This chapter describes the principal means by which the federal government deliberately affects the level of economic activity in order to reduce adverse fluctuations. As I have already mentioned, the federal government does this through managing the level of aggregate demand. Fiscal policy is the government's intentional use of its budget, including both the revenue and expenditure sides, to affect the levels of aggregate demand and therefore general economic activity. The second principal tool of demand management is monetary policy, which I describe after fiscal policy.

FISCAL POLICY: TAXING AND SPENDING

It does not take years of intense study to figure out that if the federal government increased its total purchases of goods and services from the private sector without changing anything else, it would have a positive effect on the volume of goods and services produced and sold. The GDP would go up. The same amount of analytical insight yields the parallel observation: if the federal government were to reduce personal income taxes and not change anything else, the chances are that it would have a positive effect on the volume of consumer goods and services produced and purchased. Again the GDP would go up. This is indeed the essence of fiscal policy, but I can be a bit more precise than this.

Let's say that the federal government increases its purchases of privately produced goods and services by $400 million, and there is no offsetting negative effect. This immediately increases GDP by $400 million, and since we will pretend that disposable income equals three-quarters, or 75 percent, of GDP, disposable income rises by $300 million. But this is only the beginning; there is an echo effect through household consumption expenditures. Ignoring imports for the moment, we'll imagine for
of arithmetic convenience that households’ consumer expenditures always gobble up 80 percent of any increase of disposable income, and thus 20 percent of added income goes into new savings. The proportion of additional income that goes to additional consumption is called the marginal propensity to consume (MPC). Now we’re ready to trace the echo effect through the system.

The $400 million increase in GDP trickles down to a $300 million increase in disposable income (75 percent of the change in GDP), and that $300 million rise in after-tax income induces $240 million more in household consumption expenditures (MPC = 0.8 times $300 million). But the echo has not died away yet. The $240 million of new consumption expenditures means $240 million more in GDP, and therefore it generates $180 million more in disposable income. That increase in turn triggers $144 million in new consumption expenditures (80 times $180), which means that GDP increases by the $144 million, and thus a new round begins again. Successive rounds continue around and around in a steadily declining manner, and the final result is that GDP has been stimulated by a multiple of the government's original spending increase. The process is called (surprise, surprise) the multiplier.

In my numerical example, the multiplier would work out to be 2.5, which means the initial stimulus of $400 million generates a total increase in GDP of $1,000 million (or $1 billion). I portray this more concretely below, where G is government purchases of goods and services, Y is disposable income, and C is consumer expenditures.

\[
\begin{align*}
\text{Change } G &= \text{ Change GDP} \rightarrow \text{ Change } Y, 75 \rightarrow \text{ Change } C, 80 = \\
(400M) & \quad (400) \quad (300M) \quad (240M)
\end{align*}
\]

\[
\begin{align*}
&= \text{ Change GDP} \rightarrow \text{ Change } Y, 75 \rightarrow \text{ Change } C, 80 = \text{ Change GDP} \rightarrow \\
(240M) & \quad (180M) \quad (144M) \quad (144M)
\end{align*}
\]

\[
\begin{align*}
&\rightarrow \text{ Change } Y, 75 \rightarrow \text{ Change } C, 80 = \text{ Change GDP} \rightarrow \text{ and so on.} \\
(108M) & \quad (86.4M) \quad (86.4M)
\end{align*}
\]

So adding up all of the Change GDP's yields $400M + $240M + $144M + $86.4M + $51.8M + $31.1M + ... = $1,000M (2.5 times the initial $400 million increase). This kind of exercise is useful for illustrating the process, but it is not worthwhile spending much time in calculating a precise multiplier. There are too many other factors involved. For example, some of the impact of the initial $400 million is offset by crowding out some private production; some consumption expenditures go for imported goods that siphon increased expenditures out of the system; and the size of the MPC depends on the composition of the increased government expenditure in ways that are not specified in the model. In regard to the last point, whether the expenditure goes for a new space station or new schools affects whether well-to-do professionals or less prosperous construction workers receive the bulk of the new income. This in turn may influence the kinds of goods and services purchased and the employment effects of the next round of spending.

Without getting caught up in false precision, the general principle is important: induced consumption through the marginal propensity to consume means that an initial change creates an echo effect that goes through a series of diminishing rounds that cumulate into a total effect greater than the initial increase. The multiplier gives extra leverage to government policies aimed at stimulating or cooling off the economy, but the multiplier is not limited to government expenditure.

An increase in investment expenditures spurs, say, by a drop in interest rates, technological changes, mistaken expectations, or the need for expanded productive capacity would set off a similar round of diminishing changes working through the marginal propensity to consume. A sudden boost of exports would have identical effects. The basic idea behind the multiplier is that when increased production generates increased income without bringing to the market the corresponding values of consumer goods on which that income is spent, there is a multiplier effect.

Let's pretend that Stonewall, Mississippi (population 1,189), received a million-dollar bequest from a local boy who made it big in Chicago. The town council decides to use the money to erect a large statue of their favorite Civil War hero astride an even larger horse. The people working on the statue are paid, the suppliers of the stone and tools are paid, and they create a million dollars' worth of statute. All of this new production and income, however, did not create the equivalent value of consumer goods and services for those workers and suppliers to buy. Ergo, the statue produces a local multiplier effect parallel to that of a million-dollar increase in, for example, exports.

In all of this, of course, there is nothing to prevent exactly the same set of relationships generating cumulative negative changes of GDP in response to a decline in government, investment, or export expenditures.

Fiscal policy working through the tax side has a similar effect, but there is a significant difference. If the federal government returns $400 million in income taxes in a one-year, lump sum rebate, it kicks off a multiple chain reaction, but a smaller chain reaction. The first increase in expenditure (and thus of GDP) is not $400 million; it is the consumption expenditures induced by the $400 million increase in disposable income: $320 million (MPC = 0.8 times $400 million). That $320 million (making for an identical change in GDP) then rebounds around the system in a similar way, increasing disposable income by $240 million (75 of $320 million). This in turn stimulates an increase in household consumption expenditures by $192 million (80 of $240 million), and on and on until the total increase of GDP adds up to $800 million. Granting a tax break, then, results in a smaller ultimate increase in GDP than increasing government expenditures on goods and services by the same amount, and that difference is due to the smaller initial change in expenditure that sets off the rounds of consumption expenditure.

If the government were to stimulate the economy by increasing transfer payments or hiring more people (increased government wages and salaries), we expect a result-
ing increase in GDP closer to the tax break rather than to government purchase of goods and services.

The discussion of the multiplier and the government budget reveals the logic behind the occasional fiscal strategy of lowering taxes with the expectation of stimulating the economy to the point that total tax revenues would increase, even with lower tax rates. This supply-side economics strategy, which was supposed to stimulate private enterprises by increasing pecuniary incentives, simply did not come through as hoped. As a consequence, President Ronald Reagan's administration holds the title for piling up more federal government debt than any other peacetime administration. The consistent insistence of cutting taxes on the rich is primarily a play for very rich donors under the guise as a strategy to stimulate the general economy.

President G. W. Bush's tax cuts were not designed to fight recession. He proposed them in March 2001 well before the recession began, but he did take the opportunity of the recession to convince enough people in Congress and the public of the need for tax cuts. The state of Kansas volunteered to test the supply-side mantra, and the result was (and is) disastrous. The rhetoric justifying the shift of the tax burden from

PYRAMIDS AND CATHEDRALS?

