because while credit has the capacity to build a modern economy, a lack of credit has the power to destroy it swiftly and completely, which is what inevitably happens when people are unable to get loans to buy a house, start a business, fill store shelves, or buy a car. In short, without credit, demand dries up and this undermines the other factors of the Formula:

production, trade and labor.

The banks were left in a disastrous state of insolvency, with massive debts, and ceased to fulfill their social role, which is to be the channel for the flow of cash; they held up the circulation of money while they licked their wounds.

They pushed the world to the brink of collapse, as all this happened very fast. As they watched events unfold, many people began to panic, wondering: Will my money be safe in the bank? And they started withdrawing their savings. Then there were long lines at the banks, bank closures, and within a couple of weeks there was no food in the stores.

The situation stabilized very slowly, through huge injections of money taken from public taxes into banks around the world. But we must not forget that this crisis could happen again unless governments and central banks impose sufficient controls on financial institutions.

In short, as can be seen, the key to this crisis was a severe manipulation of demand, which was no longer natural.

What is money?

It is one of man's most brilliant creations, because without it we would never be able to feed the billions of inhabitants of the world today.

First of all, it is worth clarifying that money is nothing more than a simple convention. Its solidity depends on the confidence that its holder needs to have that he will be able to exchange this piece of metal or paper in his hands for goods in the country that issued that currency.

Money was born out of a need for individuals and societies to have an effective instrument for exchanging goods.

In the most ancient times, in societies much simpler than ours, these transactions were limited to the mere exchange of merchandise between individuals. Thus, for example, a man in possession of a wheat surplus would seek to exchange it for animal hides for clothing from a man who produced more than he needed. Probably this was how the art of haggling was born, an art still practiced in many parts of the world, because it must have been difficult to determine, for example, how much wheat should be given in exchange for a sheepskin. It would be reasonable to assume that these transactions would have been sealed after long nights of discussions that no doubt would have been enjoyable in themselves.

Things started to get complicated when, as a consequence of demographic growth and production specialization, it became harder to make significant trading deals and compare prices and values, which represented an obvious obstacle to large-scale trade. This problem was resolved with the ingenious invention of what we know today as money. Once it appeared, trade expanded quickly, since it facilitated the exchange of goods both between individuals and between communities.

In the beginning, in the absence of a monetary system, trade was conducted using chickens, cows or pigs as units of reference. In fact, the first Roman coins minted bore images of these animals and received the name of "pecunia", a term derived from "pecus", which in Latin means "livestock".

But what is money, really? As I mentioned above, it is a convention, an unwritten agreement, as physically it is generally just a piece of metal or paper of barely any value in itself.

Without attempting to offer an analysis of its evolution throughout history, I will point out a few important points that will hopefully shed some light on what it is.

Until a short time ago, all the money placed in circulation in a country corresponded to the total value of the gold reserves held in the national bank. This was what is known as the economy of scarcity. This system lasted from ancient times right up to quite recently. Money was thus a kind of check to bearer, payable immediately, issued by the State, which the holder expects to be able to exchange in gold or equivalent goods at the value specified. For example, if the Bank of France had 100 tons of gold in its coffers, it would produce and circulate coins and bills equal to that total value; its division into smaller units gave rise to what has come to be known as the national currency, to which each country gave its own name. This meant that the value of any currency in circulation was guaranteed by the equivalent proportion of gold deposited in the State Bank. In some cases, the coins were even produced directly in gold or silver, and thereby acquired value in themselves.

This system—the gold standard—fell into disuse around the middle of the last century as a consequence of the deflationary crisis of 1929. It was replaced by a complex system directed mainly by the central banks of each country, with varying degrees of independence from their respective governments, in which various factors are taken into account to determine the amount of money that should be placed in circulation: Gross domestic product (GDP), the currency needs of companies, individuals and States, balances of payments, inflation, etc.

This new system has resulted in what is called the economy of abundance because its implementation makes it possible to increase the number of people with a reasonable standard of living continuously, as there are no limits on the production of money other than the imagination and hard work of individuals to create wealth.

What is the stock market?

The stock market began as a source of financing for companies, in addition to or instead of traditional loans. Over time, it has turned into a mechanism for facilitating public access to companies, as it allows any citizen to purchase a share in them for a little money.

Companies that need a capital injection to be able to take on new projects or to stabilize the ones they are developing have the opportunity to obtain it from individuals or entities who entrust their savings to them and who, by doing so, become shareholders.

The main advantage of companies listed on the stock exchange is, in addition to obtaining financing, they don't pay interest for the money they receive, as they would have to in the case of loans. The shareholder or investor, meanwhile, becomes a co-owner of the company, and is therefore subject to its financial fate. In other words, if the company in which he has bought shares earns profits, part of those profits will go to him, always in accordance with the percentage of his share. On the other hand, if the company takes losses, the shareholder could end up losing all the capital he invested in it

As noted above, this source of financing has played a key role in the growth of companies in recent decades and has made their ownership public, because there are millions of small investors around the world who use their savings to buy shares on the stock market. These investments are known as risk capital, because if the company takes a loss, its shares drop in value and part of their savings is lost; but if it earns profits, the investor can have a share in them and his share value will increase.

