Chapter 1

Introduction to the Economics of Context

Economic thinking, whether we recognize it or not, is an essential part of household, business, government, and Federal Reserve decision making. But how do we use economic information to make intelligent decisions so we can make our lives or businesses better? The answer is not complex, but it does require a certain logic that is too often missing in most economics books.

When it comes to using economics to help make decisions, what matters most is context. While economists like to argue that theory is the truth, theory only gets you so far. Economics and economic policies don’t operate independent of the way people think and react. Economics is all about taking human reactions and creating a way to understand how those decisions are made. Those reactions will differ under a variety of economic circumstances. Thus, you need to know where you have been and where you are so you make a correct decision about how you can go forward.
If real people or real businesspeople want to manage their lives or their companies in a way that actually takes into account the economic factors in which they are operating, they need to know why the growth, decline, or stagnation they are experiencing is occurring. That is because we haven’t repealed the business cycle.

It is all about where you are in the business cycles and how outside factors, such as the world economic activity as well as human perceptions, combine to create the economy we must deal with. And, most important, it needs to be recognized that conditions change and any business decision must be made in the context that what currently exists may not be the case going forward.

We will look at examples from two different industries—trucking and hospitality—to see what context means in the real world.

**Adapting to the Economy—View from the Cab of a Truck**

In the trucking business, the difference between a down time in the economy and a buoyant economy can be felt in the pocketbook.

During dry times, truckers sit around waiting for loads to haul. Competition for the few available loads is fierce. To save money, truckers put off buying new equipment.

But when the good times are rolling, truckers rock. They can pick and choose where they want to go and when they want to go there. They can buy vital fuel-efficient equipment that can save them money in the long run or just make the rig look good. Trucker Scott Grenerth, who has been driving since 2002, has seen it all. Here’s how the business cycle matters to him.

When Grenerth pilots his powerful tractor-trailer down the highway, he sees more than the road ahead—he sees the economy. He has that unique view because most of the time he’s moving large coils of steel that are used to make vehicles.

In a typical day, Grenerth, who owns and operates his own rig, picks up a coil of steel at a mill in a place such as Burns Harbor, Indiana, and then drives it 463 miles to a steel service center in La Vergne, Tennessee, near where a Nissan plant turns out vehicles.
As he makes his run, he gets a rough idea of what’s going on—or not going on—at the auto plants by looking at the lots where they store cars until they get an order from a dealer to ship them.

Is the lot full? Is it empty?

On a day when the lake-effect snow was slowing traffic as he arrived at a steel plant to pick up a load, he talked on his bluetooth phone about his experience when the economy was at its lowest point in the recession.

“Anytime I drove past any of the auto plants, whether Detroit-based companies or Japanese-based, or the BMW plant down in South Carolina, any of the plants—and I see them pretty good from the cab of the truck—you could tell the number of vehicles sitting in their lots ready to ship out,” he recalls. “I mean I am going 65 miles per hour, and you can see there are 20 of them sitting there. You can easily estimate it and that is not normal.”

And, of course, Grenerth could also tell how bad the economy was by what was happening to him. After delivering a load, he would pull into a truck stop and sit there with other truck drivers waiting for a dispatcher to offer him an assignment.

“If I arrived first thing in the morning, I would not get a load to pick up until the next day,” he says. “So I would miss an entire day’s work to make some income.”

**Bottom of the Recession**

He remembers what turned it around for him: the Cash for Clunkers program started in 2009 by President Obama. The federal government, in an effort to stimulate the economy and help the auto industry, gave individuals cash to trade in gas guzzlers for new cars. The plan, which cost Uncle Sam over $2.8 billion, resulted in about 700,000 trade-ins, according to the Department of Transportation, which managed the program.¹

In addition, under the American Recovery and Reinvestment Act (ARRA) of 2009, the Obama administration gave extra tax breaks for small business.²

According to the IRS, the ARRA allowed small businesses the option to expense up to $250,000 of the cost of certain equipment and
property. And the IRS, on its web site, said many small businesses that had expenses exceeding their income for 2008 could carry back their losses for up to five years instead of the normal two years.³

However, Grenerth says that he did not get any help from any of the government programs. “My truck was already paid off by then,” says Grenerth. “To the best of my knowledge, there was nothing substantial in the way of government programs that I used.”