John Maynard Keynes, writing in the depths of the Great Depression, was convinced that modern capitalism was chronically plagued by deficient levels of aggregate demand and needed continual boosts of a multiplier-type stimulus in order to be viable. In his inimitable style, he wrote:

Ancient Egypt was doubly fortunate, and doubtless owed to this its fabled wealth, in that it possessed two activities, namely pyramid-building as well as the search for precious metals, the fruits of which, since they could not serve the needs of man by being consumed, did not stave with abundance. The Middle Ages built cathedrals and sang ditties. Two pyramids, two masques for the dead, are twice as good as one, but not two railways from London to York. Thus we are so sensible, have schooled ourselves so close a semblance of prudent financiers, taking careful thought before we add to the “financial” burdens of posterity by building them houses to live in, that we have no such easy escape from the sufferings of unemployment. (John Maynard Keynes, The General Theory of Employment, Interest and Money, 1936, 131)

Well, how about permanent war readiness?

Financial and real capital to middle and lower quintiles of income receivers suggests that the very rich need to be bribed heavily to use their resources productively.

President Obama's stimulus package was definitely in the legacy of John Maynard Keynes, whose work (and macroeconomics in general) had been shoved to the side-

lines of the economics profession in the last thirty years. While fairly successful as a stimulus, President Obama's stimulus should have been an initial down payment on more fiscal stimulus. It was blocked in Congress by so-called deficit hawks who tirelessly try to scare U.S. citizens about the burden of such a heavy debt for our children and grandchildren.

First of all, the U.S. national debt is denominated in U.S. dollars, the volume and value of which is controlled by the U.S. government—the Fed and Treasury. If push came to shove, some of the real debt can be reduced through expanding the U.S. money supply, and a little deliberately manipulated inflation would reduce the real value of the national debt. The idea that Greece and Detroit offer cautionary tales for the United States is badly informed; neither controls the currency in which they owe their creditors. (Nigeria and Ecuador are similar in that they have adopted the U.S. dollar as their currency.)

In addition, arguments about the debt burden to future generations ignore the fact that draconian cuts in federal expenditure will create a more onerous type of burden: broken school systems; dangerous and inefficient transportation and sanitation infrastructures; reduced levels of public safety; weakened judicial systems; environmental degradation; unemployment; and ineffective provisions for global warming. Like deregulation and other antigovernment sentiments, such a strategy pleases those who wish to have few restrictions on the use of their resources, have an underdeveloped sense of community, and are able and willing to stay in the private sector for such services as health, education, security of persons and property, transportation, and recreation. Free markets mean freedom for capital to operate without considering anything other than private gain and are liberating for those whose wealth and exercise of power were constrained by government policy. On the other hand, free markets can be debilitating for those whose standards of living depend on the availability of jobs, workers' rights, and the provision of public services.

MONEY IS AS MONEY DOES

The adage that serves as this section's title aptly defines money; anything that performs the three functions of money—medium of exchange, standard unit of value, and store of value (or of deferred payment)—is money. A wide range of things have served these purposes and thus been money; things that included large stones in the South Pacific, mollusk shells among Native Americans, sticks of chewing gum in occupied Germany after World War II, pieces of printed paper, and notations in bank ledgers and electronic files, among others. Gold holds the historical record for being most closely identified with money, in good part because of its scarcity, malleability, ease of dividing it into small units, and a chemical inertness that prevents it from rusting and otherwise deteriorating over time. (The last three qualities make gold useful for filling cavities in teeth as well.)
Confidence is the key to something functioning successfully as money. You willingly accept some form of money in payment for a service or commodity only if you believe the value of that money will be maintained in the eyes of others at least until you wish to exchange it for a good or service. The psychological element has imparted a mysterious, even mythical and transcendental, quality to money, despite its rather mundane and socially determined character. The U.S. government no longer backs up its currency with gold or any other tangible commodity. Instead, its paper currency boldly declares: "This note is legal tender for all debts, public and private." The source of the U.S. dollar's value, then, depends on the authority of the U.S. government and the confidence that the dollar will hold its value in the eyes of others.

Currency, however, is only one component of what functions as money in the United States. There is a whole array of financial instruments, including currency, various kinds of bank accounts, stocks, bonds, IOUs for gambling debts, life insurance certificates, and arcane forms of option contracts. Each of these has some possibility of performing the three monetary functions, albeit with widely varying degrees of satisfaction, but they possess very different degrees of liquidity—how easily, quickly, and cheaply one can convert a particular asset into another kind of asset. Cash (currency and coins) is the most liquid of assets, and with cash one can pretty much buy anything (i.e., convert it into another kind of asset, whether a shirt or another financial instrument) immediately and with no transaction costs. Over 80 percent of transactions in the United States are in cash, but these transactions constitute less than 1 percent of the value of total transactions.

Checking accounts (or demand deposits, including interest-bearing NOW accounts) are almost as liquid as cash, but they are not legal tender. People can, and often do, refuse payment by check—try an out-of-town check in New York City. Various kinds of interest-bearing savings accounts are less liquid than checking deposits, U.S. government bonds are even less liquid, and so on. Where does one draw the line on what is money in the here and now?

At the risk of sounding like a grumpy old man again, it was easier to answer this question when I began teaching economics. Cash and checking deposits constituted money, and all interest-bearing assets that were less easily convertible were not strictly money. Well, this definition still holds, but now it is called \( M_1 \). And there is also an \( M_2 \) and an \( M_3 \). The problem is that in the postwar years, pushed by demand and enabled by the deregulation of the financial industry and electronic communication technology, financial instruments have proliferated to the extent that many of them blur together in terms of the liquidity criterion.

Anyway, \( M_1 \) is cash and checking deposits, and in August 2016, we did so with $1.391 billion in currency and $1.817 billion in various kinds of checking deposits, adding up to $3,208 billion in total. \( M_2 \) includes \( M_1 \) plus a set of somewhat less liquid financial assets (e.g., savings accounts) that added $97.73 billion to \( M_1 \). The final step is \( M_3 \), which includes \( M_2 \) plus a range of financial assets that are even less liquid. Which definition is the most appropriate depends on the use to which it is put, and I use \( M_1 \), which fits my purposes the best because it includes the financial instruments that are most often involved in transactions.

**FINANCIAL MARKETS, THE FEDERAL RESERVE SYSTEM, AND MONETARY POLICY**

The first thing to know about banks (that is commercial banks, which take deposits) is that they accept deposits in one window and lend them out another window, and they make their profits by charging a higher price (interest rate) for the money they lend than the price (interest rate) they pay depositors. Lending depositors' money is possible because they work on a fractional reserve system, in which banks do not have to keep all their deposits on hand. If they had to keep all the deposits behind the counter, they would simply be warehouses and would charge depositors for keeping their money rather than paying depositors for the use of it.

Banks cannot lend out everything that they get in deposits, however, because they do have to be able to cover themselves in the event of experiencing adverse clearing balances—when withdrawals are greater than new deposits. The fraction of deposits that banks keep for the contingency of net withdrawals is determined by bankers' prudence and, more importantly, by state and federal regulatory agencies.

