

Chris Farrell's

SOUND MONEY® GUIDE TO ECONOMIC LITERACY

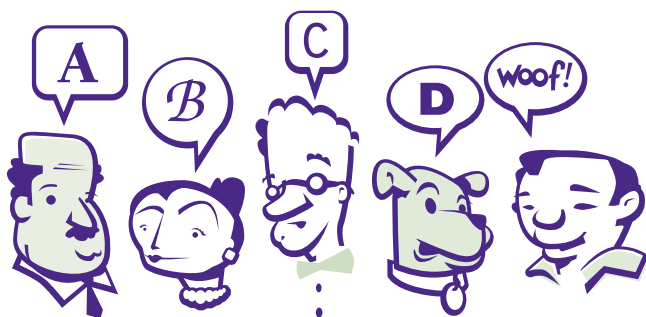


*There are few, if any,
useful ideas in economics
that cannot be expressed
in clear English.*

John Kenneth Galbraith

THE CASE FOR ECONOMIC LITERACY

Why learn economics? After all, for many people economics is synonymous with dull. The discipline's jargon-laden language confuses more people than it enlightens. Many economists are surprisingly disdainful of engaging noneconomists in any kind of general discussion, further widening an already yawning gap between the profession and the general populace. And who hasn't heard a disparaging quip about economics, such as "Ask five economists, and you'll get five different answers," or "An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen."?



That's too bad, for the economy touches everything we do. The British economist Alfred Marshall described economics as "the study of mankind in the ordinary business of life." We are all amateur economists at work or at the neighborhood barbecue, talking about jobs, paying off credit card debt, and puzzling over the stock market's latest move.

Even young people find the economics of everyday life fascinating. A while back, I made a few brief remarks on several economic and personal finance topics before

a junior high school class in Pine City, Minnesota. When asked for questions, they came one right after the other. Should I work to pay for college or take out loans? Why should I save for retirement? What is a mutual fund? During the give-and-take, it became apparent that many had learned about retirement savings plans through their part-time jobs.

Economics grapples with many of the social and pocketbook issues that affect us as workers, consumers,

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savers, investors, and voters. For instance, why are cable television fees surging higher while the price of using cellular phones is plummeting? How should I go about deciding the right mix of stocks, bonds, and cash for my retirement savings?

Economics also struggles with some of society's knottiest issues—questions that go to the very soul of a nation. Where does growth come from? Does trade with other countries do more good than harm? Why do perfectly good employees get tossed out of their jobs? What can be done to improve living standards? Little wonder economics has become the modern language of ethical and political discourse.

Economics is a genuinely diverse topic. This booklet aims to make the case that knowing the basics of how the economy works is not only useful for managing our everyday affairs, but also intellectually stimulating in its own right. If you are enticed to learn more, check out the list of recommended books and web sites toward the end of the booklet.

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THE GLOBAL ECONOMY AND YOU

From the assembly line worker to the multimedia web designer to the English major entering college, a basic grasp of economic concepts seems to matter more than before. The late Joseph Schumpeter, one of the 20th century's intellectual giants, came up with the evocative metaphor of "creative destruction" for the process by which new technologies, new markets, and new organizations supplant the old. Creative destruction is an inescapable, essential part of capitalism. Typically, the rise and fall of corporate fortunes, the ebb and flow of job prospects, and the increments and improvements in technology are a constant backdrop to everyday life.

Every once in a great while, the economy is transformed at an unusually rapid pace. Like now. Technological

innovation and global commerce, two of the most powerful economic forces defining the turn of the millennium, have unleashed unprecedented levels of market competition.

Markets, which bring together producers, consumers, competitors, labor, and capital, are increasingly powerful at home and abroad. For much of the 20th century, communist countries tried to replace the market with a state-run command-and-control system. The state dominated the economy in many non-communist countries, too, especially among the developing nations of Latin America and Asia. Yet with the collapse of communism and the embrace of freer markets by much of the developing world, most countries are shifting toward a market-oriented system. The policy debate is no longer the state versus the market, but the far more intriguing question of the proper boundaries between government and markets, says David S. Dahl, economist at the Federal Reserve Bank of Minneapolis.

