Economics Glossary
Some of the commonly used economic terms are defined here.

ABSOLUTE ADVANTAGE

This is the simplest yardstick of economic performance. If one person, firm or country can produce more of something with the same amount of effort and resources, they have an absolute advantage over other producers.

AGENCY COSTS

These can arise when somebody (the principal) hires somebody else (the agent) to carry out a task and the interests of the agent conflict with the interests of the principal.

AMORTISATION

The running down or payment of a loan by instalments. An example is a repayment mortgage on a house, which is amortised by making monthly payments that over a pre-agreed period of time cover the value of the loan plus interest. With loans that are not amortised, the borrower pays only interest during the period of the loan and then repays the sum borrowed in full.

ANTITRUST

GOVERNMENT policy for dealing with MONOPOLY. Antitrust laws aim to stop abuses of market power by big companies and, sometimes, to prevent corporate MERGERS AND ACQUISITIONS that would create or strengthen a monopolist.

APPRECIATION

A rise in the value of an ASSET and the opposite of DEPRECIATION. When the value of a currency rises relative to another, it appreciates.

ARBITRAGE

Buying an ASSET in one market and simultaneously selling an identical asset in another market at a higher price.

ARBITRAGE PRICING THEORY

This is one of two influential economic theories of how assets are priced in the financial markets. The ARBITRAGE pricing theory says that the price of a financial ASSET reflects a few key risk factors, such as the expected RATE OF INTEREST, and how the price of the asset changes relative to the price of a portfolio of assets. If the price of an asset happens to diverge from what the theory says it should be, arbitrage by investors should bring it back into line.

ASSETS: Things that have earning power or some other value to their owner.

ASYMMETRIC INFORMATION

When somebody knows more than somebody else. Such asymmetric information can make it difficult for the two people to do business together, which is why economists, especially those practising GAME THEORY, are interested in it.

AUCTIONS

Going, going, gone. Holding an auction can be an extremely efficient way for a seller to set the price of its products, especially if it does not have much INFORMATION about how much people may be willing to pay for them. Auctions fascinate economists, especially those who specialise in GAME THEORY. An English auction is the most familiar. Bidders compete to offer higher prices and drop out until only one remains. In a Dutch auction, the auctioneer calls out a high price then keeps lowering it until there is a buyer.

AUTARKY

The idea that a country should be self-sufficient and not take part in international trade.

AVERAGE

A number that is calculated to summarise a group of numbers. The most commonly used average is the mean, the sum of the numbers divided by however many numbers there are in the group.

BACKWARDATION

When a COMMODITY is valued more highly in a spot market (that is, when it is for delivery today) than in a futures market (for delivery at some point in the future). When spot prices are lower than futures prices it is known as contango

BALANCE OF PAYMENTS

The total of all the MONEY coming into a country from abroad less all of the money going out of the country during the same period. This is usually broken down into the current account and the capital account.

BALANCED BUDGET

When total public-sector spending equals total government income during the same period from taxes and charges for public services.

BANK

Starting out as places that would guard your MONEY, banks became the main source of CREDIT CREATION. Banks come in many different forms. Commercial banks, also known as retail banks, cater directly for the general public and lend to (mostly small and medium-sized) firms.

BANKRUPTCY

When a court judges that a debtor is unable to make the payments owed to a CREDITOR

BARTER

Paying for goods or SERVICES with other goods or services, instead of with MONEY. It is often popular when the quality of money is low or uncertain, perhaps because of high INFLATION or counterfeiting, or when people are ASSET-rich but cash-poor, or when TAXATION or extortion by criminals is high. Little wonder, then, that barter became popular in Russia during the late 1990s.

BASIS POINT

One one-hundredth of a PERCENTAGE POINT. Small movements in the INTEREST RATE, the EXCHANGE RATE and BOND YIELDS are often described in terms of basis points. If a bond yield moves from 5.25% to 5.45%, it has risen by 20 basis points.

BEAR

An investor who thinks that the PRICE of a particular security or class of SECURITIES (SHARES, say) is going to fall; the opposite of a BULL.

BETA

Part of an economic theory for valuing financial SECURITIES and calculating the COST OF CAPITAL, known as the CAPITAL ASSET PRICING MODEL, beta measures the sensitivity of the PRICE of a particular ASSET to changes in the market as a whole.

BLACK ECONOMY

If you pay your cleaner or builder in cash, or for some reason neglect to tell the taxman that you were paid for a service rendered, you participate in the black or underground economy. Such transactions do not normally show up in the figures for GDP, so the black economy may mean that a country is much richer than the official data suggest.

BLACK-SCHOLES

A formula for pricing financial options.

