

Economic Downturns

Suresh Naidu

for the Center for Political Education

Class Outline

Outline: June 9, 2008

- Series Goals
- Guidelines for Participation
- Pair up and discuss: How are you, your families, communities, and neighborhoods impacted by recession/economic downturn?
- Recession, Unemployment and Business Cycles
 - What are they?
 - How do different economists/ideological trends explain theories of the business cycle?
 - Housing in relationship to the current economic downturn
- Policy Making and Government Intervention
 - The Federal Reserve and their role under capitalism
 - Means of controlling inflation and unemployment
- Drawing connections: Housing, Oil and Food Crises
- Class Evaluation

Goals for Housing Crisis and Recession Series

- Understand what recession is, the current economic downturn and the impacts of the current situation
- Understand key economic concepts
- Understand the specific impacts on housing in the Bay Area and around the country
- Learn about community responses and resistance to the foreclosure housing crisis

Guidelines for participation

- Step up, step back.
- Raise your hands, please don't interrupt.
- WAIT (Why Am I Talking?)--thanks to SOUL for this.
- Feel free to ask questions during an appropriate time, but consider whether the question is tangential and can be brought up at a different time or after class.
- Remember our shared interests.
- Respect the facilitators.
- Respect the presenter and the other participants.
- Turn technology to off or vibrate.

Pair up and discuss

- How are you, your families, your communities, and neighborhoods impacted by recession/economic downturn?

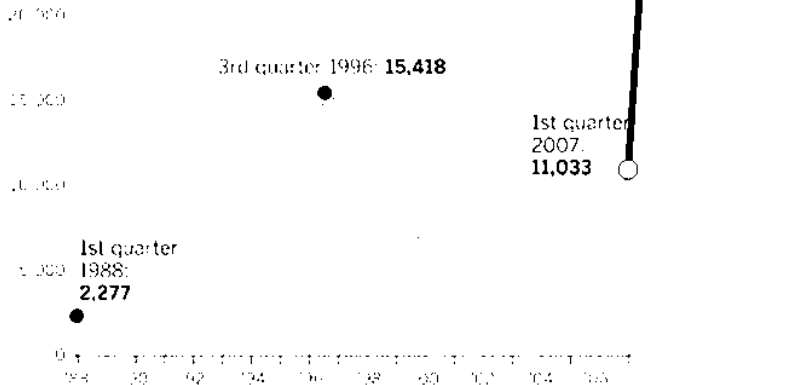
Where we are today?

- Friday June 6th
Unemployment up .5%
 - But lots of new grads entering workforce.
- Oil price hit 140\$ a barrel.
- Dow Jones index of stocks falls almost 400 points (out of ~ 13,000)

Mortgage foreclosures

Home foreclosures are up sharply in California as many borrowers struggle to make higher payments on adjustable-rate mortgages.

Number of foreclosures statewide, quarterly data



Source: DataQuick Information Systems

Los Angeles Times

Some Definitions

Recession, unemployment, and business cycles

- **Business cycle** = 5-7 year swings in the economy from boom (increase) to bust (fall).
- **Asset** = any resource representing future payments
 - E.g. shares in a company, or an owed debt.
- **Mortgage** = loan to buy a house.
- **Interest rate** = rate of repayment on a loan.
- **Commodity** = bulk goods traded on an exchange, generally for cash.
 - E.g. coffee, oil.
- **Future** = agreement to buy or sell something at a time in the future at a pre-specified price.
 - E.g. food futures.
- **Security** = tradable asset
 - E.g. shares in a company. Mortgages. Bonds
- **Bond** = a loan that can be bought and sold.

What is a recession?

- 2 consecutive quarters of lower economic activity (output per person).
- Associated with higher unemployment, lower investment, falling asset prices.
- Generally “Tough Times” - even for the rich.
- Unemployment is really rough on working people (even those who don’t get wages!)
- Are foreclosures the new unemployment...?

What is unemployment?

- **Definition:** When people who want jobs at the going wage are unable to get them.
- **Measured Unemployment** = people who were looking for a job this month but didn’t have one.
 - Doesn’t include prisoners, discouraged workers, “women’s work” (reproductive labor), etc. etc.
- Still the measure of the strength of the economy relevant to most people.
- Later (class #2) we’ll return to how to think about housing in a similar lens.



Are recession and unemployment a bug or a feature of capitalism?

Recession, unemployment, and business cycles

- Depends on who you talk to....
- Some Far Right wingers think they engineer shakeout of lame businesses and industries.
- Other Far Right wingers think they are bad, but caused by the state and regulation.
- Liberals think they are bad, but that the government can manage them.
- Classic Marxist critique is that cycles are endemic to capitalism, and can't be regulated or forever managed by the state.
- Questions...

*Recession, unemployment, and
business cycles*

Why do business cycles happen?