In this highly competitive, tumultuous era, the traditional paternalism of society's major institutions, from business to government to education, is crumbling. Employers now insist that their workers take more responsibility for their retirement arrangements and funding. Colleges count on parents and their children to come up with more tuition dollars on their own. Individuals are increasingly expected to prepare themselves for rapid change and bear much of the risk from the upheavals in our economy. The case for economic literacy among students and citizens is compelling to the extent that it helps people better understand and navigate their world.

WHAT IS ECONOMIC LITERACY?

Certainly, economic literacy does not mean an ability to construct mathematical models or to calculate investment multipliers. Let's leave that to the professionals. Nor does economic literacy mean adherence to a particular ideology or political party. Economics is a very big tent that has no trouble including small business owners, unionists, conservatives, liberals, democrats, republicans, or any of the other major divisions in our society.

A half century ago, the economic journalist Henry Hazlitt reduced economics to one sentence: "The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for

one group but for all groups.” More recently, the National Council on Economic Education has developed 20 standards for the U.S. Department of Education that taken altogether define the discipline’s scope. The standards range from defining the role of market prices to explaining the dynamic force of entrepreneurship. For example, standard No. 15 reads, “Investment in factories, machinery, new technology and in the health, education, and training of people can raise future standards of living.”



THERE IS NO FREE LUNCH

You’ve heard such phrases as “You can’t have it all,” or “There is no free lunch.” The essence of economics is trade-offs. Indeed, some people call economics the science of choice. Paul Romer, economist at Stanford University, views the fundamental task of teaching economics as helping students “to set aside their immediate emotional reactions and to reason carefully about the question at hand.” Learning how to think through choices logically is extremely useful.

For example, whenever there is a tragic accident at a railroad crossing, someone will suggest that the imperative of saving lives demands getting rid of all the railroad crossings. Instead, cars should travel under or over a railroad. It sounds reasonable. It may be worth the money in some parts of the

country. But a wholesale re-routing and re-building around the country costs a bundle, and eventually you'll get to the point where the money might be better used elsewhere. The same is true for other "tragic choices," such as keeping airplane prices reasonable while preventing vicious acts of terrorism. Similar questions come up all the time.

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Researchers have learned that an expensive CT scan can detect lung cancer at an early stage. Should everyone now get screened? The procedure could be very cost-effective if it truly extends lives. Then again, the test's steep cost and potential burden on the health care system could be too great if the benefit turns out to be limited.

THE KEY CONCEPTS

Three basic, related concepts emerge from the trade-off theme in economics. The first is that resources are scarce (remember, you can't have it all). That's certainly true for any household—even for Microsoft billionaire Bill Gates. When we go on a budget and start salting away some of our income, we can no longer afford take-out food several times a week. If we finally splurge and buy the car or CD player we've always wanted, other purchases will be delayed, such as new furniture or a home computer. The same dynamic is at work throughout society. Our desires are nearly limitless but there aren't unlimited funds, goods, and services available to satiate those needs.

The second idea stems from the notion that resources are scarce. Whenever you make a decision to do something, you foreclose other options. Economists call the value of the goods and services you sacrificed in undertaking any activity an "opportunity cost." It's a measure (albeit a very imprecise one) of what we have given up, and it helps us better understand the return we expect from our choices.

The late Robert Eisner, an economist at Northwestern University, somewhat tongue-in-cheek illustrated the notion of opportunity cost this way. The cost of buying and reading his book—*The Misunderstood Economy*—was not only the dollars spent on it but also the value of the time spent reading it and the alternative use of that

time. In other words, his book should only be read if you believe your return, both in enlightenment and enjoyment, exceeds its opportunity cost, that is, money spent on the book and the time required to read it.

The same dynamic is at work when a student not only pays for four years of college but also doesn't earn a steady income during those years. Again, she must believe the monetary reward and intangible benefits exceed the opportunity cost.