This process of accepting deposits and making loans is called financial intermediation, which is conventionally described as gathering together large numbers of small deposits in order to lend out large lump sums. Although the size patterns of bank deposits belie the notion that many small deposits are the principal sources of funds, the function played by financial intermediaries is clear—they act as brokers connecting lenders (depositors) with borrowers, putting the money to work, as they say. Financial intermediaries in the United States used to be quite specialized, with each type of institution legally restricted to certain sources of funds and to specific kinds of lending. Financial deregulation, however, beginning in the late 1970s, accelerated in the next decades, and continues to blur the distinctions among financial institutions. As a result, commercial banks, investment banks, savings and loan associa-
tions, mutual savings banks, and even brokerage firms, insurance companies, and mutual funds are increasingly able to cross over and compete in what had formerly been one another’s particular domains.

In 1913, the U.S. government established the Federal Reserve System (the Fed) to regulate banks in order to reduce the incidence of financial panics, and later, in 1933, it established the Federal Deposit Insurance Corporation, or FDIC, which currently guarantees singly owned accounts up to $250,000 through an insurance program.

When the public lost confidence in a bank, large proportions of the bank’s depositors tried to withdraw their money at the same time. Of course, the bank could not meet the demands of all (or even most) of its depositors, whether the initial loss of confidence was or was not justified. The bank had to close, at least temporarily, an action that undermined depositors’ confidence in other banks. The contagion thus had the potential of escalating into a full financial panic that severely disrupted financial markets and economic activity in general. Two of the most serious pre-Federal Reserve panics occurred in 1873 and 1907, and the bank panics and closings of the 1930s led to the FDIC.

The Fed is the central bank for the United States, although uneasiness about centralized authority gives the U.S. central bank some unique features: the Fed is organized into twelve regional banks, and it has substantial insulation from elected government officials. Its headquarters and major policy-making bodies, however, are located in Washington, D.C., and its regulation of financial institutions is subject to and dependent on federal legislation. Nevertheless, in formulating and implementing monetary policy, the Fed operates with considerable autonomy.

**Monetary Policy**

Although not a part of the original intention, it soon became clear that the Fed’s acting as the financial agent for the U.S. Treasury had the potential of affecting financial markets in ways that significantly influenced levels of general economic activity. It did this by being able to expand or contract the amount of money in circulation and therefore to change interest rates. The deliberate use of this influence is called **monetary policy**. There are three major mechanisms by which the Fed affects the availability of financial liquidity—money.

**Open Market Operations**

The most important mechanism is the Fed’s purchase and sale of federal government bonds on the open market. The first step in describing this process is to understand the counterintuitive relationship between a bond’s price and its yield (interest payments). If you buy a $100 government bond, you are lending the government $100. If that bond promises to pay you $110 in one year (the original $100 plus $10 extra) then the yield of the bond is 10 percent (10/100)—the rate of interest that the government is paying you for lending it the money. If you were to pay only $98 for the same bond that pays $110 in one year, the net $12 you earn means a rate of return is 12.24 percent (12/98). On the other hand, if you were to pay $102 for that bond, your rate of return would be 7.84 percent (8/102). Get it? As the price of the bond falls, the absolute and relative differences between what you are paying for the bond and the fixed value of what you will get for it rises. The equal and opposite hold for rising bond prices.

With that under our belts, let’s look at what happens when the Fed sells a large volume of bonds. It soak up liquidity in the private economy by selling relatively illiquid bonds in exchange for private buyers’ liquid checking deposits and cash (money). This net loss of liquid assets reduces the amount of loanable funds available to banks and other financial intermediaries. This is shown in figure 4.1 as a shift to the left of the supply curve of loanable funds from $S_1$ to $S_2$. The demand curve for loanable funds includes all demand for borrowed money, including for plant and equipment, inventories, home and auto purchases, international commerce, stock market speculation, and three-day funerals. Although the supply curve for loanable funds is determined principally by Fed monetary policy, it is usually drawn with some positive slope, because economists still like to believe that higher interest rates induce people to save more, and therefore make more money available for lending.

In our example in figure 4.1, however, the Fed’s policy reduces the availability of loanable funds, which puts upward pressure on interest rates (the price for renting/borrowing loanable funds) as potential borrowers compete with one another for loans. The rise in interest rates chokes off some investment and consumption ex-

![Figure 4.1 The market for loanable funds and Fed policy](image)
penditures and may slow down exports. This restrains the general level of economic activity.

Why would people necessarily buy the bonds offered by the Fed? All the Fed has to do is to reduce slightly the price of the bond and thus raise the rate of return slightly above what is generally available. These are offers that professional money managers cannot refuse. Whether the money managers work for banks, mutual funds, pension funds, insurance companies, manufacturing corporations, rich individuals, or whatever, they are paid by their employers to take advantage of any such opportunities and to rush to get such a deal. Moreover, some managers probably had to sell some financial assets in order to buy the government bonds, and to do so, slightly discounted their prices in order to sell them quickly to take advantage of the good deal. So the initial transaction begins the process of raising the yield and effective interest rates, and the process works itself throughout financial markets, raising interest rates and discouraging primarily investment and consumption expenditures.

On the other hand, when the Fed buys bonds, in an appropriately massive volume, it pays by check. Let's say that those selling the bonds to the Fed had done so only because they got an especially good deal (a slightly above-market yield), but they really did want interest-bearing bonds rather than a liquid deposit that earns little or no interest. These people would turn around and replace the bonds sold to the Fed by buying some other bonds from private bondholders. This process of excess liquidity churning through the system continues the process of bidding up the price of bonds and lowering interest rates, thus encouraging new borrowers to enter the market and stimulate investment and consumption expenditures.

When private parties buy and sell bonds between them, one private party (corporation, individual, bank) gives up money from a checking account or from cash and another private party gains the same amount in a checking account or cash. But it is different with the Fed's purchases and sales of bonds, because the Fed's checking balances are not available to the public as loanable funds. When private parties buy bonds from or sell bonds to the Fed, the amount of money (e.g., checking account balances) in the private sector declines or rises, respectively. Well, yes, there is a certain arbitrariness, even sleight of hand, to all of this, but the money available to be lent for private expenditures is, for all intents and purposes, the money circulating in the private sector.

An extremely important aspect of this process is that when the Fed injects more liquidity/money into the economy by buying bonds, it is not a direct increase in incomes. The Fed is not handing out money on street corners. The increase in the amount of money in the economy is due to money managers having been induced to adjust their portfolios of financial holdings by exchanging relatively illiquid bonds for liquid cash and checking deposits. The creation of more money in the economy, therefore, is not done by directly increasing anybody's income (aside from some fat commissions); it is due to changes in the composition of previously held financial assets. Any increase in GDP and income from these transactions comes about through a drop in interest rates that stimulates more expenditure and production.

One last note on language. The Fed usually announces its actions in terms of changing the federal funds rate, the interest rate that banks charge one another for very short-term loans (often just overnight) to tide the borrowing bank over a temporary shortfall of what it needs to meet its reserve requirements. The Fed and many others watch this particular interest rate very closely, because they consider it to be a significant indicator of financial market conditions in general, and the Fed uses the sensitive federal funds rate as its target. When the Fed announces, let's say, that money markets need to be tightened and it is raising the federal funds rate by a quarter of a percent, it means that it intends to sell enough bonds that the reduction in loanable funds is almost immediately registered as a quarter of a percentage point in the federal funds rate. The federal funds rate is merely a target variable, and its rise soon is felt in rises throughout the highly integrated financial markets. A wide range of different interest rates coexist at any one time, depending primarily on the length and risk of each type of loan.