Four competing theories about business cycles:

- **Austrian/Monetarist Right-Wingers:** government control of the money supply causes misallocation of investment
- **“Normal” Right-Wingers:** “technological” changes exacerbated by government policy and unions
- **Liberal-Keynesian:** insufficient investment and demand
 - The standard model the state uses to manage the economy.
- **Radicals:** inherent instability of markets/the capitalist financial system

*Recession, unemployment, and
business cycles*

Liberal-Keynesian theory re: business cycles in a nutshell

- Something random, say “animal spirits,” induces businesses to not invest or people to stop buying.
- Businesses then layoff workers and lower wages.
- This means that there is less demand for products because people are poorer.
- So businesses continue to not invest.
- Needed: a jolt to get people working in order to buy things. The jolt is called “countercyclical fiscal policy” or “stabilizers”. E.G. The New Deal

Jolts: Fiscal Policy options *Recession, unemployment, and business cycles* **during an economic downturn**

- Need to pump money into the parts of the economy that will spend it quickly.
- Options: Tax cuts, food stamps and unemployment benefits, public works, lump sum rebates.
- Congressional Budget Office writes “Food stamps would have the biggest direct impact”
- Instead government goes with lump sum rebates
- At least they didn’t do tax cuts!
- Implicit assumption: consumers, not the government spends
- But if the consumers own debt payments....
Questions...

Prelude: *Recession, unemployment, and business cycles* **What is herd behavior?**

What does this explain? It explains financial crisis

- Herd behavior/Beauty Contests/Fundamental uncertainty.
- Captures the idea that financial markets are volatile and exhibit vast collective stupidity.
- A few people get nervous, pull their money out of an asset, then everyone else gets nervous, and there’s a huge stampede out.
- Similarly, can get bubbles. E.G. excessive investment in dot com
- True about bonds, currencies, housing, stock market.
- Fundamental to the left critique of finance.

Radical theory #1 re: business cycles in a nutshell

*Recession, unemployment, and
business cycles*

- Current Favorite: Hyman Minsky's theory of financial fragility. Marx's theory in Capital actually kind of similar.
- Suppose there's some new innovation that gets investors excited (e.g. dot-com)
- Start seeing herding
- Everyone gets very excited, and lending occurs to people/companies that have high risk of default.
- Debt gets used as collateral for even more debt. (I can use the fact that someone owes me 20\$ as collateral for a 40\$ loan)

Radical theory part 2 re: business cycles in a nutshell

*Recession, unemployment, and
business cycles*

- Then, at some point, somebody asks for the debt to be repaid.
- Finds out it can't be repaid. Then they can't repay their own debts.
- Financial system unravels. Everyone is defaulting and selling off their assets. Asset prices fall.
- Businesses start going under, output, investment, and employment falls.

Questions...

Regulation As a Damper on Crisis

*Recession, unemployment, and
business cycles*

- In light of potential for herding....
- Demand more regulation of financial companies to prevent excessively risky loans.
- E.G. Regulation on hedge funds and investment banks.
- If the state is going to bail them out, it should be able to tax and regulate them.
- But financial wizards are remarkably good at figuring out how to get around regulation.
- And the political power of finance deters regulation. (e.g. Spitzer)

Boom part of the biz cycle: herding, finance, and housing

*Recession, unemployment, and
business cycles*

- Dot-com was part boom, part bubble.
 - Some seriously productive new technologies.
 - Some pure hype.
- Housing prices started going up because some people were richer.
- After dot-com bust, interest rates kept low by the Fed.
- This means that investors can keep borrowing money.
- This money goes into the housing market (classic herding)

Finance and Housing

Housing and economic downturn

- A lot of lending to the financially insolvent.
- Housing market tied to a complex financial market of mortgages.
- Those loans get repackaged and used as collateral for more loans.
- Bad regulation means nobody is checking for the underlying chance of default.
- Some people realize they can't make their mortgage payments.
- Default on mortgages and then foreclosure.
- Defaults bubble throughout the financial system.
- We will talk much more about this in the next class on June 23rd (so come back!).

Ok, we have crisis. Who you gonna call? The Fed! *The Federal Reserve*

- Q: What does the Fed do?
- A1: Regulates the health of the financial system
- A2: Stimulates or reduces investment by managing money supply using 3 (now 4!) tools.
 - Open Market Operations
 - Discount Rates
 - Reserve Requirements
 - New! Temporary Auction Facility
- Uses control of the interest rate facing banks.
- This is called monetary policy.

What is the Federal Reserve?

- Founded in 1913 to regulate national banks and govern money supply.
- Supposed to be independent of any political party.
- Chair appointed for 14 year terms.
- Key body is the Federal Open Market Committee (FOMC).
- Meets every 6 weeks to decide what the interest rate should be.
- Decisions by FOMC are made by consensus, though Chair mostly gets his/her way.

How does open market operations work?

- The Fed regulates the amount of cash big banks have to borrow and lend.
- Open Market Operations allows the fed to buy and sell bonds to banks.
- Fed buying a bond increases the amount of cash that banks have to lend.
- Selling a bond decreases the amount of cash that banks have to lend.

