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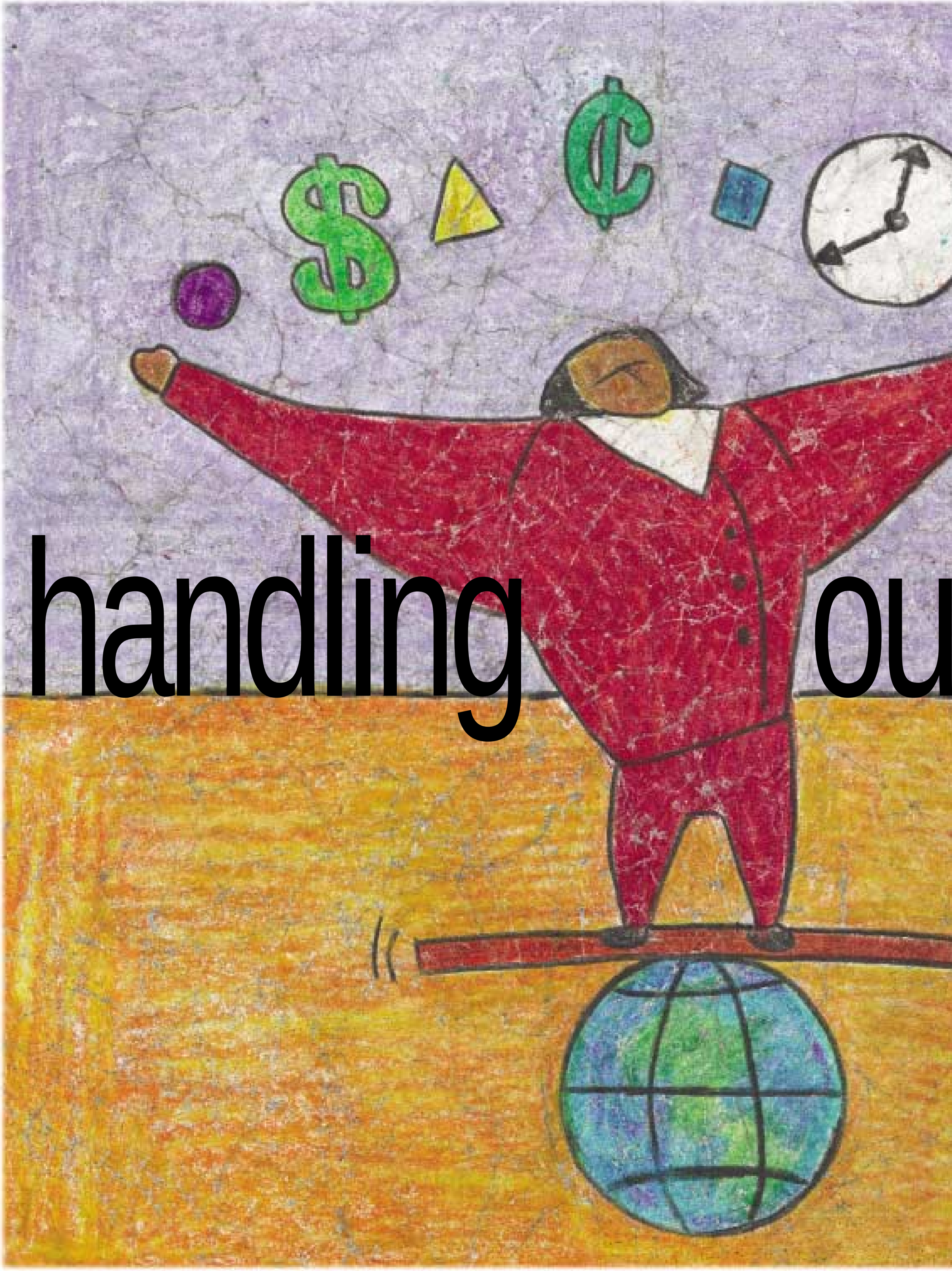


r money

In 1981, anyone with money to invest didn't have to think very hard about where to put it. Thirty-year U.S. Treasury bonds yielded upwards of 14 percent. And for those who preferred to stay short-term, the yield on 3-month Treasury bills topped 16 percent. Backed by the full faith and credit of the United States Government, both were as close to risk-free as an investment can be.

A certificate of deposit from the local bank was another attractive investment option. In May of 1981, the average return on a 3-month CD had brushed past 19 percent, and as long as you stayed below the $100,000 FDIC insurance limit, the risk to your principal was virtually nonexistent.

