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An Economics Primer

Here are a few basic terms to help you better understand economic reports.

Almost every business publication barrages readers with economic data — changes in the CPI and the GDP, falling dollars and rising oil prices, the Fed funds rate, to name just a few. We asked Leo Kamp, an economist at TIAA-CREF, to help make sense of it all with a brief introduction to some key economic terms and concepts.

You'll come across the term **Gross Domestic Product (GDP)** in discussions about the overall condition of the economy, because it measures the market value of the goods and services that were produced throughout the economy during a particular period. The “**nominal**” **GDP** reflects that value in today's dollars and encompasses both the number of goods and services produced and the overall price movement, as measured by the GDP price index. The “**real**” **GDP** subtracts the inflation component from the nominal GDP to measure the actual growth of the economy — how fast the output of products and services has grown over a particular period. In addition to the GDP price index, economists also measure inflation using the **Consumer Price Index**, which attempts to measure overall price changes for commonly purchased goods and services.

What actually determines the growth of real GDP is the interaction of **aggregate demand**, that is, the total desired spending in unit terms by various entities (households, firms, governments and foreigners) in the economy, and **aggregate supply** — the amount of goods and services that can be produced — both as functions of the overall price level. If aggregate demand exceeds aggregate supply at a particular overall price level, that price level tends to rise (i.e., inflation occurs) so that ultimately supply equals demand.

A number of factors determine aggregate demand for households (i.e., consumer spending), and while inflation-adjusted after-tax income generally has the most direct impact, other factors such as changes in wealth, interest rates and taste also play important roles. With businesses, the profits (cash flows), interest rates, and the current and expected future demand for what they produce drive their spending on capital goods and services, and that, in turn, affects the overall demand for commodities like raw materials and machinery that businesses use in production. For many businesses, spending is affected by foreign demand for our goods, and this demand depends upon the strength of foreign economic activity, as well as the price of our goods and services compared with what is produced abroad. Government demand for goods and services tends to be driven by political rather than economic forces.

Aggregate supply is subject to different forces, especially the amount of labor and capital (e.g., factories) available to produce goods and services (real GDP). Labor productivity, as measured by the ratio of output to hours worked in producing that output, is vitally important in determining how fast aggregate supply can grow over the longer term without straining resources. If the demand for products and services is more than what labor and capital can supply, prices rise because of that pressure, causing inflation. The trend rate of growth of labor productivity (influenced by both technological advances and how much capital is used per labor hour worked), together with the trend rate of growth of the labor force, determine the trend rate of growth of “potential output” (i.e., noninflationary output).

Government fiscal policy primarily influences real GDP and inflation by affecting aggregate demand. If the government wishes to stimulate growth, it can boost aggregate demand directly by increasing public expenditures, or indirectly by affecting the demand or spending of certain economic sectors. For example, government income tax cuts tend to increase spending by households, while changes in the tax depreciation rules can induce firms to invest more in capital equipment and factories.

In addition to fiscal policy, the government also uses monetary policy to influence the economy through the Federal Reserve Board (the Fed), which has the authority to alter short-term U.S. interest rates. If the Fed wishes to slow economic growth to curb inflation, it can raise

short-term interest rates. By making it harder for households to borrow money to finance housing and other expenditures, the Fed diminishes aggregate demand. Higher interest rates would also likely dampen investment demand by firms. Generally, higher interest rates increase the incentive to save rather than spend, thereby lessening aggregate demand. So, by using fiscal and monetary levers, the government can play a key role in influencing aggregate demand and output.

Why does all this matter to people planning for retirement? Mainly because economic factors affect investment returns. Stock and bond prices are both influenced by corporate profits — the difference between revenues and expenditures, both of which are sensitive to economic conditions. Strong demand relative to supply tends to boost prices and sales volume, both potentially favorable to profits, while weak demand generally has the opposite effect. However, persistent higher demand for goods and services tends to drive up wages and the price of raw materials. If wage gains are not offset by increased productivity, the cost of labor per unit of production increases, thereby crimping profit margins (assuming the wage increases are not passed through in higher prices). So, both on the revenue and cost sides, macroeconomic conditions affect profits.

Macroeconomic conditions also affect interest rates. When the economy is strong, interest rates tend to rise as the demand for money (e.g., loans) increases and as the Federal Reserve raises short-term rates to ward off inflation. Interest rate movements are critical to many investment decisions. For example, rising mortgage rates usually adversely affect demand for real estate. And rising interest rates generally reduce prices on existing bonds and may put downward pressure on stock prices as well, although variable rate investments like money market funds tend to increase in nominal returns. Of course, rising rates often reflect expected increases, which erode the purchasing power of fixed incomes over time.

It may be tempting to change your investment strategy as economic trends shift. But because there are so many economic factors to consider, making major bets can produce haphazard results. Rather, develop an asset allocation strategy that's designed to provide you

with the retirement income you need while balancing the risks and opportunities of a changing economy.

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