BONDS

A bond is an INTEREST-bearing SECURITY issued by governments, companies and some other organisations. Bonds are an alternative way for the issuer to raise capital to selling shares or taking out a BANK loan.

BRAND

The stalking-horse for international CAPITALISM. A focus for all the worries about environmental damage, human-rights abuses and sweated labour that opponents of GLOBALISATION like to put on their placards. A symbol of America's corporate power, since most of the world's best-known brands, from Coca Cola to Nike, are American. That is the case against.

BULL

An investor who expects the PRICE of a particular SECURITY to rise; the opposite of a BEAR.

BUYER'S MARKET

A market in which SUPPLY seems plentiful and PRICES seem low; the opposite of a SELLER'S MARKET.

CAPITAL

MONEY or ASSETS put to economic use, the life-blood of CAPITALISM. Economists describe capital as one of the four essential ingredients of economic activity, the FACTORS OF PRODUCTION, along with LAND, LABOUR and ENTERPRISE.

CAPITAL ADEQUACY RATIO

The ratio of a BANK’s CAPITAL to its total ASSETS, required by regulators to be above a minimum (“adequate”) level so that there is little RISK of the bank going bust. How high this minimum level is may vary according to how risky a bank’s activities are.

CAPITAL INTENSIVE

A production process that involves comparatively large amounts of CAPITAL; the opposite of LABOUR INTENSIVE.

CAPITAL MARKETS

Markets in SECURITIES such as BONDS and SHARES. Governments and companies use them to raise longer-term CAPITAL from investors, although few of the millions of capital-market transactions every day involve the issuer of the security. Most trades are in the SECONDARY MARKETS, between investors who have bought the securities and other investors who want to buy them. Contrast with MONEY MARKETS, where short-term capital is raised.

CETERIS PARIBUS

Other things being equal. Economists use this Latin phrase to cover their backs. For example, they might say that "higher interest rates will lead to lower inflation, ceteris paribus", which means that they will stand by their prediction about INFLATION only if nothing else changes apart from the rise in the INTEREST RATE.

CLOSED ECONOMY

An economy that does not take part in international trade; the opposite of an OPEN ECONOMY. At the turn of the century about the only notable example left of a closed economy is North Korea (see AUTARKY).

COLLATERAL

An ASSET pledged by a borrower that may be seized by a lender to recover the value of a loan if the borrower fails to meet the required INTEREST charges or repayments.

COMMAND ECONOMY

When a GOVERNMENT controls all aspects of economic activity (see, for example, COMMUNISM).

COMPETITIVE ADVANTAGE

Something that gives a FIRM (or a person or a country) an edge over its rivals.

COMPOUND INTEREST

If a deposit account of $100 earns an INTEREST RATE of 10% a year, then at the end of the year the account will contain $110. If all of that money is left in the account, then the 10% interest will be paid on the $110, so at the end of the second year $11 of interest will be added, making $121 in all. This is known as compound interest. By contrast, SIMPLE INTEREST pays the 10% only on the original sum in the account.

CONSUMER PRICES

What people are usually thinking of when they worry about INFLATION. The PRICES paid by whoever finally consumes goods or SERVICES, as opposed to prices paid by FIRMS at various stages of the production process.

CONSUMER SURPLUS

The difference between what a consumer would be willing to pay for a good or service and what that consumer actually has to pay. Added to PRODUCER SURPLUS, it provides a measure of the total economic benefit of a sale.

CONTAGION

The domino effect, such as when economic problems in one country spread to another.

CREDIT

A loan extended or (sometimes) taken by, for example, delayed payment of an invoice.

CREDIT CRUNCH

When BANKS suddenly stop lending, or BOND market LIQUIDITY evaporates, usually because creditors have become extremely RISK AVERSE.

CREDITOR

A lender, whether by making a loan, buying a BOND or allowing MONEY owed now to be paid in the future.

CURRENCY PEG

When a GOVERNMENT announces that the EXCHANGE RATE of its currency is fixed against another currency or currencies.

DEFAULT

Failure to fulfil the terms of a loan agreement. For example, a borrower is in default if he or she does not make scheduled INTEREST payments on a loan or fails to pay off the loan at the agreed time. Judging the likelihood of default is a crucial part of pricing a loan. Interest rates are set so that, on AVERAGE, a portfolio of loans will be profitable to the CREDITOR, even if some individual loans are loss-making as a result of borrowers defaulting.

DEFICIT

In the red – when more MONEY goes out than comes in. A BUDGET deficit occurs when PUBLIC SPENDING exceeds GOVERNMENT revenue. A current account deficit occurs when EXPORTS and inflows from private and official TRANSFERS are worth less than IMPORTS and transfer outflows

DEMAND CURVE

A graph showing the relationship between the price of a good and the amount of DEMAND for it at different PRICES.