However, shares have a subjective value, which takes on increasing importance every day thanks to the law of supply and demand. If there is a lot of demand for certain shares—more potential buyers than sellers—their price will rise; in most cases, this is due more to the herd mentality of buyers than the income statements of the companies concerned. Conversely, shares fall when the number of buyers—or the amount of buyer money—is lower than the offer of shares made at a particular price.

This behavior has made speculative transactions so significant in recent years that shares in companies facing an unstable financial situation can end up being overvalued while others in a healthy condition can be undervalued. Consequently, with the passage of time, the stock market has lost its usefulness as a gage of the state of health of a country's economy.

The problem lies in the fact that the means have been confused with the ends. The original purpose of the stock market as a source of financing for business projects has been obscured by the mere speculative game of chasing a quick profit. These days, hardly anybody trusts their savings to the same shares for any length of time to reap a company's profits when its projects are successful. In the current reality, investors on the stock market buy and sell shares compulsively, looking for a quick profit from the speculative rise or fall of the shares they are trading. In other words, the stock market has basically turned into something like a virtual business which, in most cases, does not generate any collective wealth at all.

It would be interesting to consider returning the stock market to its roots, especially after the globalization of finance, since this has meant that speculative transactions in New York, for example, influence and endanger the savings of thousands of investors around the world who have neither the information nor the training necessary to have any control over what they invest.

What should the role of the State be in the economy?

The role of the State in a modern economy should be as a regulator of the economic sectors that participate in it, creating laws that are sensible and agreed on with the sectors concerned. It should also perform two other essential roles: as an arbitrator in the resolution of any conflicts that may arise, and as a careful monitor of strict compliance with the rules by the different economic sectors, especially the financial sector in view of its huge influence.

But what the State should never be—except in very limited strategic cases of obvious public interest—is an entrepreneur, as it doesn’t know how to do it. Every time a State has turned into an entrepreneur, in the medium term it has ended up plunging the citizens of its country into poverty.

Moreover, it is important to understand that the State does not create wealth or employment. When a government hires officials it isn’t creating employment; it is creating expenditure. The reason that this is so—returning to the Formula—is because most government officials perform activities that have not arisen from any natural demand of the public, but from a decision by the politicians in power at that moment. In other words, they are not producing anything that has been requested or demanded by the community.

It is undeniable that for the State to be able to provide the services for which it exists (security, public works, justice, etc.), it has to collect taxes from the citizens and employ officials to carry out these obligations. But it should do so with the utmost prudence, because an increase in government officials has the inevitable consequence of increasing bureaucratic costs, and with it the obligation to increase taxes, which leads to a reduction in demand because there is less money available to citizens and, as a result, there would be a foreseeable increase in unemployment in the medium term.

However, according to current political philosophies, it is unacceptable that one part of society should have to live in poverty, which is why today’s governments, when spending the money received from their citizens in the form of taxes, have to provide funds to help the weakest members of society. But they should also manage this money very prudently, because if the number of aid recipients increases, the government will have to increase costs to support them (and to keep their votes in the process), and this can only be done by either increasing taxes or going into debt, which will create more poverty, leading into a perverse economic circle that can only end by bankrupting us all. Governments must ensure that the burden of the subsidized classes does not impoverish the active workforce, who are the ones who keep the economy going.

The best way that governments can really help society’s weakest members is by contributing to the creation of employment, and the best way to do this is by removing barriers to business creation and encouraging entrepreneurs. This can be achieved by providing social stability, rules of play that are sensible and generally agreed on, and legal certainty.

Is consumerism negative?

There is a highly significant anecdote that is in a way related to this question. Mario Soares (the leader of the socialist party in Portugal) had just won the elections in his country when he received a congratulatory phone call from his Swedish counterpart, Olof Palme (also a socialist).

In this conversation, Soares said to Palme: “In two years, I will have gotten rid of all the rich people in Portugal.” To which the Swede replied: “I don’t want to get rid of the rich, my plan is to get rid of the poor.”

Of course, Palme was right. The problem is not that there are rich people, but that there are poor people. The fact that many people spend huge sums of money on eccentric consumer products is not negative, if they can afford it.

Why does anyone need a Ferrari, a hundred pairs of shoes, or a private airplane? The obvious answer is nobody, as they are not a vital necessity, offering nothing more than the vain pleasure of being able to show them off. But in buying such goods these rich people have paid taxes and created employment, because they have generated demand for something worth a lot of money, which then turns into labor.

On the opposite extreme—and socially much more favorably viewed than the above example—is the citizen who has only two suits: one to wear and the other to wash, and brags about not needing more. Such stoicism is intellectually satisfying, but unfortunately it contributes nothing to society, and does not help create work for others.