What a difference 20 years make!

By the end of 2001, the Treasury was no longer offering 30-year bonds, the average rate on 3-month CDs had slipped below 2 percent, and Americans were handling their money far differently than they had in 1981 — or even 1991, for that matter.

The action moved to Wall Street during the 1990s as investors showed a decided preference for equities (stocks and stock mutual funds) over income instruments (CDs, bonds, and money market mutual funds). Two sets of numbers offer an indication as to how popular stocks had become:

• In 1990, the total volume of shares traded on the New York Stock Exchange was just shy of 40 billion. In 2000, total trading volume topped 265 trillion.

• By the end of 1998, almost half of all American families held stock — either through direct investment in the shares of a particular corporation or through investment in a mutual fund. Just six years earlier, in 1992, the figure had stood at less than 37 percent.

What was responsible for the Wall Street resurgence? The short answer is "low inflation and low interest rates." Two economics truisms offer guidance:

(1) Inflation distorts economic and financial decision-making.

(2) High interest rates tend to inhibit economic growth; low interest rates tend to foster it.

During the late 1970s and early 1980s, the psychology of inflation had worked its way into the head of nearly every American investor. The CPI had jumped 13.3 percent in

1979, followed by a 12.5 percent increase in 1980, and double-digit inflation was starting to seem like the norm. Investors expected it and factored it into their financial decisions. If inflation was going to take a 12 percent annual bite out their wealth, they'd be looking for at least a 14 or 15 percent return on their investments.

But nothing lasts forever — not double-digit inflation and not double-digit returns on investment. During the mid-'80s and early '90s, effective monetary policy and a commitment to fiscal restraint combined to foster the steady, sustainable economic growth that would draw investors back to the stock market.

There were reversals: The Crash of 1987, when the Dow dropped more than 500 points in a single day, and the recession of 1990-91. Both left scars, but neither was enough to frighten investors away from Wall Street for very long.

As investors saw it, the risk of playing the market was outweighed by the fact that the return on CDs, Treasury securities, and money market mutual funds had fallen sharply. During the decade of the '90s, the average annual yield on Treasury bills was 5.01 percent in nominal terms, or 1.93 percent in real terms. In contrast, the average annual yield on stocks was 18.17 percent in nominal terms, or 15.19 percent in real terms. (See the box, "When is 15 percent not really 15 percent?" for an explanation of *nominal* versus *real* rates of return.)

Sure, stocks might be risky, but so was leaving your money in an investment that offered a negligible return.

The mechanics of investing had also changed. Investors took a more direct role in handling their own transactions. When the 1990s began, almost everyone who bought stock went through a full-service broker. But as the decade progressed, investors were more inclined to do their own research and place their own trades through discount brokerages.

The Internet became a significant factor as well. By mid-2001, nearly 8.8 percent of the 143 million Americans on the Internet were trading stocks, bonds, and mutual funds online.

And investors' desire to diversify led to explosive growth in the number of stock mutual funds. Equity funds — those that invest only in stocks — numbered 1,100 at the end of 1990, but by the end of 1999, there were 3,952.

The more things change . . .

During the 1990s, the "new economy" became a hot topic. Is there such a thing? Maybe it's too soon to tell, but one thing is certain: "New" or "old," the economy is still subject to some of the same old ups and downs. The Nasdaq is proof of that.

Between December 31, 1990, and December 31, 1999, the Nasdaq Composite Index soared from 373.8 to 4,069.3. Many of its top performers — Sun, Cisco, Microsoft, Dell, Intel, Oracle — epitomized the phrase "new economy." By 1999, the Nasdaq, which hadn't even existed prior to 1971, had become the largest U.S. stock market by dollar volume.

Then the magic seemed to end. From a high of more than 5000 in the spring of 2000, the Nasdaq composite began to plummet — victim of an overall economic downturn that had a particularly severe impact on the high-tech sector. In the aftermath of the tragedy on September 11, 2001, it plunged below 1400 before struggling back into the 1700 to 1900 range in early 2002.

"Old economy" blue chip stocks had their share of trouble, too. But overall the Dow Industrials didn't suffer as much damage as the Nasdaq. After flirting with the 12,000 mark in early 2000, the Dow retreated to nearly 8000 after 9/11 and then managed to make its way back above 10,000 in February 2002.