From the Bush Economic Stimulus Act of 2008, Grenerth and his wife did get a rebate check, which would have been about $1,200. “I have no clue what happened to that money,” says Grenerth. “It went in the checking account and got spent.”

As Detroit recovered, Grenerth’s business started to improve as well. In fact, by January 2013, the economy had improved so much that his dispatcher at Fikes Truck Line, Inc. in Hope, Arkansas, which leases his rig, was offering him loads 24 hours in advance.

What the Business Cycle Meant to the Business

But there is also no question that the downcast economy affected his business and his life. For a trucker, one of the major factors in whether they make any money is how much they spend on fuel. Fuel is critical since they put so many miles on their trucks: Grenerth estimates he logs 120,000 miles a year. In early 2013, his 2002 International 9200 had over 1,120,000 miles on the odometer. So his big white truck has burned a lot of diesel.

One way to cut down on fuel consumption is to install what are called “low rolling resistance” tires. He describes the tires as made of compounds that lower the rolling resistance of the tire. “It takes less effort to get down the road,” says the trucker.

Grenerth had wanted to switch to the tires before the recession, but they were an expensive purchase. Once things slowed down, so did the idea of getting the new tires.

“When you are not making as much profit as you were before, you are more likely to say, ‘Put that on the backburner,’’” he says. And, indeed, they went on the backburner until 2012.

At the same time, as things slowed down, Grenerth became a lot less picky about his jobs. For example, when times are good, he’ll ask
his dispatcher to try to find a load at the end of the week that will get him relatively close to his home in Arlington, Ohio, which is about an hour south of Toledo. But as he waited for work, he told the dispatcher, “I’ll take whatever and wherever you’ve got. I need to go where loads are available.”

Like a lot of truckers, the 44-year-old Grenerth gets to experience the ups and downs of the economy firsthand—in fact almost before most people because he hauls semiprocessed material that is used to make other things.

The closest to the economic action are the truckers who move goods to retailers, says Grenerth. When consumers pull back, merchants stop ordering. Goods back up at the warehouse. “People who are hauling goods to the retailers are feeling it pretty close to the economy when it slows down,” he says.

But, eventually, the company buying the goods stops ordering as well. And that’s when Grenerth feels it. “I know if it slows down for me, it’s eventually going to slow down for everybody else,” he says.

Of course, Grenerth was correct.

During the recession, at the same time Grenerth was waiting at truck stops for work, the restaurant business was struggling to fill tables, which leads us to the next example.

**The Service Sector—The Enchilada Stops Here**

The restaurant industry is particularly tied to the business cycle and consumer confidence. When times are good, Americans go out to eat. And, for the most part, times have been good and the restaurant industry has grown.

According to the National Restaurant Association, industry sales in current dollars have increased from $239 billion in 1990 to a projected $660.5 billion in 2013, an increase of 176 percent. The Restaurant Association says the industry share of the food dollar has grown from 25 percent in 1955 to an estimated 47 percent in 2013.

However, there have been some minor downturns in sales during economic sniffles in 1974, 1980, and 1991. By far the worst fall-off in
dining out was in 2008 and 2009 when the economy caught a really bad cold. According to Restaurant Association data, inflation-adjusted sales fell 1.2 percent in 2008 and 2.9 percent in 2009.6

Although sales dropped, many consumers just scaled back where they ate, says Mary Tabacchi, an associate professor of food and beverage management at the Cornell School of Hotel Administration.

“If they were eating at a better restaurant, they might have just scaled down to T.G.I. Friday’s,” says Ms. Tabacchi. “If they had been eating at T.G.I. Friday’s they might have scaled down to something cheaper. The consumer does not stop going to restaurants.”

The belt tightening in the most recent recession caught Posados Restaurants, based in Tyler, Texas, by surprise. Here’s how the changing economy affected this growing regional chain and what they did to adapt to the shifting context around them.

Texans love their spicy beef and bean chimichangas, burritos stuffed with ground beef, diced tomatoes, and shredded lettuce, and fried chalupas, which are crispy on the outside and filled with chicken and beans on the inside. More cheese on everything, thank you.

Restaurant entrepreneur Andy Gugar understood this craze for spicy food, and in 1987 he decided to build a full-service Tex-Mex restaurant in Tyler, Texas, in the eastern part of the Lone Star State.

With only $50,000 in his pocket, he opened up Mercados. For his first two years he and his wife worked 20 hours a day building up the restaurant customer by customer. He started expanding the full-service casual-dining concept into a chain called Posados.