DEPRECIATION

A fall in the value of an ASSET or a currency; the opposite of APPRECIATION.

DEVALUATION

A sudden fall in the value of a currency against other currencies. Strictly, devaluation refers only to sharp falls in a currency within a fixed EXCHANGE RATE system. Also it usually refers to a deliberate act of GOVERNMENT policy, although in recent years reluctant devaluers have blamed financial SPECULATION. Most studies of devaluation suggest that its beneficial effects on COMPETITIVENESS are only temporary; over time they are eroded by higher PRICES

DISCOUNT RATE

The rate of INTEREST charged by a CENTRAL BANK when lending to other financial institutions. It also refers to a rate of interest used when calculating DISCOUNTED CASHFLOW.

DISEQUILIBRIUM

When SUPPLY and DEMAND in a market are not in balance. Contrast with EQUILIBRIUM.

DISINFLATION

A fall in the rate of INFLATION. This means a slower increase in PRICES but not a fall in prices, which is known as DEFLATION.

ECONOMETRICS

Mathematics and sophisticated computing applied to ECONOMICS. Econometricians crunch data in search of economic relationships that have STATISTICAL SIGNIFICANCE. Sometimes this is done to test a theory; at other times the computers churn the numbers until they come up with an interesting result. Some economists are fierce critics of theory-free econometrics.

ECONOMIC INDICATOR

A statistic used for judging the health of an economy, such as GDP per head, the rate of UNEMPLOYMENT or the rate of INFLATION. Such statistics are often subject to huge revisions in the months and years after they are first published, thus causing difficulties and embarrassment for the economic policymakers who rely on them.

ECONOMICS

The “dismal science”, according to Thomas Carlyle, a 19th-century Scottish writer. It has been described in many ways, few of them flattering. The most concise, non-abusive, definition is the study of how society uses its scarce resources.

EFFICIENCY

Getting the most out of the resources used. For a particular sort of efficiency often favoured by economists.

ENDOGENOUS

Inside the economic model; the opposite of EXOGENOUS

ENGEL'S LAW

People generally spend a smaller share of their BUDGET on food as their INCOME rises. Ernst Engel, a Russian statistician, first made this observation in 1857. The reason is that food is a necessity, which poor people have to buy. As people get richer they can afford better-quality food, so their food spending may increase, but they can also afford LUXURIES beyond the budgets of poor people. Hence the share of food in total spending falls as incomes grow.

EURODOLLAR

A deposit in dollars held in a BANK outside the United States. Such deposits are often set up to avoid taxes and currency exchange costs. They are frequently lent out and have become an important method of CREDIT CREATION

EXCHANGE CONTROLS

Limits on the amount of foreign currency that can be taken into a country, or of domestic currency that can be taken abroad.

EXPORTS

Sales abroad. Exports grew steadily as a share of world OUTPUT during the second half of the 20th century. Yet by some measures this share was no higher than at the end of the 19th century, before FREE TRADE fell victim to a political backlash.

FACTOR COST

A measure of OUTPUT reflecting the costs of the FACTORS OF PRODUCTION used, rather than market prices, which may differ because of INDIRECT TAX and subsidy.

FACTORS OF PRODUCTION

The ingredients of economic activity: LAND, LABOUR, CAPITAL and ENTERPRISE.

FACTORY PRICES

The PRICES charged by producers to wholesalers and retailers. Because these prices are eventually passed on to the end customer, changes in factory prices, also known as producer prices, can be a LEADING INDICATOR of CONSUMER PRICE INFLATION.

FINANCIAL INSTRUMENT

Certificate of ownership of a financial ASSET, such as a BOND or a SHARE.

FINANCIAL INTERMEDIARY

A middleman. An individual or institution that brings together investors (the source of funds) and users of funds (such as borrowers). May be increasingly at risk of DISINTERMEDIATION.

FIXED COSTS

Production costs that do not change when the quantity of OUTPUT produced changes, for instance, the cost of renting an office or factory space. Contrast with VARIABLE COSTS.

FLOTATION

Going public. When SHARES in a company are sold to the public for the first time through an initial public offering. The number of shares sold by the original private investors is called the "float". Also, when a BOND issue is sold in the FINANCIAL MARKETS.

FULL EMPLOYMENT

Jobs for all that want them. This does not mean zero UNEMPLOYMENT because at any point in time some people do not want to work.

FUNGIBLE

You can't tell them apart. Something is fungible when any one single specimen is indistinguishable from any other. Somebody who is owed $1 does not care which particular dollar he gets. Anything that people want to use as MONEY must be fungible, whether it be GOLD bars, beads or shells.

GEARING

A company's DEBT expressed as a percentage of its equity; also known as leverage.