Reserve Requirements

A second policy option for the Fed is to change the fraction of deposits that member banks have to hold as reserves. Although banks chartered by the Fed ("national banks") are only a third of the total—most are chartered by states—they are the larger banks and hold most of total bank assets and significantly affect general financial activity. A rise of the reserve requirement immediately reduces the capacity of member banks to lend, thus tightening financial markets and raising interest rates. On the other hand, lowering the reserve requirement increases the supply of loanable funds and reduces interest rates.

Changing reserve requirements is an extremely blunt instrument used when immediate and large changes seem to be needed. For more precisely targeted changes, the Fed prefers open-market operations.

Discount Rates

The discount rate is the interest rate that the Fed charges for lending money to its member banks, usually for augmenting their reserves to the desired levels. Most of such lending takes place among banks in the federal funds market rather than between the Fed and banks, and the discount rate has become primarily a matter of symbolic value. This does not mean that symbols are without significance, however. The Fed uses changes in the discount rate as explicit signals to the financial community of its concerns about the economy, concerns that might soon result in more than symbolic gestures. People ignore such declarations of the Fed's stance at their peril. After the credit crisis of late 2008, more banks turned to the discount window
for short-term loans, and not only because credit was readily available and relatively inexpensive.

**BUSINESS CYCLES, INFLATION, AND UNEMPLOYMENT**

At the end of every long economic upswing, one always hears claims that the business cycle has been abolished, but the fact remains that overall levels of economic activity do fluctuate over time.

In studying economic fluctuations, the interaction between the multiplier and accelerator makes it relatively easy to explain why, once begun, economic upswings continue going up, and once begun, downswings continue down. For example, when a vigorous multiplier effect is working its way through the economy with new rounds of consumption expenditure, demand for particular goods and services may begin to outstrip firms' capacities to produce enough to keep up with the increased demand. Those producers are likely to invest in enlarging their productive capacities, encouraged by a generally optimistic business climate created by the expansion. This induced investment is called the accelerator, and one can think of it as renewing the multiplier. That is, any new investment induced by heightened demand kicks off a new multiplier impact, which in turn induces more investment, and so on. The same mechanism can also work in reverse, and downward-spiraling levels of general economic activity, with attendant underutilized productive capacity and business pessimism, lead to the cancellation of investment projects and plunge the economy even deeper into the doldrums.

Inadequate levels of economic activity create unemployment, and the Employment Act of 1946 charged the federal government with the responsibility of maintaining rates of job growth sufficient for full employment. Although the Employment Act seems to have been unofficially repealed in the 1980s, low or negative rates of economic growth reduce income, innovation, profits, consumer satisfaction, as well as the likelihood of a public official's being reelected.

The U.S. Congress has not codified the goal of avoiding inflation, but the Fed is staffed with bankers and it functions as the frontline defense against inflation. Bankers and their colleagues in other financial institutions are extremely allergic to inflation. In inflationary times, banks have to pay higher interest rates for deposits while many of their previous loans were made at lower interest rates. More generally, inflation can disrupt financial markets by introducing uncertainty into the value of the units in which all financial instruments are calibrated.

Employers do not mind a bit of unemployment in order to keep workers disciplined, and those most interested in full employment do not mind a bit of inflation as part of the process. Nevertheless, it is obviously in the interests of elected government officials to steer the economy safely between the Scylla of inflation on one side and the Charybdis of unemployment on the other. Public stabilization policy is interested in reducing the size of business fluctuations in a way that promotes steady economic growth. This also means reversing or reducing the momentum of an established upswing or downswing that threatens to have unfavorable effects.

**Up, Up, Up...**

Inflation is defined as a general rise in prices, but you do have to keep in mind that prices never rise uniformly across the board. The principal explanation for inflation is excess demand—too much money (expenditures) chasing too few goods leading to prices being bid up. In the latter half of the nineteenth century, this was taken literally through the quantity theory of money. It was believed that a change in the amount of money circulating in the economy would have a fairly immediate and proportional effect on general price levels. Although there are economists who still pay lip service to the quantity theory of money, most economists today agree that changes in the money supply affect the economy primarily through changes in interest rates.

Although I mention a couple of exceptions below, modern economics sees inflation to be primarily a demand-driven process, despite disagreements about the sources of the excess demand. So think of all those individual short-run demand and supply curves for particular markets with demand curves shifting to the right and new equilibria established farther up the respective supply curves at higher prices and increased output. In competitive markets, short-term supply curves slope up and to the right because increased output increases the derived demand for labor and inputs, leading to their prices rising. Producers cannot continue to produce more goods and services without higher product prices to compensate for higher production costs.

In contrast, supply-side explanations for inflation depend on the existence of noncompetitive markets. If a firm, a group of firms, or a labor organization gains sufficient market power in a certain market, it could exercise this market power by raising its prices in order to increase returns, be they profits, wages, or most likely both. The resulting higher prices are then registered as inflation. This strategy requires not only market power, whether in markets for intermediate products, labor, or final products; it also requires a generally buoyant economy. But declining purchases of the higher-priced goods and services by the majority of the population who did not have the market power to protect their incomes can lead to unemployment and recession.

When OPEC used its market power to quadruple the price of petroleum in the early 1970s, it was so effective that the supply side shock threw most of the capitalist world into a recession. The jumbo price rise also stimulated conservation and the use of substitutes (coal, natural gas, nuclear, solar, and wind energy, as well as bicycles and feet). Although OPEC withstood these pressures from reduced demand for pe-
Chapter 4

Fiscal Policy, Monetary Policy, Recession, and Inflation

that people find themselves underwater. That is, they owe more on their mortgages than the house is worth—negative equity.

A related device is that lenders occasionally index the amount (principal) of each loan—tying the dollar amount of the bond/loan to an indicator (index) of inflation, such as the consumer price index (CPI). So if you borrow $100 for a year and the CPI increases 4 percent during that year, you have to pay back $104 plus interest. Some union contracts provide for indexing wages, and Social Security payments are adjusted for price changes. It is time, therefore, to look more closely at the CPI, the most important measure of inflation.

Since values are prices times quantities, we have to standardize quantities in order to measure changes in prices. But the CPI is not a general price index; it is an index intended to measure price changes that are the most important for families. So how does one find out which prices are most important, and how important? The Bureau of Labor Statistics of the Department of Labor takes surveys, and in this case, surveys of the expenditures of “average urban families.” (No, I have never known one either.)

So the surveys tell us that the average urban family buys a particular pattern of goods and services—the typical “market basket”—and pays such and such prices for them. The CPI is based on price changes of around two hundred items, but for the purposes of illustration, table 4.1 lists only eight large categories. The first column is approximate measures, and I made up the other numbers for illustrative purposes. The total (115.5), however, is realistic: consistent with rates of inflation between 1.5 percent and 2.0 percent a year. Now we know which prices are important and their relative importance (weights). We’re in business.

Table 4.1 shows how the CPI is constructed: calculate the value of the identical market basket of goods and services (i.e., holding quantities constant) in each period’s prices; establish a base point (not necessarily the same year as the weighting year) by dividing the value of every year’s market basket by the value of the year that you want to be 100 (the base point), and multiply by 100.

