

## **Econ 105: Introduction to Political Economy**

### **Lecture Eighteen: Finance**

1. Money and Banking (Chapter 16)
2. Inflation and the Federal Reserve (Chapter 17)

### **Recap from end of last lecture**

#### **E4E Table 12.2: Understanding investment**

Note that labor and other regulations, tax policy, trade policy and the general political/legal environment are important factors in deciding if capitalists will invest in a certain region or not.

**Capitalists (as we saw in the discussion on the political aspects of full employment) have a very important weapon called capital strike or capital flight.**

They can refuse to invest their capital. Or they can threaten to take it elsewhere. And **since in a capitalist economy, the government usually does not have the resources to generate employment and run an economy without the help of private capital, it must negotiate with the capitalists.**

#### **Capital mobility versus labor mobility:**

This is a key conflict in today's global economy. Thus far, economic globalization has meant freedom of capital to move across the globe as needed, but to a far lesser extent has it meant the freedom of labor to move where it wants.

Why is that?

### **Money and Banking (Chapter 16)**

The “real sector” versus the “financial sector”- what is the difference?

*What is Money?*

Economists define money as anything that is generally accepted in payment for goods or services or in the repayment of debts. It consists of *currency*, but also checking deposits (among others) because you can pay with checks.

Wealth is a different concept—the totality of all pieces of property that serve to store value. Wealth not only includes money but also other assets (bonds, stock, furniture, houses, land, cars etc.)

### *Functions of Money*

**1. It is a medium of exchange.** A medium of exchange is an intermediary used in trade to avoid the inconveniences of a pure barter system (problem of “double coincidence of wants”). It promotes economic efficiency by minimizing the time spent on economic transactions.

**2. It is a unit of account.** A unit of account is a standard numerical unit of measurement of the market value of goods, services, and other transactions.

**3. It is a store of value.** To act as a store of value, a commodity, a form of money, or financial capital must be able to be reliably saved, stored, and retrieved.

While money has existed in one form or another for centuries, in a capitalist economy, it assumes new importance. Its importance is in two key respects:

- a. **It is the goal of production.** Since firms produce in order to make a profit and profit is usually measured in terms of money.
- b. Profit-seeking financial companies (like banks) create money via credit or lending.

The profit-seeking private motives of banks can diverge from the public interest. For example, as with the current recession, in an economic downturn banks fearful of getting their loans paid, actually reduce lending when the economy needs more, not less purchasing power and credit.

In such instances the government steps in to provide credit or liquidity because private motives are not up to the task.