At first it seemed too easy.

“There have been years like 2004 to 2006 when all you had to do was show up to make money,” recalls Scott Nordon, the chief operating officer, who started working for Posados in 2001.

“It gave you a false sense of security. We’d say, ‘Let’s put up more stores, expand the overhead.’”

Expansion was relatively easy. GE Capital was providing loans at what seemed like a good rate to the company. With sales growing and money available, expansion seemed to make sense.

Posados grew from East Texas to Dallas and into Louisiana. By 2007, right before the recession, there were 14 Posados. For the managers, it seemed like the good times would not end.
Before the recession, on a Saturday night—the busiest night of the week—Nordon says there could be a 30- to 45-minute wait for a table. The average location could ring up about $12,000 to $14,000 in sales.

Helping to drive sales is the upbeat mood in the restaurant. Background music helps give the restaurants a festive feeling. The beat of the music picks up through the day until by dinner the restaurant is throbbing with hip Latin music.

“The goal is that we want people to think they are on vacation in Mexico,” says Nordon.

The Cash Register Stops Singing

But, on the down cycles of the economy, things are different. In 2009, the operative word for Nordon was “slower.” Customers coming into the restaurants did not have to wait for tables. The buzz that comes from a full restaurant was missing. Instead of growing at a normal 2 percent to 3 percent per year, sales plunged 8 percent to 10 percent.

“It was shocking. It was a real eye-opener,” says Nordon. He recalls the management at Posados having to spend extra time doing morale building for the staff.

“We kept telling them this is a temporary thing, we’re going to come out of this even stronger on the other side,” he says.

The downturn forced the Tex-Mex restaurant to look deeply at its own business practices.

“We had to ask ourselves what can we do without and what do we really need,” says Nordon.

There were layoffs. The company decided to outsource purchasing, information technology (IT), and human resources. The goal was to cut corporate overhead but not diminish the dining experience by reducing wait staff or cutting back on the quality of the food.

“We did not want to sacrifice the guest experience,” recalls Nordon.

Managers were told to let customers know how much they appreciated their business.

“When those guests come in, wrap your arms around them, thank them for coming in,” Nordon told his managers. “You have to make
sure they are getting the best possible product, the best food and service because there are so many dining options out there.”

The economic downturn also forced Posados to go after customers it would have turned down when times were good.

“I know there were catering orders where the customer would say we only have $5 or $6 per person to spend on the event,” he says. “Before, we would have shied away from it, but now we were saying, ‘Someone is taking that money—why not let it be us?’”

During the downturn, Posados found that customers became very price conscious. Instead of ordering two margaritas, they only ordered one. They looked for specials. Nordon refers to it as “managing the bill.”

Observing this, the restaurant decided to use it to their advantage. It offered a promotion every day of the week of $6.99 for any two items such as one taco and one enchilada, or one chimichanga and one burrito. Rice and beans were included. Nordon bought advertising on television and ran banners in the restaurants to let potential customers know what they were doing.

“Our customers went crazy,” he recalls. “People who had been coming in maybe once a month or once every 21 days started coming in once a week,” he says.

Posados became more creative. With the purchase of an adult entrée, they offered customers a “kids eat free on Mondays and Tuesdays” promotion.

“When we tried to take it away, the customers became real vocal about it, so we said why not go ahead and leave it in place,” says Nordon.

While Posados was adapting to the changing economic landscape, U.S. government efforts to stimulate the economy had a very limited effect on Posados. After some people received rebate recovery credit in 2009, Nordon says they saw a spurt of new business for a few weeks. “Customers were actually talking about it—‘hey, I got a stimulus payment and I’m coming out to eat.’ That lasted about two or three weeks.”

As a small business, Posados got no help from Uncle Sam. “We just had to suck it up,” he recalls. One of the lessons of the downturn, Nordon says, is not to get too excited about the good times.
Celebrate for 15 Minutes

“What we’ve learned is to celebrate the good times but not for too long,” he says. “We tell the managers when they have a good month, it’s their 15 minutes of fame and then go focus on next month.”

The downturn also made the company look more closely at its own expansion. It became much more conservative in its approach, which may also say something about why the post-recession economic expansion in the nation has been so slow.

Any new Posados are more modest in size—6,000 square feet instead of 12,000 square feet—a typical size for a prerecession location.