Perhaps these famous lines from American poet Robert Frost capture the idea best:

**Two roads diverged in a wood, and I—
I took the one less traveled by,
And that has made all the difference.**

The third concept is that the more efficiently we use our resources, the more needs and wants can be met. Resources are allocated by prices set by the interaction between supply and demand. This is why economists are so fond of talking about efficiency. And it is here that there is a great deal of agreement among economists, despite the popular sense that they can't agree on anything

Let's say a carmaker builds both mid-sized cars and sport utility vehicles. Yet it turns out that customers are indifferent to the cars, and the only way dealers can get them off the lot is by offering customers a deal well below the published invoice. However, buyers are willing to pay the dealer more than the full sticker price to get their hands on the sport utility vehicles. That's a clear price signal to the automobile manufacturer to make fewer mid-sized cars and more SUVs. Indeed, sales of SUVs, minivans, and pickup trucks have soared over the past decade.

POPULAR ECONOMICS

Whether it's acquired by listening to the radio, watching television, reading a newspaper or a magazine, economic literacy is also synonymous with people having a reasonable understanding of the money, business, and economic stories being discussed. "Economic literacy," says Alice Rivlin, the former vice-chair of the Federal Reserve Board, "means a rudimentary working knowledge of the concepts and language of economic activity and economic policy." This kind of economic literacy can improve the quality of

public discussion about economic policies, such as Social Security, the minimum wage, and environmental regulation.

Stadium Economics

Consider sports stadiums. Sports facilities are very controversial these days since much of the funding comes from taxpayers, even though most of the profit goes to the teams' owners and players. Promoters typically laud the economic benefits of stadiums. Stadiums, they say, create construction jobs, expand local employment, attract tourists, and lure new companies to the area. Consequently, a new stadium generates economic activity throughout the region.

Many economists are dubious. They point to the trade-offs. For example, much of the spending that goes on inside a stadium may be a substitute for spending on other forms of entertainment, such as movies or restaurants. Depending on how you do the calculations, the public's return on investment in a new stadium is minor to none.



Yet professional sports are popular and glamorous. The media reports heavily on local football, baseball, and hockey teams, and many residents identify closely with their professional teams. The real question may be how much that intangible is worth to local taxpayers.

Trade Economics

Here's another example where a rudimentary knowledge of economics pays. The evening newscast reports that America has reached a record trade deficit with the rest

of the world—a fairly common occurrence over the past two decades. What does it mean when Americans are buying more steel, shoes, toys, power drills, and the like from overseas companies than consumers and businesses abroad are willing to buy from American firms?

A trade deficit is usually presented as troubling news. Yet all trade deficits are not created equal. Why worry if U.S. companies are importing goods that will increase the productivity and efficiency of their factories and offices? The investment could more than pay for itself. Is there a trade deficit because the U.S. economy is strong even as growth falters elsewhere in the world? That was the case in 1998 following the collapse of the Asian economies, and U.S. buying staved off a global depression. Or is there a trade deficit because consumer spending is spiraling out of control while U.S. companies are producing goods and services no one wants? What's more, the trade deficit figure itself is suspect. For example, the value of many high-tech goods, including software and E-commerce, is often underestimated.

Still, the most important issue is the policy implications of a trade deficit. Many people reflexively argue for putting up trade barriers to low-cost competitors from Japan, South Korea, Brazil, and elsewhere. After all, over the past quarter century, foreign rivals battered the U.S. steel, auto,



and machine tool industries. A lot of workers have lost their jobs, and many industries are up in arms against “unfair” foreign competitors. Yet U.S. companies that export have created millions of jobs, as have the U.S. branches of foreign companies.

Trade both creates and destroys jobs. Yet most economists are ardent supporters of open borders and oppose trade barriers. The reason? Efficiency. “If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry,” the Scottish political economist Adam Smith wrote more than 200 year ago. Trade is not a zero-sum game. Trade both increases and improves the trade-offs facing society. At the same time, it’s good policy to look for ways to enable more people to share in the gains and to alleviate the pain.

Economics can also shed light on some remarkable trends. Do you ever wonder why celebrities earn such astronomical sums or why talent today reaps so much more than talent only a quarter of a century ago?

The Economics of Superstars

Economics can also shed light on some remarkable trends. Do you ever wonder why celebrities reap so much more than talent only a quarter of a century ago? One answer might be that the powerful impact of information technologies operating in the global economy has vastly multiplied the rewards to talent, reputation, and luck.