### *What is the financial system?*

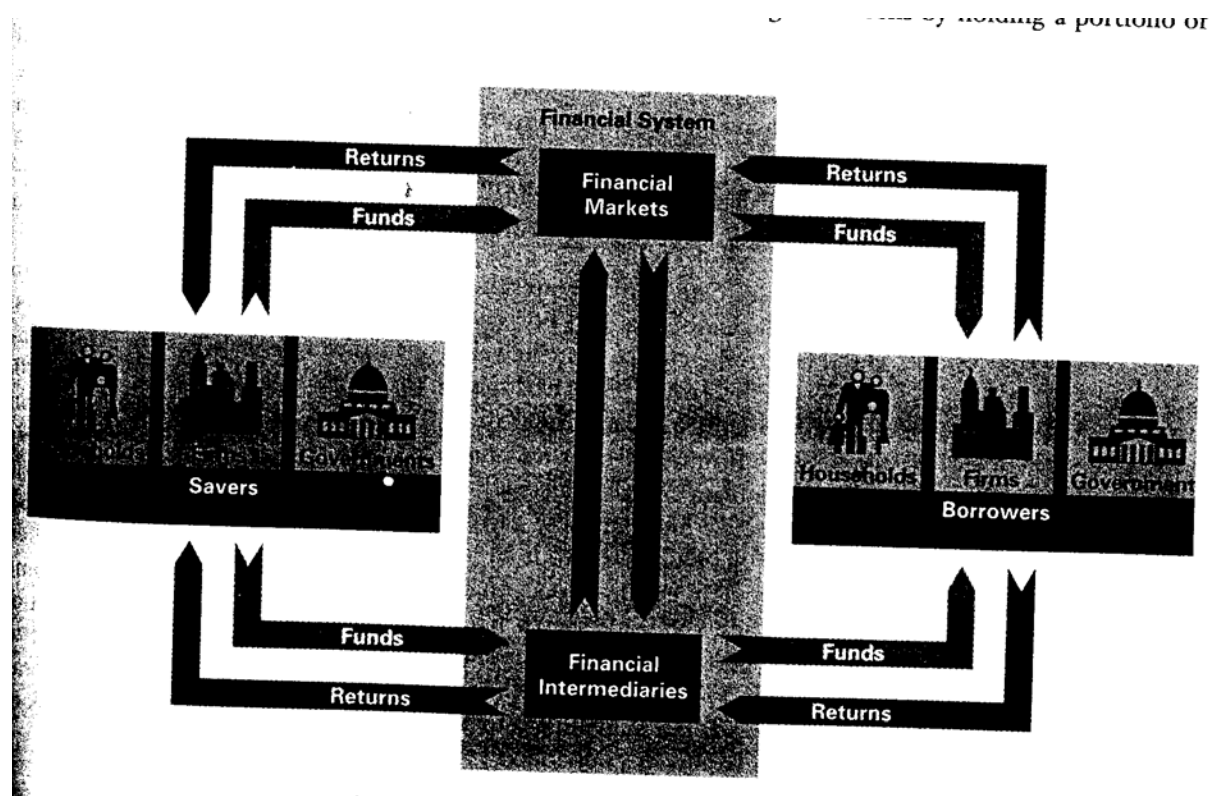
We have heard a lot about the financial system and its faults and the need for regulating it, in the last few months. But what exactly is the financial system and what does it do?

We will not be able to go into the sophisticated details here, but I will present a barebones picture of it.

**Financial markets perform the essential economic function of channeling funds from households, firms, and governments that have saved surplus funds by spending less than their income to those that have a shortage of funds because they wish to spend more than their income.**

Thus finance is valuable only to the extent that it stimulates and facilitates this real production and consumption.

Slide on Financial System (apologies for the quality of the image)



As shown in the figure a financial system consists of **Financial Markets** (viz. bond and stock markets) and **Financial Intermediaries** (banks, insurance companies, pension funds).

**Direct Finance:** Here borrowers borrow funds directly from lenders. The borrower sells a SECURITY or FINANCIAL INSTRUMENT, which is a claim of the lender on the borrower's future income or assets (any financial claim or property that can be owned). Thus a security (stock or bond) is an ASSET for the LENDER but a LIABILITY for the BORROWER.

*Two ways of borrowing:*

### 1. BONDS

One common way in which firms and government bodies raise funds to finance their projects is by issuing a DEBT INSTRUMENT i.e. a BOND. Similarly an individual may raise funds (by incurring a debt) by taking out a MORTGAGE. These are contractual agreements by the borrower to pay the holder of the security fixed dollar amounts (in nominal terms) at regular interval (INTEREST and PRINCIPAL payments) until a specified date (when the bond MATURES). This is the COUPON AMOUNT, a name derived from the pre-computer days when bonds actually had coupons which had to be clipped and sent back to the issuing entity to receive the interest payment (hence the name COUPON-CLIPPERS for people who live off of interest income).

### 2. STOCKS/EQUITY

The second common way of borrowing in by issuing EQUITIES or STOCK. A common stock or simply "stock" represents **a share in the ownership** in a corporation. In other words it is **a claim on the net income (after expenses and taxes) and assets** of a business. Stocks often make periodic payments called DIVIDENDS. Since they have no maturity date, stocks are considered LONG-TERM SECURITIES.