GENERAL AGREEMENT ON TARIFFS AND TRADE

Or GATT, the vehicle for promoting international FREE TRADE, through a series of rounds of negotiations between the governments of trading countries. The first GATT round began in 1945. The last led to the establishment of the WORLD TRADE ORGANISATION in 1995.

GIFFEN GOODS

Named after Robert Giffen (1837-1910), a good for which DEMAND increases as its PRICE rises. But such goods may not exist in the real world

GNI

Short for gross national income, a term now used instead of GNP in national accounts.

GNP

Short for gross national product, another measure of a country's economic performance. It is calculated by adding to GDP the INCOME earned by residents from investments abroad, less the corresponding income sent home by foreigners who are living in the country.

HORIZONTAL EQUITY

One way to keep TAXATION fair. Horizontal equity means that people with a similar ability to pay taxes should pay the same amount.

HORIZONTAL INTEGRATION

Merging with another firm just like yours, for example, two biscuit makers becoming one. Contrast with VERTICAL INTEGRATION, which is merging with a firm at a different stage in the SUPPLY chain. Horizontal integration often raises ANTITRUST concerns, as the combined firm will have a larger market share than either firm did before merging.

HOT MONEY

Money that is held in one currency but is liable to switch to another currency at a moment's notice in search of the highest available RETURNS, thereby causing the first currency's EXCHANGE RATE to plummet. It is often used to describe the money invested in currency markets by speculators.

INCOME EFFECT

A change in the DEMAND for a good or service caused by a change in the INCOME of consumers rather than, say, a change in consumer tastes. Contrast with SUBSTITUTION EFFECT.

INCUMBENT ADVANTAGE

The importance of being there already. FIRMS that are in a market can have a significant COMPETITIVE ADVANTAGE over aspiring entrants to that market, for instance, through having the opportunity to erect barriers to entry.

INDEXATION

Keeping pace with INFLATION. In many countries, WAGES, pensions, UNEMPLOYMENT benefits and some other sorts of INCOME are automatically raised according to recent movements in the consumer PRICE index. This allows these different sorts of income to retain their value in REAL TERMS

INDIFFERENCE CURVE

A curve that joins together different combinations of goods and SERVICES that would each give the consumer the same amount of satisfaction (UTILITY). In other words, consumers are indifferent to which of the combinations they get.

INDIRECT TAXATION

Taxes that do not come straight out of a person's pay packet or ASSETS, or out of company PROFIT. For example, a CONSUMPTION tax, such as VALUE-ADDED tax (see EXPENDITURE TAX). Contrast with DIRECT TAXATION, such as INCOME TAX. Indirect taxation has become increasingly popular with politicians because it may be less noticeable to people paying it than income tax and is harder to avoid paying.

INELASTIC

When the SUPPLY or DEMAND for something is insensitive to changes in another variable, such as PRICE.

INFERIOR GOODS

Products that are less in demand as consumers get richer. For NORMAL GOODS, DEMAND increases as consumers have more to spend.

INTANGIBLE ASSETS

Valuable things, even though you cannot drop them on your foot – an idea, say, especially one protected by a PATENT; an effective corporate culture; HUMAN CAPITAL; a popular brand. Contrast with TANGIBLE ASSETS.

INTELLECTUAL CAPITAL

The part of a country's or a firm's CAPITAL or an individual's HUMAN CAPITAL that consists of ideas rather than something more physical. It can often be protected through PATENTS or other intellectual property laws.

INTERVENTION

When CENTRAL BANKS try to influence an EXCHANGE RATE by buying the currency they want to appreciate and selling the one they want to weaken. The evidence seems to suggest that it is at best a short-term measure. In the longer term, governments probably do not have the resources to beat MARKET FORCES

INVISIBLE TRADE

EXPORTS and IMPORTS of things you cannot touch or see: SERVICES, such as banking or advertising and other intangibles, such as copyrights. Invisible trade accounts for a growing slice of the value of world trade.

INWARD INVESTMENT

Investment from abroad; the opposite of OUTWARD INVESTMENT

J-CURVE

The shape of the trend of a country's trade balance following a DEVALUATION. A lower EXCHANGE RATE initially means cheaper EXPORTS and more expensive IMPORTS, making the current account worse (a bigger DEFICIT or smaller surplus). After a while, though, the volume of exports will start to rise because of their lower PRICE to foreign buyers, and domestic consumers will buy fewer of the costlier imports. Eventually, the trade balance will improve on what it was before the devaluation. If there is a currency APPRECIATION there may be an inverted J-curve.

JOINT SUPPLY

Some products or production processes have more than one use. For instance, cows can both provide milk and be eaten. If farmers increase the number of cows they own in response to an increase in DEMAND for milk, they are also likely to increase, a little later, the supply of meat, causing beef prices to fall.