We have always preferred to listen to the best singers and watch the best movie heroes. Similarly, in the high-stakes business world, every board of directors wants to come up with the fiercest, smartest, and best-regarded chief executive it can find. Indicted for murder? Hire the best lawyer. What’s different today is that markets keep getting bigger, thanks to the global economy and the communications revolution. Whoever gains star status in a highly competitive business—whether through skill or luck—has the leverage to get a disproportionate share of the rewards. Film star Arnold Schwarzenegger’s action films do well in both the U.S. entertainment market and in the international market. Luciano Pavarotti reaches millions through the global technologies of radio, records, television, and satellite hookups.

THE ECONOMICS OF EVERYDAY LIFE

A reasoned grasp of trade-offs can improve the quality of our financial lives—especially when it comes to money. That's no small achievement at a time when personal bankruptcies are at record highs, consumer credit burdens are strapping many family finances, and more people are expected to take financial responsibility for their retirement.

These days, it's almost impossible to get away from the markets. Like civic associations at the turn of the century and homeownership following the Second World

Like civic associations at the turn of the century and homeownership following the Second World War, investing now has all the characteristics of a powerful mass social movement.

War, investing now has all the characteristics of a powerful mass social movement. Millions of people are flocking to Wall Street to save for their retirement, for their children's college education, and for a financial safety net against a corporate

restructuring. More than half of American families own equities and draw a paycheck.

Here are two examples where economic theory meets the real world.

Investing For Retirement

A knowledge of economics can help you save that nest egg. Despite the hours people spend picking mutual funds and worry over the market's every twist, economic research suggests that asset allocation—how you divide your money among stocks, bonds, cash, and other assets—will be the main determinant of your portfolio's long-term performance.

The essence of asset allocation is the inevitable trade-off between risk and return. The more risk you are willing to take, the greater your chance for higher returns—or disappointment. For instance, the stock market has returned nearly 7.5% annually, after adjusting for inflation since 1946. But on the way to earning that return its value has sharply fluctuated. Remember the crash of 1987? Long-term Treasury bonds, by contrast, returned 1.1% over the same time period, but reflecting their lower level of risk, their volatility was about half of

stocks. And T-bills returned 0.5% annually since 1946, with only minor annual fluctuations.

The trick is to mix asset “classes” such as these to get the highest potential return for the amount of risk you’re willing to accept. As Don Quixote de la Mancha said: “Tis the part of a wise man to keep himself today for tomorrow, and not venture all his eggs in one basket.”

However, asset allocation or diversification is a far more powerful and subtle idea than simply creating a margin of safety. We know from our everyday experience of going to work, and from reading the newspaper that we face many more risks than volatility in the markets. Diversification is a technique that allows you to reason through the risks you confront, to embrace the risks you are willing to accept, and to insure against the risks you’d prefer to minimize.

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A College Diploma

A college education is expensive. The total cost of four years at the average public college, including both educational expenses and foregone earnings, is nearly \$90,000, according to Thomas Kane, economist at Harvard University. That’s enough to buy a nice house in most parts of the country.

Again, there is a trade-off. You could be earning money instead of spending a substantial sum to attend college. Or you could save your money and buy a home.

Still, in today’s fast-paced high-tech economy, parents and their children increasingly see a college degree as a passport to long-term material success. With good reason. Like any market, be it oil or cars, wages are sensitive to the ebb and flow of supply and demand. For more than two decades, those with a college education or technical skills have been well-paid while everyone else stagnated. In 1997, male and female college alumni earned a wage premium of 44% and 51% compared to their peers with only a high school degree. In 1979, the wage differential



was 27% and 31%, respectively. Young people are heeding the market's message by attending college in record numbers.

Of course, the risk and reward trade-off could change with time. For instance, in the 1970s the returns to a college education dropped sharply when well-educated baby boomers flooded the market. That was a period when Ph.D.s drove cabs. But most economists expect the demand for well-educated, skilled labor will remain robust for years to come.

YES, IT'S THE ECONOMY

It's the economy that matters in today's world. When the economies of developing Asia and Russia slipped in 1998, the upheaval affected everything from the value of retirement funds to the price of gasoline at the pump.