Before leaving table 4.1, let’s talk about the behavior of some of the categories. The decline in apparel prices sounds like China, right? The rise (and recent decline) of transportation prices reflects changes in the price of fuel and monopolistic pricing by airlines. Because food and fuel prices are very volatile, a separate CPI is calculated without them and is called core CPI. Why didn’t we see the sharp rises and collapse in house prices more strongly reflected in the numbers during this period? Because houses’ sale prices are not included in the index. Rentals and rental equivalents are used instead, and rents did not rise or fall as much as houses’ sale prices during the housing bubble.

The CPI no doubt exaggerates the amount of inflation, because it considers virtually all price increases as inflation, whereas some price increases represent quality improvements in the product. Automobiles and shoes are examples of current products that are definitely superior to the corresponding 1970 products. In the case of electronic products, price reductions have accompanied improved quality, so if you acknowledge quality improvements, prices should be shown to have fallen even
The second principal problem with the CPI is the difficulty of introducing new products, such as smartphones. Some recent estimates claim that the CPI overstates inflation by as much as a full percentage point or even a point and a half each year, and when payments are indexed to the CPI, this becomes a significant issue over time.

The producer price index (PPI) is the second most frequently used price index. Like the CPI, the PPI is based on a market basket made up of goods and services bought by firms; in other words, they are intermediate, not final products. The PPI's earlier name was the wholesale price index, which is a bit clearer about this. The PPI is watched closely, because if it begins to rise, can the CPI be far behind?

Down, Down, Down . . .

The rate of unemployment is one of the most visible and important indications of productive capacity utilization and also of social health. The calculation of the rate is quite straightforward: divide the number of unemployed people by the size of the civilian labor force. But of course, it is not quite that straightforward. Beginning with the denominator of the ratio, who is in the civilian labor force? Everyone who is sixteen years old or older and employed or actively seeking work in the past four weeks. Since we explicitly are talking about the civilian labor force, it excludes the one and a third million people on active duty in the military and all institutionalized persons. Among the institutionalized, the number of prisoners in the United States doubled between 1987 and 1997 and in 2013 numbered 2,220,000. Although the numbers declined slightly in the last couple of years, we are still the world's leader! Women were only 7 percent of the prisoners, but their number is growing faster than the number of men.

One final note on the definition of the labor force: those over sixteen years of age neither employed nor actively seeking work in the past four weeks are not considered to be in the civilian workforce. This includes students and retirees who are not working because they are presumably doing something they prefer doing. But it also includes perhaps 300,000 to 400,000 people who had sought jobs but became discouraged and stopped trying to find something decent.

Now let's look at the numerator of the unemployment ratio: the number of unemployed people. Over 6.2 million part-time workers are counted as being employed although they want to work full time. The skilled machinist who lost his job to computerized methods of reconfiguring production machinery is working as a clerk in a liquor store is employed.

Now that we have some idea about the measurement of unemployment, we can explore the different types. The usual distinctions among kinds of unemployment are seasonal unemployment, frictional unemployment, structural unemployment, and cyclical unemployment. Seasonal unemployment, as the name might have suggested to you, bears most heavily on those working in agriculture and tourism. In
addition, there are a range of other specific jobs and places that go through predictable seasonal employment cycles.

**Frictional unemployment** is made up of people temporarily in transition into the workforce and into and out of particular jobs. The following examples all fall into the frictional category. Michael decides that harsh winters are not for him anymore, quits his job, moves to Arizona, and looks for work. Eva tells her supervisor what she thinks of his style of personnel management. Mary and Frank’s book and record shop goes under because a Barnes & Noble bookstore opened down the street. Torsten graduates from college and begins job hunting. Frictional unemployment generally is thought to be a rather benign sort of thing, illustrating both the adjustments necessary to accommodate changes in the economy and the freedom of workers to move from job to job. Nevertheless, better access to information makes the job search more efficient and satisfactory, and there is some hope that online services are beginning to perform that function.

**Structural unemployment** is less nice. This is the type of unemployment that is due to a mismatch between the skills of the workforce and the requirements of the jobs. Structural unemployment is when the technical proficiency required for jobs rises beyond the skills and training of the available workforce. Recruiting, say, foreign nurses and engineers relieves this shortage of trained workers—or at least a shortage at the wages employers are willing to pay.

This process used to be called technological unemployment, but **displaced workers** seems recently to have become the euphemism of choice. Economists argue about the magnitude and implications of this form of unemployment, but there appears to be some agreement that in the past twenty or thirty years, it has affected older workers (over forty) more severely than previously. It is not clear whether this reduced protection from seniority is due to cost-saving efforts, difficulty of training older workers, or what, but it is clear that compared to younger workers, those over forty have more difficulty finding new employment and have to take larger cuts in pay when they do find new work.

Economists usually prescribe retraining and relocation to combat structural unemployment. These are certainly worthwhile endeavors, but they do not guarantee the creation of appropriate jobs.

**Deskilling** is closely related to displacement of this kind. Deskilling occurs when technological changes enable what had previously been workers’ skills to be incorporated into machinery whose operation requires a less skilled worker. A mundane but clear example is the use of bar codes in supermarkets. By this device, stores do not have to pay people for their abilities to know the prices of items, the difference between iceberg lettuce and parsley, or how to make change. Deskilling does not mean that the workers are less skilled; it simply means that the jobs no longer require certain skills and therefore employers do not pay for them. In selected neighborhoods, some grocery stores have taken the next step: customers can check themselves out by using bar code scanners and payment machines. One employee can cover as many

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### Table 4.2 Average Civilian Unemployment Rates in Second Quarter of 2016

<table>
<thead>
<tr>
<th>Category</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total civilian labor force unemployment rate</td>
<td>4.8</td>
</tr>
<tr>
<td>Men</td>
<td>4.8</td>
</tr>
<tr>
<td>Women</td>
<td>4.8</td>
</tr>
<tr>
<td>16- to 19-year-olds</td>
<td>16.9</td>
</tr>
<tr>
<td>Whites</td>
<td>4.2</td>
</tr>
<tr>
<td>Blacks</td>
<td>8.3</td>
</tr>
<tr>
<td>Hispanics/Latinos</td>
<td>5.6</td>
</tr>
<tr>
<td>Asians</td>
<td>3.8</td>
</tr>
</tbody>
</table>


as four checkout stations, and the effect of bar code technology has gone beyond deskilling and become technological unemployment.

The last category is **cyclical unemployment.** As the level of economic activity enters the negative phase of a business cycle, cyclical unemployment rises. In the past twenty years, the peaks of unemployment (corresponding to the troughs of the business cycle) have resulted in unemployment rates close to 10 percent in the early 1980s, almost 8 percent in the early 1990s, and a full 10 percent in 2009. Although these rates include frictional, structural, and cyclical unemployment, only the last accounts for rapid changes in the overall rates. Cyclical unemployment is the type of unemployment that fiscal and monetary policies are designed to offset by stimulating aggregate demand, and table 4.2 shows how unevenly unemployment affects different groups of workers, an unevenness that has proven to be extremely durable.

