Financial Crises, Stabilization, and Deficits

CHAPTER OUTLINE

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Stocks and Bonds

**stock**  A certificate that certifies ownership of a certain portion of a firm.

*An increase in the value of an asset.*

**capital gain**  An increase in the value of an asset.

**realized capital gain**  The gain that occurs when the owner of an asset actually sells it for more than he or she paid for it.

The total return that an owner of a share of stock receives is the sum of the dividends received and the capital gain or loss.
Determining the Price of a Stock

One thing that is likely to affect the price of a stock is what people expect its future dividends will be. The larger the expected future dividends, the larger the current stock price, other things being equal.

The farther into the future the dividend is expected to be paid, the more it will be “discounted.” The amount discounted depends on the interest rate. The higher the interest rate, the more expected future dividends will be discounted.

Aside from the interest rate, the discount for risk must also be taken into account. People prefer certain outcomes to uncertain ones for the same expected values.

The price of a stock should equal the discounted value of its expected future dividends, where the discount factors depend on the interest rate and risk.

Stock prices may also depend on what people expect others to expect them to be in the future, bringing about stock market “bubbles.”
Dow Jones Industrial Average  An index based on the stock prices of 30 actively traded large companies. The oldest and most widely followed index of stock market performance.

NASDAQ Composite  An index based on the stock prices of over 5,000 companies traded on the NASDAQ Stock Market. The NASDAQ market takes its name from the National Association of Securities Dealers Automated Quotation System.

Standard and Poor’s 500 (S&P 500)  An index based on the stock prices of 500 of the largest firms by market value.
FIGURE 15.1 The S&P 500 Stock Price Index, 1948 I–2012 IV
FIGURE 15.2 Ratio of After-Tax Profits to GDP, 1948 I–2012 IV
Housing Prices Since 1952

▲ FIGURE 15.3  Ratio of a Housing Price Index to the GDP Deflator, 1952 I–2012 IV
Household Wealth Effects on the Economy

Much of the fluctuation in household wealth in the recent past is due to fluctuations in stock prices and housing prices. When housing and stock values rise, households feel richer and they spend more.

An increase in stock prices may also increase investment. The cost of an investment project in terms of shares of stock is smaller the higher the price of the stock.

Financial Crises and the 2008 Bailout

In a financial crisis, macroeconomic problems caused by the wealth effect of a falling stock market or housing market are accentuated. Many people consider the large fall in housing prices that began at the end of 2006 to have led to the financial crisis of 2008–2009.
The federal government bailed out most of the large financial institutions experiencing financial trouble in the mortgage market—a $700 billion bailout bill that was passed in October 2008. The Federal Reserve also participated in the bailout by buying huge amounts of mortgage-backed securities.

These bailouts lessened the negative wealth effect but had bad income distribution consequences.

**Asset Markets and Policy Makers**

Policy makers’ ability to stabilize the economy is considerably restricted by the fact that changes in asset prices affect the economy and are not predictable.

In 2010 a financial regulation bill, known as the Dodd-Frank bill, was passed to try to tighten up financial regulations in the hope of preventing a recurrence of the 2008–2009 financial crisis.
Depositors in Cyprus End Up as Shareholders!

When people deposit money in banks, bankers hold some in reserve, but lend out the rest, earning interest in excess of what they have to pay those depositors.

In the case of the Cypriot banks, many of the loans went to businesses in neighboring Greece. But in the period 2012 and 2013, many Greek businesses failed and took with them the Cypriot bank investments.

With the Bank of Cyprus in need of recapitalization, bank depositors from outside Cyprus were forced to help.

The government of Cyprus decided to wipe out 40 percent or more of the largest deposits on the books of the banks, offering these largest depositors hard-to-trade and perhaps worthless shares of stock in return.

THINKING PRACTICALLY

1. When the Central Bank “took” part of large depositors’ accounts, what happened to the reserves needed for the bank?
**Time Lags Regarding Monetary and Fiscal Policy**

**stabilization policy**  Describes both monetary and fiscal policy, the goals of which are to smooth out fluctuations in output and employment and to keep prices as stable as possible.