The Internet is reshaping business

and the economy at an astonishing, indeed revolutionary, rate. The powerful combination of technological innovation and the global economy are behind America's resurgent productivity, the fundamental building block for higher living standards. Productivity is the measure of the economy's output of goods and services per hour of work. Productivity has been growing at a 2% pace since 1995—more than double the rate of the 1970s and 1980s. And it's strong productivity growth that allows business to hike wages while keeping a tight lid on prices.

Yet the same forces that account for improved productivity are also behind widening income inequality. High-tech gear especially transformed the workplace by taking over many routine, low-skill chores and leaving employees with the more complicated, high-skill tasks. Those with an education and skills have done relatively well while the less educated have lagged far behind in the income sweepstakes.

We are living during an epoch-making period, one that seems to rival the Industrial Revolution, the Age of the Dynamo, the Era of Mass Production, and the Nuclear Age. Now is a wonderful time for gaining a greater facility with the fundamentals of economics. Fortunately, when it comes to economics Americans are more literate than before. The reason is experience. Life is a good teacher.

For instance, we've certainly learned a lot about inflation. For several decades, the specter of inflation haunted America. Remember the energy crisis, soaring food bills, mortgage rates in the high teens, Gerald Ford's "Whip-Inflation-Now" buttons? In the 1970s, inflation rose in the 5% to 10% per year range, a terrible period of a sustained rise in the general price level.

Over the past two decades, an arsenal of domestic and global forces was unleashed against inflation, from the money policies of the Fed to brutal domestic and international competition. Inflation is now at its lowest level in three decades, and price stability may well be within reach.

But life is also a harsh instructor. Learning more about economics beforehand may not stop us from doing something financially foolish or voting for a well-intentioned program that will backfire. But a better stock of economic knowledge should improve our capacity for thinking through our choices and our ability to exercise critical judgment when it comes to policy.

Let's give the last words to John Maynard Keynes. In one of the most famous passages in economics, Keynes eloquently called for greater economic literacy:

"The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling in their frenzy from some academic scribbler of a few years back. I am sure the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas... But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil."

RESOURCES FOR FURTHER RESEARCH

Books

The Armchair Economist: Economics & Everyday Life by Steven E. Landsburg (The Free Press). This clever, well-written book is a terrific introduction to economic concepts and reasoning.

Hidden Order: The Economics of Everyday Life by David Friedman (HarperBusiness). Friedman likes Star Trek. He also knows some good jokes. An accessible introduction to the economist's toolkit.

From Here to Economy: A Short Cut to Economic Literacy by Todd Buchholz (Plume). The title says it all—and he succeeds in the task he set for himself.

Economics in One Lesson by Henry Hazlitt (Fox & Wilkes). A conservative manifesto penned fifty years ago and recently reissued. This is a passionate argument against the economic house built by John Maynard Keynes. Hazlitt makes you think.

Essays in Persuasion by John Maynard Keynes (Norton). The great economist of the 20th century was a master essayist. Especially intriguing is his 1930 essay, "Economic Possibilities for Our Grandchildren."

Economics by Joseph Stiglitz (R.S. Means Company). Textbooks are intimidating. There is also a great deal of overlap among most of the large economic textbooks. This one, by a former chairman of the White House Council of Economic Advisors and the current chief economist at the World Bank, is especially good at coming up with examples to illuminate economic questions.

Economic Report of the President, by the Council of Economic Advisors. This annual report written by some of the nation's best economists is a gold-mine of analysis and information. This is the place to begin if you want a well-written summary of what economists know about trends in inequality, productivity, inflation, regulations, growth, and so on.

Sports, Jobs, and Taxes: Are New Stadiums Worth the Cost? by Roger Noll and Andrew Zimbalist, Brookings Institution,

The Brookings Review, Summer 1997 Vol. 15 No. 3 Pages 35-39. A nice example of economic reasoning dealing with a public policy issue.

"Risk and Return" a commencement address at Albertson College by Paul Romer. A very accessible discussion of the trade-off between risk and return by one of the profession's leading lights.

Tragic Choices by Guido Calabresi & Philip Bobbitt (W.W. Norton) A nice discussion of the trade-offs we face when trying to create a safer world.