KLEPTOCRACY

Corrupt, thieving GOVERNMENT, in which the politicians and bureaucrats in charge use the powers of the state to feather their own nests.

KONDRATIEFF WAVE

A 50 year-long BUSINESS CYCLE, named after Nikolai Kondratieff, a Russian economist. He claimed to have identified cycles of economic activity lasting half a century or more in his 1925 book, *The Long Waves in Economic Life*. Because this implied that CAPITALISM was, ultimately, a stable system, in contrast to the Marxist view that it was self-destructively unstable, he ended up in one of Stalin's prisons, where he died. Alas, there is little hard evidence to support Kondratieff's conclusion.

LABOUR INTENSIVE

A production process that involves comparatively large amounts of LABOUR; the opposite of CAPITAL INTENSIVE.

LABOUR THEORY OF VALUE

The notion that the value of any good or service depends on how much LABOUR it uses up. First suggested by ADAM SMITH, it took a central place in the philosophy of KARL MARX. Some neo-classical economists disagreed with this theory, arguing that the PRICE of something was independent of how much labour went into producing it and was instead determined solely by SUPPLY and DEMAND.

LAGGING INDICATORS

Old news. Some economic statistics move weeks or months after changes in the BUSINESS CYCLE or INFLATION. They may not be a reliable guide to the current state of an economy or its future path. Contrast with LEADING INDICATORS.

LIBERALISATION

A policy of promoting LIBERAL ECONOMICS by limiting the role of GOVERNMENT to the things it can do to help the market economy work efficiently. This can include PRIVATISATION and DEREGULATION.

LIBOR

Short for London interbank offered rate, the rate of INTEREST that top-quality BANKS charge each other for loans. As a result, it is often used by banks as a base for calculating the INTEREST RATE they charge on other loans. LIBOR is a floating rate, changing all the time.

LIQUIDITY PREFERENCE

The proportion of their ASSETS that FIRMS and individuals choose to hold in varying degrees of LIQUIDITY. The more cash they have, the greater is their desire for liquidity.

LUXURIES

Goods and SERVICES that have a high ELASTICITY of DEMAND. When the PRICE of, say, a Caribbean holiday rises, the number of vacations demanded falls sharply. Likewise, demand for Caribbean holidays rises significantly as AVERAGE INCOME increases, certainly by more than demand for many NORMAL GOODS. Contrast this with necessities, such as milk or bread, which people usually demand in quite similar quantities whatever their income and whatever the price.

MARKET CAPITALISATION

The market value of a company's SHARES: the quoted share PRICE multiplied by the total number of shares that the company has issued.

MARKET FORCES

Shorthand for the pressures from buyers and sellers in a market, rather than those coming from a GOVERNMENT planner or from REGULATION.

MARKET POWER

When one buyer or seller in a market has the ability to exert significant influence over the quantity of goods and SERVICES traded or the PRICE at which they are sold. Market power does not exist when there is PERFECT COMPETITION, but it does when there is a MONOPOLY, MONOPSONY or OLIGOPOLY.

MEAN REVERSION

The tendency for subsequent observations of a random variable to be closer to its mean than the current observation. For example, if the current number is 7, the average is 5, and there is mean reversion, then the next observation is likelier to be 6 than 8.

MEDIUM TERM

Somewhere between SHORT-TERMISM, which is bad, and the LONG RUN, lies the hallowed ground of the medium term – far enough away to discourage myopic behaviour by decision makers but close enough to be meaningful. But not many governments say exactly how long they think the medium term is.

MISERY INDEX

The sum of a country's INFLATION and UNEMPLOYMENT rates. The higher the score, the greater is the economic misery.

MONOPSONY

A market dominated by a single buyer. A monopsonist has the MARKET POWER to set the PRICE of whatever it is buying (from raw materials to LABOUR). Under PERFECT COMPETITION, by contrast, no individual buyer is big enough to affect the market price of anything.

NAFTA

Short for North American Free-Trade Agreement. In 1993, the United States, Mexico and Canada agreed to lower the barriers to trade among the three economies. The formation of this regional TRADE AREA was opposed by many politicians in all three countries. In the United States and Canada, in particular, there were fears that NAFTA would result in domestic job losses to cheaper locations in Mexico. In the early years of the agreement, however, most studies found that the economic gains far outweighed any costs.

NAIRU

The non-accelerating-inflation rate of unemployment

NATIONAL INCOME

Shorthand for everything that is produced, earned or spent in a country

NOMINAL VALUE

The value of anything expressed simply in the MONEY of the day. Since INFLATION means that money can lose its value over time, nominal figures can be misleading when used to compare values in different periods. It is better to compare their real value, by adjusting the nominal figures to remove the inflationary distortions.