Discount rates and reserve requirements

- **Discount Rate** = the rate at which the Fed can directly loan money to banks. This happens through the regional Discount Windows.
- **Reserve Requirements** = a regulatory tool the Fed has. It lowers the amount that banks are mandated by law to keep in reserve, increasing the amount available for them to lend.

Summing up Monetary Policy

- If the Fed wants to “stimulate” the economy it increases the cash that banks have available to lend for investment.
 - A) Buys bonds from them,
 - B) Allows them to borrow from the discount window,
 - C) Lowers reserve requirements
- This is what “lowering the interest rate” does.

Questions...

Why does lowering the interest rate increase output and employment?

The Federal Reserve

- Lower interest rate = increased ability of capitalists to borrow from banks and invest.
- “Invest” here can also mean buy other stocks and assets (e.g. housing! Or oil and food)
- The theory is that investment would eventually lead to higher output and employment.

Why doesn't the Fed always stimulate the economy?

Introducing Inflation

- The other job of the Fed is to keep inflation down.
- Too much expansion of credit (money circulating) can lead to inflation (higher prices).
- So what?

What is inflation?

- Means prices are going up
- Possible causes:
 1. Wage inflation: The economy is growing and workers are demanding higher wages (normal times)
 2. Supply shock inflation: The price of certain critical goods is rising
 3. The government increases money supply.
- Inflation also depends crucially on “expectations”.

Expectations

- Inflation depends on beliefs about the future or “Expectations”.
 - This explains why the Federal Reserve tries to move quickly and surprisingly.
 - Otherwise, people will start raising their prices, anticipating that the Fed will lower interest rates and cause inflation.
 - Tends to happen when prices are “sticky” (e.g. unions, oil cartels, construction)
 - Therefore businesses don’t invest, because the “real” interest rate (taking into account the effects of inflation), is still high.
 - Like pushing on a string
- Questions...

An example

- E.g. Union contracts are often indexed to inflation. So if unions are really scared about future inflation, they'll write in higher wage increases in the future.
- This means that firms will pass some of that along in higher prices in the future.
- So this increases inflation fears for other unions, who will demand higher wages in their future contracts.
- The spiral continues....called wage-price spiral.
- But what if there are no more unions....
- Questions...

Why do rich people really hate inflation?

- Why? It reduces the value of future investments, in particular savings.
- Rich people have lots of investments.
- These will be worth a lot less in the future if the inflation rate rises.
- Financial capitalists, in particular, really hate inflation.
- Inflation is a giant tax on finance.
- Example: stocks.
- However, good for people in debt. (E.G. Student loans)

What is the relationship between employment and inflation?

Inflation

- Higher employment means wages are higher.
- This makes firms raise their prices-inflation!
- Means there is a contradiction between high employment and low inflation.
- Higher employment → higher wages → higher inflation (prices)

Return to The Fed

The Fed & Inflation

- Fed's job is to "balance" unemployment and inflation, using the interest rate.
- Fed tends to be more hostile to inflation than unemployment.
- Real capitalists likely to keep investing in plants and equipments, and create jobs, despite substantial increases in inflation.
- Radical economists tend to believe that the US economy can handle substantially more inflation than it has.
- The anti-inflation view reflects class interest of finance capitalists.

Questions...

Summing up current actions to deal with economic downturn

The Fed & Inflation

- When faced with a potential economic downturn, the Fed can use control of the money supply to stimulate investment.
- However, the risk is inflation.
- The political power of financial capital (e.g. private banks) in the Federal Reserve is an obstacle to risking high inflation and preventing a downturn.
- Similarly, finance resists regulation.

International Dimension

The Dollar in the World

- Unfortunately, there's no time to really get into international dimensions.
- If you've left the country in the last little bit you know the dollar isn't doing so well.
- Reason: U.S. crisis has triggered fears among foreign investors.
- They pull money out of the U.S., exchanging lots of U.S. dollars for foreign dollars.
- Lowers the exchange rate (price of U.S. dollars in foreign dollars).
- Means have to spend a lot more U.S. dollars to get foreign dollars.
- Equally, foreigners have to spend a lot less of their money to buy U.S. things.
- This is good for US exports, although tourism sucks for people from the U.S.
- Means Canadian tourists are going to invade!!! Auggh!

How are things related: housing, food and fuel

Drawing Connections

- Housing bubble collapsing.
- This is leading to lots of defaults on mortgages and loans.
- Government response is to lower interest rates.
- This induces investors to keep borrowing and invest in something new.
- This induces herding on Oil and Food futures.
- These are seen as guaranteed profit because there is real scarcity.
- Herding perhaps responsible for some (don't know how much) of the increase in oil and food prices.
- The rest of the increase is probably real scarcity (e.g. climate change, global economic growth).

Summing Up the Current Situation

In Conclusion

- Preconditions for this crisis:
 - Insufficient regulation of finance
 - Finance capital's natural tendency for herding
 - It may have been propped up by the federal reserve's low interest rates

Perhaps we're out of the woods because the Fed is willing to risk inflation and the wrath of finance to keep output and employment high.

Exactly how willing are they....?

- Questions...