One more thing while we're on the subject. Ever wonder why TV news cameras always show wild cheering or deep despair on the floor of the New York Stock Exchange, but we never see similar scenes from the Nasdaq trading floor? The answer is less complicated than you might think: There is no Nasdaq trading floor. All Nasdaq trades are handled electronically through a computer and telecommunications network.

When is 15 percent not really 15 percent?

Back in the early 1980s, double-digit returns on T-bills and bank CDs sounded spectacular. Fifteen percent with little or no risk! It doesn't get any better than that, right?

Well, not exactly.

Let's look at the real rate of return — the nominal rate minus the rate of inflation. If a Treasury bill yields 16 percent, but inflation is running at 13.3 percent a year, then the real rate of return is 2.7 percent. That's enough to keep you ahead of inflation, but no one would call it spectacular.

Money in the Bank

The ’80s and ’90s left their mark on banking, too. Between 1980 and 2000, a wave of consolidations reduced the number of U.S. commercial banks from 14,434 to 8,318. (Yet it still might have seemed as if there were more banks than ever because the number of commercial bank branches actually increased from 38,738 to 64,680.)

The total number of thrift institutions — savings & loan associations, savings banks, and cooperative banks — declined sharply. In 1985, thrifts and their branches numbered 24,707, but by the year 2000, consolidation and the S&L scandal of the 1980s had cut the total to 14,497.

Changes in government regulations had a major impact on the products banks were allowed to offer. During the mid-1990s, banks got the green light to sell mutual funds (but they had to make it plain that the mutual fund investments were not insured by the FDIC). Then, in 1999, Congress passed the Gramm-Leach-Bliley Financial Services Modernization Act, which effectively repealed most of the Depression-era Glass-Steagall restrictions that had prohibited banks from offering investment and insurance products.

Want to Know More?

The FDIC web site has capsule descriptions of significant federal banking legislation, starting with the National Bank Act of 1864 and ending with the Gramm-Leach-Bliley Act of 1999. **http://www.fdic.gov/regulations/laws/important/index.html**

The PBS web site features an informative and entertaining look at electric money, and it includes a teachers guide. **http://www.pbs.org/opb/electricmoney/**

“Dawn of a New Era . . . The U.S. Retail Payments System,” was the featured article in the Federal Reserve Bank of Boston’s

Paper or plastic?

Another form of plastic gained widespread acceptance during the 1990s. Stored-value cards accounted for $21 billion worth of transactions in 1999, and that figure is projected to reach $57 billion in 2005. Perhaps the type of stored value that’s most familiar to American teens — at least among those who don’t carry their own cell phones — is the prepaid phone card. But during the late 1990s, stored-value cards were used increasingly at the gas pump and in place of paper gift certificates.

Let’s not forget that old reliable standby — cash. Despite recurring predictions of a “cashless society,” cash is still very much with us. In fact, there was a lot more of it in circulation in 2000 ($530 billion) than there was in 1980 ($115 billion). But even cash has changed. In the mid-1990s, the U.S. Treasury introduced redesigned currency for the high-tech era. The new design features were a response to the fact that counterfeiters — like the rest of us — had greater access to color photocopiers and computer scanners.

Technology had a major impact on banking during the ’80s and ’90s.

• As of mid-2001, 17.9 percent of all Internet users were banking online.

• The number of automated teller machines mushroomed.

	1980	1999
	18,500	227,000

• Point-of-sale terminals experienced dramatic growth during the 1990s.

	1990	1999
	53,000	2,350,000

• And there was a corresponding increase in debit card use.

	1990	1999
Number of debit cards	164,000,000	228,000,000
Number of transactions	274,000,000	7,517,000,000
Dollar volume of transactions	$12 billion	$322 billion

What about credit cards?

• Credit cards remained popular.

American families with at least one general purpose credit card:

	1989	1998
	56.0%	67.5%

Median credit card balance (the amount you owe):

	1989	1998
	$1,300	$1,900

• Debit cards didn’t replace credit cards.

Percent of all consumer payments transactions:

	1990	1999
Credit cards	14.8	27.9
Debit cards	14.5	22.5

Changes in the Dow

The economy changes and so does the list of 30 Dow Jones Industrials. Here's a comparison of component stocks of the Dow Jones Industrial Average (DJIA) at the start of 1980 and the end of 1999.