NON-PRICE COMPETITION

Trying to win business from rivals other than by charging a lower PRICE. Methods include ADVERTISING, slightly differentiating your product, improving its quality, or offering free gifts or discounts on subsequent purchases. Non-price competition is particularly common when there is an OLIGOPOLY, perhaps because it can give an impression of fierce rivalry while the FIRMS are actually colluding to keep prices high.

NORMAL GOODS

When average INCOME increases, the DEMAND for normal goods increases, too. The opposite of

INFERIOR GOODS.

NORMATIVE ECONOMICS

economics that tries to change the world, by suggesting policies for increasing economic WELFARE. The opposite of POSITIVE ECONOMICS, which is content to try to describe the world as it is, rather than prescribe ways to make it better.

OFFSHORE

Where the usual rules of a person or firm's home country do not apply. It can be literally offshore, as in the case of investors moving their MONEY to a Caribbean island TAX HAVEN. Or it can be merely legally offshore, as in the case of certain financial transactions that take place within, say, the City of London, which are deemed for regulatory purposes to have taken place offshore.

OLIGOPOLY

When a few FIRMS dominate a market. Often they can together behave as if they were a single MONOPOLY, perhaps by forming a CARTEL. Or they may collude informally, by preferring gentle NON-PRICE COMPETITION to a bloody PRICE war. Because what one firm can do depends on what the other firms do, the behaviour of oligopolists is hard to predict. When they do compete on price, they may produce as much and charge as little as if they were in a market with PERFECT COMPETITION.

OPEN ECONOMY

An economy that allows the unrestricted flow of people, CAPITAL, goods and SERVICES across its borders; the opposite of a CLOSED ECONOMY.

OPTIMUM

As good as it gets, given the constraints you are operating within. For the concept of optimum to mean anything, there must be both a goal, say, to maximise economic WELFARE, and a set of constraints, such as an available stock of scarce economic resources. Optimising is the process of doing the best you can in the circumstances.

OVER THE COUNTER

In the case of drugs, those that can be purchased without a prescription from a doctor. In the case of financial SECURITIES, those that are bought or sold through a private dealer or BANK rather than on a financial exchange.

OVERHEATING

When an economy is growing too fast and its productive CAPACITY cannot keep up with DEMAND. It often boils over into INFLATION.

PERCENTILE

Part of the "ile" family that signposts positions on a scale of numbers (see also QUARTILE). The top percentile on, say, the distribution of INCOME, is the richest 1% of the POPULATION

PIGOU EFFECT

Named after Arthur Pigou (1877–1959), a sort of WEALTH EFFECT resulting from DEFLATION. A fall in the PRICE level increases the REAL VALUE of people's SAVINGS, making them feel wealthier and thus causing them to spend more. This increase in DEMAND can lead to higher employment.

POSITIVE ECONOMICS

ECONOMICS that describes the world as it is, rather than trying to change it. The opposite of NORMATIVE

ECONOMICS, which suggests policies for increasing economic WELFARE.

PRECAUTIONARY MOTIVE

Keeping some MONEY handy, just in case. One of three motives for holding money identified by KEYNES, along with the transactional motive (having the cash to pay for planned purchases) and the speculative motive (you think ASSET prices are going to fall, so you sell your assets for cash).

PRICE ELASTICITY

A measure of the responsiveness of DEMAND to a change in PRICE. If demand changes by more than the price has changed, the good is price-elastic. If demand changes by less than the price, it is price-inelastic. Economists also measure the ELASTICITY of demand to changes in the INCOME of consumers.

PRICE MECHANISM

The process by which markets set PRICES.

PRICE REGULATION

When PRICES of, say, a PUBLIC UTILITY are regulated, giving producers an incentive to maximise their profits by reducing their costs as much as possible. Contrast with RATE OF RETURN REGULATION.

PRIVATE EQUITY

When a firm's SHARES are held privately and not traded in the public markets. Private equity includes shares in both mature private companies and, as VENTURE CAPITAL, in newly started businesses. As it is less liquid than publicly traded EQUITY, investors in private equity expect on average to earn a higher EQUITY RISK PREMIUM from it.

PRODUCER SURPLUS

The difference between what a supplier is paid for a good or service and what it cost to SUPPLY. Added to CONSUMER SURPLUS, it provides a measure of the total economic benefit of a sale.

PROFIT MARGIN

A firm's PROFIT expressed as a percentage of its turnover or sales.

PROGRESSIVE TAXATION

TAXATION that takes a larger proportion of a taxpayer's INCOME the higher the income is.