By adding up frictional, structural, and seasonal unemployment rates (i.e., excluding cyclical unemployment) we get what some economists view as the natural rate of unemployment. (When anybody talks something in the social world “natural,” you should immediately be on your guard.) In any case, the natural rate of unemployment is supposedly the minimum rate possible without setting off inflationary pressures. We discuss the trade-off between inflation and unemployment later in this chapter, but now it is worth noting that just a few years ago, economists who subscribed to the idea of a natural rate of unemployment believed that it was around 5.5 percent of the civilian workforce. This meant that “full employment” was 5.5 percent unemployment, because the remaining unemployment could not be reduced by demand management countercyclical policies without causing substantial inflation. Since the late 1990s and early 2000s the rate of unemployment has stayed well below that natural rate. As I write this paragraph, the U.S. unemployment rate is 4.8 percent. For all intents and purposes, inflation did not rear its ugly head in either time period, and this entire construction has lost some of its appeal.

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### THE TOOLS OF STABILIZATION POLICY

Government authorities often try to influence the turning points of cycles. In the case of an inflationary expansion, the Fed’s monetary policy, especially open-market policy, is the principal way to cool down an overheated economy. By selling govern-
ment bonds in the financial market, the Fed reduces the amount of loanable funds available and raises the price of borrowing (interest rates). After some point, this tightening of financial markets dampens both investment and consumption expenditures and at least reduces the rate of growth of aggregate demand.

On the other hand, monetary policy is less likely to be effective in stimulating the economy than in reining it in. Fed policy that increases the amount of loanable funds and reduces interest rates is merely permissive: it allows people to borrow at lower costs, but the current situation perfectly illustrates the limits of monetary policy. Firms have idle productive capacity and are wary of expanding; lenders are gun-shy from experiencing recent high rates of loan gone sour; and consumers are worried about the security of their employment and the payment of debts undertaken in better times. In these conditions, lower interest rates are not a powerful inducement to increase spending, and in any case, the Fed has already lowered interest rates until they are approaching zero. There are a number of aphorisms that usually appear in textbooks to illustrate the asymmetry of monetary policy. One of the most common is "You can lead a horse to water, but you can't make him drink."

The Fed's restrictive policies, however, really do raise the cost of doing business and buying new consumer goods, and they do so in a very definite, tangible manner. This asymmetry does not weigh too heavily on the Fed, because it has historically been much more concerned about the dangers of inflation than the effects of recession and unemployment. Since the gradual recovery from the Great Recession, however, coupled with the paralysis of Congress, the Fed has diligently attempted to stimulate the economy through monetary policy. As expected, its effects have been modest, and after driving interest rates almost to zero, its room to make additional efforts is limited.

Government fiscal policy has been the main post-World War II tool for responding to serious recessions, but there are political problems. The 1960s were the high-water mark for optimism about controlling the economy through Keynesian-inspired policies, which were portrayed as being administered by neutral technocrats insulated from the irrational or narrowly self-serving resistance of the beleaguered. By the 1980s and 1990s, however, changes in the relationship between inflation and recession, together with increasing global economic interdependence, strengthened general skepticism about the place of government macroeconomic stabilization policy in our society. In addition, politicians from both parties competed with each other in condemning "big government" (federal expenditures) and budgetary deficits. This leaves tax cuts sounding as though they are the only legitimate antirecession fiscal policy.

Fiscal stimulus is not the only reason elected officials are fond of repeated tax cuts. These gifts can be targeted to help friends, family, campaign donors, potential employers, certain constituents, and so on. Moreover, large tax cuts not only restrain the growth of government, they pressure government to downsize. Conservatives have called this strategy "Starve the Beast." As noted earlier, it pleases those who wish to have few restrictions on their activities, have an underdeveloped sense of community, and are able and willing to stay in the private sector for such services as health, education, security of persons and property, transportation, and recreation.

Both monetary and fiscal policies have serious lags in their effects. These lags have led some economists to claim that discretionary government stabilization policies have, on balance, been destabilizing. They argue that by the time the effects of monetary policy or fiscal policy are registered, the economy often has already turned around and that the policy thereby ends up exacerbating the direction of an already-existing upswing or downswing.

A NEW DYNAMIC?

Policy makers do have to worry about lags, crowding out, and an overbearing federal government, but there are a couple of other less discussed sources of concern about the efficacy of discretionary government stabilization policies. The first source stems from the U.S. economy behaving in ways not expected by the conventional notion that inflation is the consequence of too much aggregate demand and that recession is the mirror image—the result of too little aggregate demand. This notion has governed our entire discussion so far. The second set of doubts is based on the suspicion that the greater integration of international product and financial markets has changed national economic circumstances in ways that substantially dilute the
effectiveness of demand management policies in influencing domestic levels of economic activity.

The standard reading of demand-based causation for inflation and recession implies that public policy must guide aggregate economic performance along the very narrow path between the dangers of inflation on one side and recession on the other, and that there were definite trade-offs between the two. That is, the cost of full employment was the toleration of some inflation, and the cost of no or slight inflation was tolerating some underutilization of productive capacity, most notably registered as unemployment. This conception was graphically expressed in the Phillips curve. Figure 4.2 is a Phillips curve based on observations from the 1960s, and it indicates the expected negative relationship between inflation and unemployment.

The problem is that the U.S. economy has generated two kinds of anomalies that undermine the idea of an orderly universe in which the relationships between inflation and unemployment are regular, stable, and inverse. The first aberration was that the U.S. economy went through a couple of periods of simultaneous inflation and recession called stagflation.

Stagflation had been a regular feature of the economic landscape in several Latin American nations (especially Brazil, Argentina, and Chile) throughout the post–World War II decades, but it was not evident in the United States until the late 1950s. Its first appearance lasted only a short time, however, and in the 1960s, the economy acted in ways that at least in retrospect appeared reasonable in terms of the conventional ideas of excess or insufficient demand. Stagflation came back with a vengeance, however, in the 1970s, and it was more sustained. A decade of a more “normal” inflation-versus-recession relationship again followed in the 1980s, when public policy deliberately created a severe recession with high rates of unemployment that succeeded in breaking inflation.

A new anomaly appeared in the 1990s. Instead of the aberrant appearance of inflation and unemployment together in stagflation, we saw the aberrant absence of both inflation and unemployment. During most of the 1990s and the early 2000s, the U.S. economy grew vigorously with very low rates of unemployment and inflation.

These aberrations are not completely mysterious: I suggested one possibility for the stagflation of the late 1950s. The strongly oligopolized core manufacturing sectors (steel, chemicals, paper, automobiles, cleaning agents, breakfast cereals, soft drinks, electrical appliances, cigarettes, and so on) in the late 1950s with their highly organized workforces were in a position to use their market power to push prices up to the point that the majority of the population, who did not possess the requisite market power to keep up, had to reduce their demand for the higher-priced articles. This led to unemployment and recession within the same years as the higher prices (inflation) that caused them. Ergo, stagflation.

The stagflation of the 1970s was probably due to the supply-side shock of OPEC’s oil embargo and subsequent quadrupling of the price of petroleum. Again, this was a bald use of market power on the supply side, this time to increase the price of one of the chief sources of energy as well as important ingredients of fertilizer, paints, and many chemicals and plastics. This price hike led to inflation as producers in a wide range of markets struggled to recover their newly risen costs, and consequent market disruptions led to bankruptcies, unemployment, and recession with higher prices.