A Random Walk Down Wall Street (6th Edition) by Burton Malkiel. Well-written. Good history. Memorable anecdotes. Malkiel has done a superb job translating into common language an enormous body of academic and historic research into investing. A bit heavy for some people, though.

Against the Gods by Peter Bernstein. An engrossing history of risk, gambling, probability, and financial markets. "What is it that distinguishes the thousands of years of history from what we think are modern times? The answer goes way beyond the progress of science, technology, capitalism, and democracy....The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk: the notion that the future is more than the whim of the gods and that men and women are not passive before nature."

Web Sites

www.minneapolisfed.org. I frequently find myself using the Federal Reserve Bank of Minneapolis for economic research and commentary. It is also my link to the Federal Reserve Board and the eleven other Federal Reserve banks around the country. All of the Fed web sites are worth visiting. The Fed system as a whole is a rich source to mine for economic information, data, analysis, and research. Two issues of *The Region*, it's quarterly publication, are especially useful. "You Can't Always Get What You Want" (December, 1998) is a special issue devoted to the topic of economic literacy. The June 1999 issue includes a "A Report on the Economic Literacy Symposium."

www.dismal.com. Need some economic statistics? Want to know what economists think about the trade deficit or the government's budget surplus projections? It's easy to spend an hour or two at this web site created by Regional Financial Associates, an economic consulting firm. I click on it at least several times a week.

www.economics.about.com. A basic introduction to the dismal science run by John Irons, a Ph.D. candidate at the MIT Department of Economics.

www.econ161.berkeley.edu. I love economic and financial history. Brad De Long, professor of economics at the University of California, Berkeley, takes a long-term perspective in his economics. Check out the draft chapters from his 20th century history book, *Slouching Towards Utopia*.

www.census.gov. The Census Bureau is a treasure trove of economic and social data. A link to other government web sites.

www.dol.gov. At the web page of the Department of Labor you can click on minimum wage, pensions and divorce, labor-related data, and other areas of interest.

www.bea.doc.gov. The Bureau of Economic Analysis. This is more for people who love data and statistics.

www.whitehouse.gov. The White House web site is a good home to begin your search for statistical information and data throughout the U.S. government.

www.rich.frb.org/econed/frbeconed.html. A link to all the education pages at the Federal Reserve Banks, courtesy of the Richmond Fed.

www.ms.com. Get the latest reading on the global economy from Morgan Stanley Dean Witter. It can be heavy going, but every day the investment bank's economists churn out thoughtful commentary on economies and economic trends around the world. We do live in a global economy.

www.yardeni.com. Edward Yardeni is the chief economist of Deutsche Morgan Grenfell. Who says economists are boring? Yardeni isn't. He's always bold and a good read. Among Wall

Street economists he has done an especially stellar job grappling with the economic implications of the end of the Cold War and the spread of information technologies.

www.soundmoney.org. *Sound Money*, a nationally syndicated public radio personal finance call-in show, keeps up on the latest economics and financial trends.

www.rightonthemoney.org. *Right on the Money*, a public television series on personal finance, takes an economic approach to personal finance.

Four publications take economics extremely seriously.

Business Week (www.businessweek.com);

The Wall Street Journal (www.wsj.com);

The New York Times (www.nytimes.com); and the

Economist (www.economist.com).

www.nationalcouncil.org. The National Council on Economic Education. In addition to coming up with the 20 standards for teaching economics and much of the supporting material, the NCEE is a clearing house of information for anyone interested in advancing economic literacy in their state or school.



Chris Farrell is chief economics correspondent at Minnesota Public Radio. He can be heard on *Sound Money*, where he tackles a different economic or investment topic in his commentary each week and takes calls from listeners. Farrell is also a contributing economics editor at *Business Week* magazine and host of *Right on the Money*, a public television personal finance show.



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Sound Money is public radio's only call-in program on personal finance. Whether you're living paycheck to paycheck or living on your investment income, *Sound Money* has information you can use to make your life more comfortable.

For more information on *Sound Money*, the economic literacy summit, and on downloading an online copy of this booklet go to www.soundmoney.org.

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