PROTECTIONISM

Opposition to FREE TRADE. Although intended to protect a country's economy from foreign competitors, it usually makes the protected country worse off than if it allowed international trade to proceed without hindrance from trade barriers such as QUOTAS and TARIFFS.

PUBLIC SPENDING

Spending by national and local GOVERNMENT and some government-backed institutions. See FISCAL POLICY, GOLDEN RULE and BUDGET.

QUARTILE

Part of the "ile" family that signposts positions on a scale of numbers (see also PERCENTILE). The top quartile on, say, the distribution of INCOME, is the richest 25% of the POPULATION.

QUOTA

A form of PROTECTIONISM. A country imposes limits on the number of goods that can be imported from another country. For instance, France may limit the number of cars imported from Japan to, say, 20,000 a year. As a result of limiting SUPPLY, the PRICE of the imported good is higher than it would be under FREE TRADE, thus making life easier for domestic producers.

R SQUARED

An indicator of the reliability of a relationship identified by REGRESSION ANALYSIS. An R2 of 0.8 indicates that 80% of the change in one variable is explained by a change in the related variable.

RATE OF RETURN REGULATION

An approach to REGULATION often used for a PUBLIC UTILITY to stop it exploiting MONOPOLY power. A public utility is forbidden to earn above a certain RATE OF RETURN decided by the regulator. In practice, this often encourages the utility to be inefficient, slow to innovate and quick to spend money on such things as big offices and executive jets, to keep down its PROFIT and thus the rate of return. Contrast with PRICE REGULATION.

REAL BALANCE EFFECT

Falling INFLATION and INTEREST rates lead to higher spending

REAL EXCHANGE RATE

An EXCHANGE RATE that has been adjusted to take account of any difference in the rate of INFLATION in the two countries whose currency is being exchanged.

REAL TERMS

A measure of the value of MONEY that removes the effect of INFLATION. Contrast with NOMINAL VALUE.

RECIPROCITY

Doing as you are done by. A grants B certain privileges on the condition that B grants the same privileges to A. Most international economic agreements, for example, on trade, include binding reciprocity requirements.

REDLINING

Not lending to people in certain poor or troubled neighbourhoods – drawn with a red line on a map – simply because they live there, regardless of their CREDIT-worthiness judged by other criteria.

REFLATION

Policies to pump up DEMAND and thus boost the level of economic activity. Monetarists fear that such policies may simply result in higher INFLATION.

REGULATORY ARBITRAGE

Exploiting loopholes in REGULATION, and perhaps making the regulation useless in the process. This is often done by international investors that use DERIVATIVES to find ways around a country's financial regulations.

REGULATORY FAILURE

When REGULATION generates more economic costs than benefits.

REPLACEMENT COST

What it would cost today to replace a FIRM's existing ASSETS.

REPO

An agreement in which one party sells a security to another party and agrees to buy it back on a specified date for a specified PRICE. CENTRAL BANKS deal in short-term repos to provide LIQUIDITY to the FINANCIAL SYSTEM, buying SECURITIES from BANKS with cash on the condition that the banks will repurchase them a few weeks later.

REQUIRED RETURN

The minimum EXPECTED RETURN you require from an INVESTMENT to be willing to go ahead with it.

RESERVE RATIO

The fraction of its deposits that a BANK holds as RESERVES.

RESERVE REQUIREMENTS

Regulations governing the minimum amount of RESERVES that a BANK must hold against deposits.

RESERVES

MONEY in the hand, available to be used to meet planned future payments or if some other need arises. FIRMS may put their reserves in a BANK, as a deposit. For a bank, reserves are those deposits it retains rather than lending them out.

RESTRICTIVE PRACTICE

A general term for anything done by a firm, or FIRMS, to inhibit COMPETITION. Generally against the law.

RETURNS

The rewards for doing business. Returns usually refer to PROFIT and can be measured in various ways

RISK MANAGEMENT

The process of bearing the RISK you want to bear, and minimising your exposure to the risk you do not want. This can be done in several ways: not doing things that carry a particular risk; HEDGING; DIVERSIFICATION; and buying INSURANCE.

RISK NEUTRAL

Someone who is insensitive to RISK. Risk-neutral investors are indifferent between an INVESTMENT with a certain outcome and a risky investment with the same EXPECTED RETURNS but an uncertain outcome. Such people are few and far between.

RISK PREMIUM

The extra RETURN that investors require to hold a risky ASSET instead of a risk-free one; the difference between the EXPECTED RETURNS from a risky INVESTMENT and the risk-free rate.

SDR

Short for special drawing rights. Created in 1967, the SDR is the IMF's own currency. Its value is based on a portfolio of widely used currencies.

SECURITIES

Financial contracts, such as BONDS, SHARES or DERIVATIVES, that grant the owner a stake in an ASSET.