There are plausible explanations for stagflation and the 1990s experience with low unemployment and inflation, but these explanations do not fit comfortably into either Keynesian or other standard views of how the economy works. These issues raise the possibility that the underlying logic of the economy is shifting away from that taught to economists in graduate school and with little or no change are still being passed on to undergraduates.

Turning now to the second source of concern about stabilization policy, remember that in discussing table 4.1, I commented on the declining price of apparel due to the availability of inexpensive imports. I explore the international economy at greater length in chapters 5 and 6, but here I list some of the factors thought to have created the propitious low-inflation and low-unemployment circumstances of the 1990s and at the same time, weakened national demand-management modes of stabilization policy.

The heightened price competition from international production has not been restricted to shirts, shoes, and whatever; it includes serious foreign competition in such goods as electronics, automobiles, raw materials, steel, and other products formerly produced by U.S. oligopolies. This competitive pressure keeps down the domestic prices of goods, while the prices of several services (notably medical services) do rise. Foreign producers are not the only ones using foreign low-wage labor, and many of the foreign plants sending goods to the U.S. market are directly contracted, owned, and even operated by U.S. firms (e.g., Apple and iPhones). Employers’ threats to send their production offshore is real and plausible and U.S. wages have stagnated, relieving employers of the cost-push wage demands of the 1950s.

Price competition in the goods and labor markets underlay the expansion in the 1990s that dampened the inflation-unemployment trade-off, and the increased concentration of income among the top income receivers generated increasing income-tax revenues that created federal budget surpluses. The Fed’s low interest-rate policy, promoted by the then-Fed–chairman Alan Greenspan, created easy credit, and the world was awash in financial capital seeking short-term profits throughout the world. In addition, both Bush administrations’ federal deficits (which Republicans supported until they were in the minority) provided a fiscal stimulus that helped sustain general economic expansion, with a short setback when the technology bubble popped in 2001.

But the new economic international integration also reduced the effectiveness of domestic demand-management tools. On the fiscal policy side, as imports became larger proportions of U.S. purchases, more and more of any increase in domestic demand leaks off to foreign producers instead of stimulating local production and employment, weakening the multiplier and accelerator. As exports become higher proportions of domestic firms’ production, local production and employment respond increasingly to demand in foreign economies and less to domestic U.S. demand.
On the monetary policy side, as barriers against the instantaneous movement of financial capital decline and the volume of footloose capital seeking the highest short-term rates of return rises, the Fed has less control over U.S. financial markets. Global financial markets increasingly gain influence over the volume and the terms (interest rates) of loanable funds available to U.S. borrowers.

For example, the Fed’s efforts to raise short-term interest rates between late 2004 and mid-2006 did not lead to the expected rises in long-term rates. That was, in part, because the Chinese and Japanese governments invested so much money in long-term U.S. government bonds that they were keeping the bonds’ prices up (and thus the yields/interest rates low), and in integrated financial markets, it holds all long-term rates down, including those for mortgages. The East Asians’ purchase of U.S. Treasury bonds began to slow down in early 2006, but by then, low threats of domestic inflation led the Fed, with its confidence in the self-correcting abilities of financial markets, to be less interested in putting on the economy’s brakes.

**FINANCIAL CRISIS**

So how did these new circumstances lead to the economic meltdown that began in late 2008? Deregulation of both the overt and covert varieties are certainly part of the story, although the real question is why would tighter controls have been necessary? In a world of low interest rates, banks, mortgage companies, insurance companies, and a myriad of other financial institutions sought higher returns than were available in traditional markets. Writing mortgages for higher-risk borrowers looked to be an attractive way to increase returns on lending, and there was an increase in subprime mortgage lending.

More to the point, once financial institutions made a mortgage, instead of holding on to it, they combined it with whole and pieces of other mortgages into financial instruments known as derivatives. The name comes from the fact that the value of the assembled financial instrument is derived from its underlying asset—mortgages in this case. The process of creating these financial instruments is called securitization, and issuing firms marketed these new, unregulated derivatives primarily to pension funds, hedge funds, mutual funds, and other financial enterprises.

The derivatives were not traded openly in transparent markets that informed investors as to their market value, but the peddlers of sliced and diced derivatives assured investors of their worth by having them rated by one of the major credit rating firms. Fitch Ratings, Standard & Poor’s, and Moody’s Investor Service are the three major firms that rate the creditworthiness of all sorts of debt and investment vehicles, and they operate essentially as high-profit oligopolies. Even worse, however, is that the issuers of the financial instruments to be rated directly pay the credit rating firm for the service. If the issuer does not like the rating, the rating firm loses a customer, which is pure conflict of interest. In addition, it is difficult and expensive to conduct authentic due diligence with these complex financial innovations. But at the time, the issuers of derivatives were not unhappy with the ratings received by their derivatives, because the credit rating firms did not hesitate to assign top ratings (AAA, Aaa) to these poorly understood derivatives.

Much of the investment in derivatives and swaps was done with massive volumes of borrowed money. The Republican Congress, allied with some leading Democratic senators, explicitly excluded the new financial instruments from regulation, and in 2004, the Securities and Exchange Commission (SEC), under pressure by the investment banks, relaxed a 12-to-1 debt-to-equity limit for the five largest investment banks—Goldman Sachs, Morgan Stanley, Lehman Brothers, Bear Stearns, and Merrill Lynch—and the ratios rapidly rose to what was called “highly leveraged.” The riskier way to be highly leveraged is to have your debt in short-term loans while your assets, like derivatives, are long-term and of dubious liquidity. Lopsided mazes of money using that business model.

So there are the initial derivatives, which are bets on the solidity of the mortgages even though it is difficult to figure out how many and which mortgages are in the derivative. There are more layers of derivatives, including credit default swaps that essentially insure investments in derivatives, for a price. The last, insurance-like derivatives were a way to insure one’s investment in derivatives and enabled bets against mortgage-based derivatives, and several institutions, notably Goldman Sachs, began to bid against derivatives in 2007 if not before, while still creating and selling them to their clients.

The financial markets did not have a monopoly on all the loose and crazy activities and extravagant voracity that was going on. For example, cheap credit fueled several high-profile and misguided takeovers that involved firms that actually produced something of worth, and even such buyout artists as Kohlberg, Kravis, Roberts (KKR), Warren Buffett, Texas Pacific Group, and the private equity arm of Goldman Sachs got burned. I have focused on the financial markets, because that is where the meltdown began.

The whole house of cards, or rather the section of the house of cards that I’ve been describing, was based on the continuing rise of housing prices. Everyone, financial professionals and amateurs, “knew” that housing prices were going to continue to rise, and with few exceptions they all piled on. Once the price of the overbuilt housing sector began to soften in 2006 and 2007, it frightened investors so badly the same herd instinct caused a stampede for the exits, exacerbating the collapse. Credit markets froze, and the value of derivatives, always murky, dropped precipitously as the underlying mortgages became shakier and foreclosures rose. With no markets for derivatives, those holding them could not sell them in order to pay the short-term debts incurred to buy them.

Despite some propping up by the Fed, Bear Stearns collapsed in early 2008, and the Fed bribed JPMorgan Chase to take it over and dissolve it. In a controversial decision, Bear Stearns’ creditors were paid 100 percent of what was owed them; after all, there is no point in having to share the pain when friends are in charge of the
public purse strings. There continue to be criminal investigations about Bear Stearns’ accounting practices used during its last year or so.