But that being said, it is worth clarifying something. Consumption is negative—and in this case it is appropriate to use the pejorative term “consumerism” for it—when these purchases are financed by loans that cannot be paid back, or with maturity periods that are longer than the average useful life of the product financed. Such behavior can certainly be classified using the pejorative sense of the term. When this happens—for example, financing the purchase of a car over twenty years, much longer than the useful life of the vehicle—all we are doing is creating excess demand today, and inflation with it, in exchange for a lack of demand tomorrow due to saturation of the market, and then we will be brewing an employment crisis for the future.

In economics, is there truth in the perception that if someone has a lot, someone else must go without?

This widespread assumption arose by default as a result of the type of economy that predominated throughout human history until relatively recently.

This economy was based on mining operations, with gold as the monetary standard: all of them goods in short supply. It therefore seemed obvious that if some had a lot, others must have to go without.

But the Industrial Revolution, and then in the last century the abandonment of the gold standard, brought an end to the economic system of scarcity, giving way to the current system based on an economy of abundance.

In the modern economy, as noted above, there are no limits on the creation of wealth other than the imagination and effort that people are prepared to exert within a regulated system, in accordance with the terms of the Formula described above.

The economy of today has completely changed the obsolete principles of scarcity, with its notion of “if someone has a lot someone else must go without”, although many politicians still successfully exploit this propaganda as a populist weapon in order to win power.

Today, the money placed in circulation in a country is related to the GDP of that country, which means that the only limit on it is capacity of that country’s citizens to create riches. Thus, the more goods that the markets want to buy are produced, the more the GDP will rise, and with it the money in circulation and the incomes of the people.

Why is Venezuela, in spite of all the oil it has, in such a terrible economic state?

Indeed, this beautiful country has been living through an intense drama, in which poverty has taken over the daily lives of the people.

I will offer a quick overview of its recent history so that the origins of these serious problems may be better understood.

In the last century, Venezuela had a theoretically democratic two-party system for decades, characterized more than anything by corruption. Lusinchi, Caldera, Pérez and other leaders drove the country to bankruptcy, and this led to social upheaval. Out of this upheaval emerged Hugo Chávez, a man of a military background, who came to power promising to clean things up and bring an end to the chaos.

But he didn’t know how to do it, nor has his successor, Maduro. Both leaders governed in ignorance, just as those before them had governed in corruption. It was out of such ignorance that they nationalized the country’s most important companies, and they have simply had no idea how to manage them efficiently. The result of this has been even more poverty than there was in the days of the corrupt rulers. This has only meant more suffering for the Venezuelan people, because demagogic slogans and incendiary speeches like those of the current government, blaming everyone else for its ills, will not solve anything at all.

From an economic standpoint, it is worth noting that Venezuela has one of the largest oil reserves in the world, as well as other important natural reserves, which, if managed honestly and effectively would be able to lift its people out of the situation they currently find themselves in.

To do this they will need to find competent rulers who can apply the formula outlined above with integrity and diligence, beginning by restoring civil peace.

If they can achieve this, a great future lies ahead for them.

How would secession from Spain affect the people of Catalonia?

While sailing on the Mediterranean recently, we saw a group of dolphins swimming harmoniously near our boat. It was a beautiful sight. With us was a marine biologist, who explained that they were pilot whale dolphins, and that they possessed some curious characteristics. One of these was that they always followed a leader, and when that leader became ill or lost its sense of direction, it would swim for the shore where it would beach and, inevitably, die. What is curious is that the other dolphins would follow it to the end and die beached on the shore with their leader.

The Catalan situation reminds me of these dolphins. A few political leaders are leading Catalonia to the shore, and a segment of the Catalan people are following them, just like the dolphins following their disorientated leader.

Catalonia is politically structured within Spain, and has a strong middle class with a very reasonable standard of living. Nevertheless, some of its political leaders want to drag it into the creation of an independent state, and some of its citizens are following them.

If this secession were to take place, they would be creating a new, independent country, and under existing laws that country would not be part of the European Union, and would obviously be out of the eurozone. They would have to create their own currency, which would have no value outside Catalonia. This is irrefutable, however much ignorant flag-waving fanatics may wish to deny it.

But continuing with the secessionist hypothesis, it is easy to foresee that as the date of secession draws near, Catalan banks would not have a single euro or dollar left in their coffers, because nearly everybody would start withdrawing them when they rightly guessed that the new government would convert them all by decree into Catalan currency, which, beyond their borders, would be worth no more than Monopoly money.

Obviously, the citizens would receive their salaries in this currency, but they would have to pay for all kinds of imported goods in dollars or euros, which they would have to buy at exorbitant prices, and this would result in a sudden spike in the costs of all imported products and, inevitably, runaway price increases in normal consumer goods, pushing the purchasing power of the new nation’s citizens through the floor.

These are not opinions. They are no less than the precise application of basic economic principles, combined with international law. These consequences are inevitable, and once again we can see the need for people to receive an economic education, as it would enable them to understand the huge risks they are taking on.

And you, doesn’t this direction being taken by the Catalan people remind you of the pilot whale dolphins?