The new restaurants are also paid for with cash flow instead of bank borrowing. In fact, in 2013 Posados was close to paying off all its debt from GE Capital. “We don’t want to deal with the banks—we want to be our own bank,” he says.

Instead, Nordon envisions the company growing only as fast as its free cash flow. “If we follow that model and don’t chase a rabbit down the trail we’ll never go out of business,” he says.

As both Grenerth and Nordon illustrate, it’s vital to adapt to the business cycle.

What Does Economics Teach Us about Context?

Economics is sometimes called the Dismal Science. For many, that saying brings a shake of the head and a “you got that right” response. Whether it was the simple fact that the worst teachers we had were our economics teachers or the totally incomprehensible presentations we saw on television or at a luncheon, listening to an economist talk was the equivalent of mental torture.

The economics discipline is viewed as dense, confusing, and maybe most damning, having very little to do with the real world we all live in. Economists are seen as having been put on this earth to make weather forecasters look good since their prognostications are not thought to be very accurate, especially with all the caveats attached to them. Compound those criticisms with the unfortunate use of jargon,
more often than not to confuse or make pronouncements sound more important than they really are and you understand why few people like to sit down and read about the economy. That is just wrong.

But the real problem with economics and economists is that the so-called economic gurus and popular writers too often provide information that is of little value to those who need the information to make critical decisions—households, businesspeople, and even those in government. For far too many, economics is really nothing more than the black arts, where mad economists put numbers into a black box and cryptically tell us the state of the economy and forecast where it is going.

While all that may be true, the term *Dismal Science* actually did not derive from our boring experiences in school or even the head scratching that the columnists or talking heads create. Its origin was the writings of economist Thomas Malthus, who theorized in his *Essay on the Principle of Population* (1798) that population would inevitably outpace food production, and that would lead to starvation.7

If it wasn’t bad enough that Malthus predicted famines would rule the world, he followed that up with a set of solutions that were even more depressing. Some of his suggestions included a greater death rate and limits on the birth rate. Basically, a distressing forecast about the world’s inability to feed itself was coupled with solutions few would ever want to see come to pass.

Thankfully, Malthus was wrong. Indeed, he turned out to be, unwittingly, a classic example of a leading economist who failed to see that numbers and logical theories by themselves do not present a full or even accurate picture of the way the economic world could or would work. Theories and models by which economists, including Malthus, understand how the economy operates do provide critical insights into the real world. They are just not the be-all and end-all of analysis.

What Malthus failed to see was that the technology that was used in farming was already changing in ways that would reshape the way the agricultural sector would operate. The budding industrial revolution would allow land that was farmable but not reachable to be brought into productive use. Critically, it would also dramatically increase the supply of food by turning land that was for a variety of reasons previously unusable for planting crops into property that could be farmed very profitably.
The whole agricultural system would benefit from what we all now know simply as technological innovation. Tractors would replace oxen, and plantings would be done by machinery producing greater crop yields. Harvesting would use machines reducing crop loss, thus raising output. The new technology of agriculture would lead to rapidly rising production on the land already being tilled as well as on the new lands, increasing world food supply and staving off the famines that once seemed inevitable.

But Malthus was not totally wrong. His ideas had value, but only in a limited sense and in certain locations—another important lesson. Even in today’s world, there still are countries where birth rates exceed the improvement in food production. Technology and its use is not evenly spread throughout the world. Those countries or regions where the ability to bring new farm land into productive use was limited or where the access to technology was restricted continue to this day to face problems meeting the food needs of their population. But the Malthusian theory had little relevance for much of the world where farmland could expand and machinery was available.

There was one last change that wasn’t foreseen but flows directly from the changing agricultural technology: Agricultural supplies are no longer viewed as being limited to what any one nation can produce but what the entire world can create. The ability to feed everyone is not simply a national issue but a global matter. That is an example of how changes seem to pop up as the needs arise. Conditions change and it is the circumstances under which the theory is applied and the data are analyzed that makes all the difference.

The lesson from the Malthusian misreading of the changes that were already under way, not the ones that were not foreseeable, is that a theory that may sound logical on the surface can make for potentially really bad policy. By assuming that farmers could not feed the world, Malthus had to look toward controlling population. That is, if the problem is that food supply could not expand fast enough, reduce the demand for food! But population growth was not the issue: It was the way farmers operated that had to be restructured, including what crops should be planted, what sizes farms should be, and what technology should be employed to create the greatest amount of food.