DJIA Component Stocks, January 1980

Allied Chemical*
Alcoa
American Can
American Tobacco
AT&T
Bethlehem Steel
Dupont
Eastman Kodak
Exxon
General Electric
General Foods
General Motors
Goodyear
IBM
International Harvester
International Nickel
International Paper
Johns Manville
Merck
Minnesota Mining & Manufacturing
Owens-Illinois Glass
Procter & Gamble
Sears Roebuck & Company
Standard Oil of California
Texas Corporation
Union Carbide
United Technologies
U.S. Steel
Westinghouse Electric
Woolworth

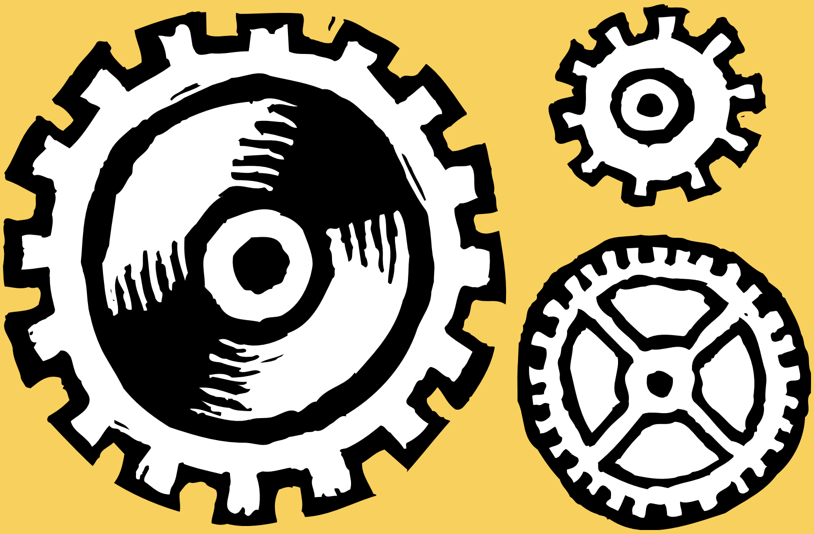
DJIA Component Stocks, December 1999

Alcoa
American Express
AT&T
Boeing
Caterpillar
Citigroup
Coca Cola
Disney
Dupont
Eastman Kodak
Exxon
General Electric
General Motors
Hewlett Packard
Home Depot
Honeywell*
IBM
Intel
International Paper
Johnson & Johnson
McDonald's
Merck
Microsoft
Minnesota Mining & Manufacturing
J.P. Morgan
Philip Morris
Procter & Gamble
SBC Communications
United Technologies
Wal-Mart

*Allied Chemical merged with the Signal Companies in 1985, and AlliedSignal subsequently merged with Honeywell in late 1999.
(**Bold** = new to DJIA since 1980)

And just for fun, here's a list of the DJIA components at the end of 1899:

American Cotton Oil
American Steel & Wire
American Sugar
Continental Tobacco
Federal Steel
General Electric
National Lead
Pacific Mail Steamship
People's Gas
Tennessee Coal & Iron
U.S. Leather (preferred)
U.S. Rubber



What's interesting is that the 1980 component corporations are more like those of 1899 than those of 1999 – another indication of how much things changed during the last two decades of the 20th century.

2000 Annual Report. **http://www.bos.frb.org/genpubs/ar/ar2000/index.htm**

What did people mean when they talked about "the new economy"? The answers are in "New Paradigm" in the Federal Reserve Bank of Dallas's *1999 Annual Report*. **http://www.dallasfed.org/htm/pubs/annual.html**

We didn't get to talk about the European Monetary Union, which was one of the big changes to take place during the last two decades of the 20th century. But the Federal Reserve Bank of Dallas web site features a comprehensive and very readable article on the topic. **http://www.dallasfed.org/htm/research/hot/bd0202.html**

"Do . . . you . . . take . . . travelers . . . checks?"

There was a time, not so long ago, when prudent travelers wouldn't dream of leaving home without travelers checks. But during the 1990s, the dollar volume of travelers check transactions declined sharply — from $22 billion in 1990 to $14 billion in 1999. Debit cards, credit cards, and network technology are the cause.

Need cash for a canal boat ride in Amsterdam? No problem. An ATM networked to a computer in the States can dispense a fistful of euros in a matter of seconds, and you're guaranteed the best available exchange rate. Shopping? Dining? Club hopping? Checking out of your hotel? Your credit card or debit card will almost always do the trick. And when you get home, you'll get a detailed statement that lists all your transactions. The downside? There really isn't any, unless you miss dealing with imperious bank clerks as you spend half your morning looking for the best exchange rate in a country where you don't speak the language.