September 2008 was a very exciting month. Lehman Brothers was similar to Bear Stearns in that it was over leveraged at over 30 to 1, and in September 2008, it collapsed. Federal officials decided to let it go through a regular bankruptcy and liquidation without federal help, and the case will be fought over in the courts for years.

Merrill Lynch hit the wall and was sold to the Bank of America. Bank of America shareholders accuse Bank of America executives of concealing how awful Merrill Lynch’s assets had become and that the failing institution intended to pay large bonuses to its failed executives.

This disagreement is mild compared to the machinations around the almost crash of the American International Group (AIG), the nation’s largest insurance company. It had issued over $440 billion worth of derivative guarantees, and since the underlying CDOs were tanking, the holders of the guarantees demanded payment on their insurance policies. In September 2008, AIG ran out of cash and sources of credit, until Congress passed a bill to bail them out to the tune of $85 billion. This turned out to be the down payment of an eventual AIG bailout of $170 billion.

There are several items about this to mull. Much of the money went directly to the investment banks holding the swaps, once again paying creditors 100 percent of what was owed them. Goldman Sachs received the largest share, and the SEC is investigating how Goldman Sachs could have issued so many severely flawed CDOs unless they were doing so only to bet against them. Legislators said that Timothy Geithner, former president of the Federal Reserve Bank of New York and secretary of the treasury in the Obama administration, failed to tell them that the $85 billion bailout of AIG was in effect a backdoor way to send more money to the big investment banks, and they were downright impolite to the secretary in Congressional hearings.

Two weeks after the $85 billion bailout, AIG threw a $440 million party at a California resort for their top executives. After all, they did have something to celebrate. In early 2009, AIG announced that it was awarding $165 million in bonuses to top executives. AIG backed down a bit after the uproar from politicians and the public, but its tone deafness persevered into early 2010. This time it planned $100 million in bonuses, including to executives in the financial products division to reward and retain them for almost bringing the firm down. There are also continuing criminal investigations of AIG’s founding CEO and other former executives.

Also in that busy September, Washington Mutual was seized by its regulator when depositors withdrew $16.4 billion in ten days. The FDIC took receivership of the bank and sold it and its assets to JPMorgan Chase. Washington Mutual’s shareholders sued the FDIC for what they claim was an unnecessary seizure and for selling Washington Mutual to JPMorgan Chase at fire-sale prices.

Finally in September 2008, federal agencies took direct control of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The federal government had sponsored the two companies in 1968 to guarantee mortgages in order to help people obtain less expensive mortgages, but they had been operating as semiautonomous entities. At the time of the takeover, Fannie Mae and Freddie Mac guaranteed or owned about $6 trillion of home loans, around one-half all U.S. residential mortgages, and they were in perilous financial shape.

In an effort to make bailout policy more expeditious, consistent, and coordinated, Secretary Paulson convinced Congress to pass the Emergency Economic Stabilization Act (October 3, 2008). The act set up the Troubled Asset Relief Program (TARP) with $700 billion to inject into financial institutions at the discretion of the secretary of the treasury. Secretary Paulson’s initial approach was to use the funds to buy toxic (“troubled”) assets to inject liquidity and remove them from banks’ balance sheets—hence the name of the program. Soon he came around to his colleagues’ views and began to supply liquidity to the institutions by acquiring equity in the firms, and so taxpayers became part owners of firms rather than owners of financial assets no one wanted. While there is some dispute about this, it seems as though the federal government actually made some money from their investments.

The criteria for selecting banks for TARP support remained a bit vague, and more than 16 percent of the total went to General Motors and Chrysler—remember that aspect of the mess? Anyway, in regard to banks, one criterion appears to be to finance stronger banks to take over shakier ones. “Too big to fail” is another criterion that is definitely on the list. This has raised calls for limiting financial institutions’ size so that if they make too many fatal mistakes, their demise would not present a systemic threat.

There are a number of ways in which this could be done, but the problem is that, encouraged by TARP, consolidation of the financial sector around larger institutions was increasing. We have seen a number of the largest institutions succumb and be absorbed by equally large firms. And below the headlines level, lots of other banks were failing. While there were eleven bank failures from 2003 to the end of 2007, there were twenty-five bank failures in 2008, 140 in 2009. These failures include local banks being taken over by regional banks, and so on. It’s called consolidation.

These growing financial institutions are not only too big to fail, they are also too politically connected to jail or be broken up, and they have no incentive to change the behaviors that created the crisis. To the contrary, they now know that the federal government believes that they have to be bailed out when their moneymaking casino ways don’t work, and when those activities do work, there’s lots of money to be made. Not a bad deal for them, but not for taxpayers.

THE GREAT RECESSION

Prediction is not easy, and there were official denials in a couple of stages about the housing bubble. In the first stage, Fed Chairman Alan Greenspan and his successor, Ben Bernanke, denied that the extreme price increases in housing were a bubble that needed attention. In the second stage, both Ben Bernanke and Treasury Secretary
Chapter 4

Henry Paulson denied in 2007 that the gathering problems in the mortgage-backed securities market would negatively affect the wider economy.

But problems in the mortgage-backed securities market did happen and did grievously affect the wider economy. From the second quarter of 2008 to the second quarter of 2009, the GDP experienced an average of almost 4 percent a quarter of negative growth (that's really how they say it). Growth became slightly positive in the third quarter of 2009 and stronger in the fourth quarter. With total job losses around 8,000,000, unemployment rose to over 10 percent, and between October 2007 and the low point in March 2009, the prices of stocks listed on the New York Stock Exchange declined over 50 percent. That is why it was called the Great Recession.

The first major legislative effort to stem the downward spiral was the Stimulus Act of February 2008. Although this was an initiative of the Bush administration, a minority of Republican lawmakers and a majority of the Democrats supported it. The act cost around $152 billion, and its principal provisions were to send rebates to most taxpayers and some tax incentives for businesses. I suppose it could be regarded as a semi-Keynesian measure, but it had little discernible effect.

Then came the Obama administration's American Recovery and Reinvestment Act (the Stimulus) of February 2009. Its $786 billion dwarfs the stimulus act of 2008 but not the TARP. But unlike the TARP, it did not hand out money to friends, neighbors, and colleagues. There was a Keynesian boldness about its emphasis on investments in infrastructure, such as transportation, education, energy, and health, which are intrinsically important. The Stimulus also included the expansion of unemployment insurance and some federal tax cuts. Even by February 2010, when a bit less than half of it had been spent or committed, the nonpartisan Congressional Budget Office reported that the Stimulus had created or saved between 1 and 2.1 million jobs and that GDP growth was between 1.5 and 3.5 percentage points higher than it would have been without the Stimulus.

At one level, this is rather heartening, but there are still serious difficulties. It is not clear that lost jobs will come back. Credit is still not readily available because even financial institutions that received federal bailout money are siting on it rather than lending. Banks have been unwilling to come through on mortgage readjustments, and the potential of continuing foreclosures is unsettling. There is nothing in place to guard against another excess and bust cycle in the financial markets. Federal politics is paralyzed.

The bailout, the Stimulus, and proposals for deregulation of financial institutions have created open and often angry disagreements among economists, and outside the economics profession, many frightened legislators and citizens see efforts to save capitalism to be an effort to destroy capitalism. Echoes of the New Deal.