In other words, Malthus wound up blaming the victim instead of getting at the root cause of the problem. Sound familiar? We seem to
do that all the time. Inflation too high? Put in wage and price controls!
Deficits too large? Raise taxes; no, lower taxes; no, increase spending;
o, cut spending! When it comes to policies, sometimes keeping it sim-
ple is simply stupid, but we do that because it is too hard for many to
recognize that the right thing to do depends on the circumstances in
which the economy is operating.

Economic Theory and Fiscal
and Monetary Policy

To bring this back to the real world of today, consider the issue of bud-
get deficits. When the economy is weak, a rising budget deficit would
be normal. Indeed, during slowdown it may even be good policy to
have it increase. Falling business activity reduces employment and that
leads to lowered business and income tax revenues. At the same time,
spending on social programs such as unemployment insurance and
food stamps soar. Is the rising government spending, much of which
kicks in automatically, bad? Hardly, as they sustain families and maintain
at least some level of spending. That is why they kick in automatically.

In contrast, when the economy is booming, you would expect tax
revenues to rise and social spending to fall. That should automatically
create a narrower budget deficit. Is that good? Well, if the budget defi-
cit increases when the economy is booming, not decreases as expected,
that could actually create more inflation, which is hardly a good thing.

If you come to the conclusion that the budget deficit should be
reduced, what should be done about it? If you hike taxes to raise more
money, the economy is supposed to slow and the deficit rise, right?
Not necessarily. After President Clinton raised taxes in 1993, the econ-
omy went on the longest expansion in history, and six years later there
was a budget surplus. But that doesn’t mean it is good to raise taxes.
In 2009, when the budget deficit was soaring because of the Great
Recession, the last thing the economy could afford was a tax increase
that would have reduced demand even further.

Will tax cuts raise or lower the deficit? Many believe strongly that
lowering taxes would increase spending, accelerating growth and ulti-
mately generating more revenues. But while President Reagan cut
taxes dramatically and the economy boomed, the deficit also widened sharply. Similarly, when President George W. Bush reduced taxes in 2001 and 2003, growth picked up, but the deficit expanded as well. As those examples show, there is no such thing as a free tax cut, which pays for itself.

The reason for this confusion about the impact of the same policy—in this case, a tax increase—is that consumers and businesspeople react differently to tax changes when their economic circumstances differ. Lowering taxes when the economy is booming would likely mean more spending, but that could create real problems by adding to inflation. But lowering taxes when the economy is collapsing, such as in the spring of 2009, may not cause the economy to grow very much or at all. Households and firms might be more interested in hoarding money, so they have a cushion just in case their jobs are lost or their businesses falter, than in spending it. Under those circumstances, a tax cut could do little for the economy.

What is true for tax cuts is just as true for spending. When is the right time to cut government spending: when the economy is good, when it is bad, when the deficit is high, or when the deficit is rising? Do you really want to cut spending when the economy is in recession? Do you really want to increase spending when the economy is growing rapidly? Where you are in the business cycle—in other words, context—determines the answer, as there is no single approach that works all the time.

That need to understand the context in which policy is being made is true not just for our political leaders, who control taxes and spending, but also for the nation’s central banker, the Federal Reserve. The Fed members look at not only where the economy currently stands when they make decisions on the proper level of interest rates, but also where it is going. A weak economy may require more stimulus, but not all the time. It could be the right move when there is a recession, but if inflation is out of control after many years of strong growth, lowering rates could be absolutely the wrong thing to do.

Finally, there is the issue of investing and the stock markets. Small investor timing of the equity markets is classic example of the failure to recognize context. It is frequently said that small investors get in at the top and sell at the bottom. They wait until prices have run up and then
simply cannot pass up a “good deal.” Prices always continue to go up, right? Unfortunately, wrong. After buying at the top when the economy is about to turn, they then wait until prices have bottomed before they sell. What goes up doesn’t have to come down significantly, but it happens in a lot of cases. Understanding the context of the rise and fall of stock prices, not just that prices have gone up or down, is the difference between having a secure retirement and working until you are 80.

The point of all this is that economic logic can provide crucial information for decisions that are being made by every part of the economy such as businesses like Posados and small businessmen like trucker Grenerth. And while they have to figure out ways to cope with the business cycle, Washington institutions such as the Federal Reserve and the White House have sometimes had to find their way as well.

Notes


5. Ibid.