**time lags**  Delays in the economy’s response to stabilization policies.
Path A is less stable—it varies more over time—than path B. Other things being equal, society prefers path B to path A.
Attempts to stabilize the economy can prove destabilizing because of time lags. An expansionary policy that should have begun to take effect at point $A$ does not actually begin to have an impact until point $D$, when the economy is already on an upswing. Hence, the policy pushes the economy to points $E'$ and $F'$ (instead of points $E$ and $F$). Income varies more widely than it would have if no policy had been implemented.

\[ \text{FIGURE 15.5} \text{ Possible Stabilization Timing Problems} \]
Recognition Lags

**recognition lag** The time it takes for policy makers to recognize the existence of a boom or a slump.

Implementation Lags

**implementation lag** The time it takes to put the desired policy into effect once economists and policy makers recognize that the economy is in a boom or a slump.

Response Lags

**response lag** The time it takes for the economy to adjust to the new conditions after a new policy is implemented; the lag that occurs because of the operation of the economy itself.
Response Lags for Fiscal Policy

The government spending multiplier measures the change in GDP caused by a given change in government spending or net taxes. Because it takes time for the multiplier to reach its full value, there is a lag between the time a fiscal policy action is initiated and the time the full change in GDP is realized.

In practice, it takes about a year for a change in taxes or in government spending to have its full effect on the economy.

Response Lags for Monetary Policy

Monetary policy works by changing interest rates, which then change planned investment.

The response lags for monetary policy are even longer than response lags for fiscal policy. When interest rates change, the sales of firms do not change until households change their consumption spending and/or firms change their investment spending.
Summary

Stabilization is not easily achieved even if there are no surprise asset-price changes.

It takes time for policy makers to recognize the existence of a problem, more time for them to implement a solution, and yet more time for firms and households to respond to the stabilization policies taken.

Monetary policy can be adjusted more quickly and easily than taxes or government spending, making it a useful instrument in stabilizing the economy.

But because the economy’s response to monetary changes is probably slower than its response to changes in fiscal policy, tax and spending changes may also play a useful role in macroeconomic management.
Social Security Changes: Long, Long Implementation Lags!

With large and growing deficits, more policy makers are looking at entitlement programs as possible places spending could be cut as a way to control the budget.

In 1983, Congress decided to control Social Security spending by raising the age at which one could retire and receive full benefits.

Such a change was slowly adjusted, two months at a time, until it reached the age of 67 for those born after 1960.

A more recent proposal to trim Social Security expenditures involves changing the way inflation is adjusted for in the benefits. Here too if the proposal is passed, the phase-in will be very slow and substantial spending reductions a long time in the future.

THINKING PRACTICALLY

1. Defense spending is another large fraction of the U.S. budget. How easy is it to reduce this spending?
Government Deficit Issues

If a government is trying to stimulate the economy through tax cuts or spending increases, this, other things being equal, will increase the government deficit.

One thus expects deficits in recessions—cyclical deficits, which are temporary and do not impose any long-run problems, especially if modest surpluses are run when there is full employment.

If, however, at full employment the deficit—the structural deficit—is still large, this can have negative long-run consequences.

The large deficits beginning in 2008 on led to a large rise in the ratio of the federal government debt to GDP. Without significant new measures, the debt/GDP ratio is projected to continue to rise.

Possible negative asset-market reactions may discipline the long-run deficit strategy of the government. If there is a structural deficit problem, policy makers may not have the freedom to lower taxes or raise spending to mitigate a downturn.
Deficit Targeting

Gramm-Rudman-Hollings Act  Passed by the U.S. Congress and signed by President Reagan in 1986, this law set out to reduce the federal deficit by $36 billion per year, with a deficit of zero slated for 1991.

**automatic stabilizers**  Revenue and expenditure items in the federal budget that automatically change with the economy in such a way as to stabilize GDP.

**automatic destabilizers**  Revenue and expenditure items in the federal budget that automatically change with the economy in such a way as to destabilize GDP.
The GRH legislation, passed in 1986, set out to lower the federal deficit by $36 billion per year.

If the plan had worked, a zero deficit would have been achieved by 1991.
Deficit targeting changes the way the economy responds to negative demand shocks because it does not allow the deficit to increase. The result is a smaller deficit but a larger decline in income than would have otherwise occurred.
Deficit targeting has undesirable macroeconomic consequences.

It requires cuts in spending or increases in taxes at times when the economy is already experiencing problems.

Locking in spending cuts or tax increases during periods of negative demand shocks is not a good way to manage the economy.

Moving forward, policy makers around the globe will have to devise other methods to control growing structural deficits.
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