Such securities account for most of what is traded in the FINANCIAL MARKETS.

SEIGNORAGE

Traditionally, the PROFIT rulers made from allowing metals to be turned into coins. Now it refers in a loosely defined way to the power of a country whose notes and coins are held by another country as a RESERVE CURRENCY.

SHAREHOLDER VALUE

Putting shareholders first; the notion that all business activity should aim to maximise the total value of a company's SHARES. Some critics argue that concentrating on shareholder value will be harmful to a company's other STAKEHOLDERS, such as employees, suppliers and customers.

SOCIAL BENEFITS/COSTS

The overall impact of an economic activity on the WELFARE of society. Social benefits/costs are the sum of private benefits/costs arising from the activity and any EXTERNALITIES.

SOCIALISM

The exact meaning of socialism is much debated, but in theory it includes some collective ownership of the means of production and a strong emphasis on equality, of some sort.

SOFT CURRENCY

A currency that is expected to drop in value relative to other currencies.

SOFT DOLLARS

The value of research services that brokerage companies provide "free" to INVESTMENT managers in exchange for the investment managers' business. Economists disagree on whether or not such hidden payments are economically inefficient.

SOFT LOAN

A loan provided at below the market INTEREST RATE. Soft loans are used by international agencies to encourage economic activity in DEVELOPING COUNTRIES and to support non-commercial activities.

SOVEREIGN RISK

The RISK that a GOVERNMENT will default on its DEBT or on a loan guaranteed by it.

STAGFLATION

Term coined in the 1970s for the twin economic problems of STAGNATION and rising INFLATION. Until then, these two economic blights had not appeared simultaneously. Indeed, policymakers believed the message of the PHILLIPS CURVE: that UNEMPLOYMENT and inflation were alternatives.

STAGNATION

A prolonged RECESSION, but not as severe as a DEPRESSION.

STANDARD DEVIATION

A measure of how far a variable moves over time away from its AVERAGE (mean) value.

STANDARD ERROR

A measure of the possible error in a statistical estimate.

STOCKS

Another term for SHARES. What are called ordinary shares in the UK are known as common stock in the United States. It is also another word for inventories of goods held by a firm to meet future DEMAND.

STRESS-TESTING

A process for exploring how a portfolio of ASSETS and/or liabilities would fare in extreme adverse conditions. A useful tool in RISK MANAGEMENT.

SYSTEMATIC RISK

The RISK that remains after DIVERSIFICATION, also known as market risk or undiversifiable risk. It is systematic risk that determines the RETURN earned on a well-diversified portfolio of ASSETS.

TANGIBLE ASSETS

ASSETS you can touch: buildings, machinery, GOLD, works of art, and so on. Contrast with INTANGIBLE ASSETS.

TARIFF

Often used to describe a tax on goods produced abroad imposed by the GOVERNMENT of the country to which they are exported. Many countries have reduced such tariffs as part of the process of freeing up world trade.

TAX ARBITRAGE

Creating FINANCIAL INSTRUMENTS or transactions that allow the parties involved to exploit loopholes in or differences between their tax exposures, so that all involved pay less tax.

TAX BURDEN

Total tax paid in a period as a proportion of total INCOME in that period. It can refer to personal, corporate or national income.

TAX EVASION

Paying less tax than you are legally obliged to. Contrast with TAX AVOIDANCE. There may be a thin line between the two, but as Denis Healey, a former British chancellor, once put it, “The difference between tax avoidance and tax evasion is the thickness of a prison wall.”

TAX HAVEN

A country or designated zone that has low or no taxes, or highly secretive BANKS, and often a warm climate and sandy beaches, which make it attractive to foreigners bent on TAX AVOIDANCE or even TAX EVASION.

TAX INCIDENCE

Where a tax really bites. Who ultimately pays a tax is often different from who the taxman collects the tax from, because the cost of the tax can be passed on. For example, by demanding higher WAGES if INCOME TAX rises, workers can transfer some of the TAX BURDEN to their employer’s customers or shareholders.

TICK

The minimum PRICE change possible in a financial marketplace.

TIGER ECONOMIES

The fast-growing developing economies of Asia, at least before their crisis in the late 1990s.

TRADE-WEIGHTED EXCHANGE RATE

A country's EXCHANGE RATE with the currencies of its trading partners weighted by the amount of trade done by the country in each currency.

TRANSITION ECONOMIES

Former communist economies that, with varying degrees of enthusiasm, have embraced CAPITALISM.

TRANSMISSION MECHANISM

The process by which changes in the MONEY SUPPLY affect the level of total DEMAND in an economy.

VAT

Value Added Tax.

ZERO BASED BUDGETING:

Setting a budget in which all spending must be justified each year, not just amounts in excess of the previous year.