An important difference between BONDS and STOCKS:

A stock is a RESIDUAL CLAIM, i.e. a corporation must pay all its debt holders (e.g. bond holders) before its pays its stock-holders. Unlike a bond, the corporation is not legally bound to pay dividends to its stock-holders.

On the other hand, since a stock is part-ownership, a stock-holder is entitled to a share in the corporations profits while a bond holder simply get the interest already specified on the bond.

**The Stock Market:** Stocks are traded in a Stock Market. The New York Stock Exchange, The NASDAQ, are both stock markets where certain equities are traded in a certain fashion.

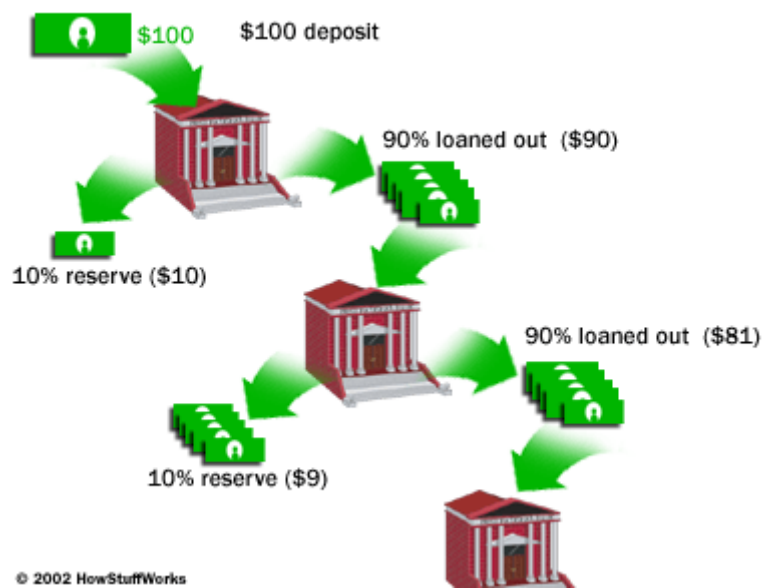
John Maynard Keynes, in his famous book “The General Theory of Employment, Interest and Money,” makes the following observations about the psychology of stock market behavior:

“Decisions to invest in private business of the old-fashioned type were, however, decisions largely irrevocable, not only for the community as a whole, but also for the individual. With the separation between ownership and management which prevails to-day and with the development of organised investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but sometimes adds greatly to the instability of the system. In the absence of security markets, there is no object in frequently attempting to revalue an investment to which we are committed. But the Stock Exchange revalues many investments every day and the revaluations give a frequent opportunity to the individual (though not to the community as a whole) to revise his commitments. It is as though a farmer, having tapped his barometer after breakfast, could decide to remove his capital from the farming business between 10 and 11 in the morning and reconsider whether he should return to it later in the week.”

“Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees.”

### *How is money created?*

The cartoon below illustrates the process of money creation that I described in class.



This cartoon assumes that:

1. Banks are required to hold on to 10% of their deposits, and can loan out 90% (the required reserve ratio is 10%).
2. The public doesn't want to hold currency but rather spends it such that it winds up in some other bank somewhere.

Say an initial \$100 deposits comes into the bank (for e.g. from the Federal Reserve injecting liquidity into the banking system). Since banks do not want to hold excess reserves, but would prefer to earn interest on a loan, bank A gives it out as a loan. With a required reserve ratio of 10% Bank A can give out up to \$90 as loans. The second borrower deposits the check at Bank B. Bank B's deposits go up by \$90 and it can loan up to \$81 (90% of 90). The third borrower deposits the check at Bank C who can loan up to \$72.90 which is again loaned out....and so on.

The total expansion of deposits =  $100 + 90 + 81 + 72.9 + 65.61 + 59.05 + 53.14 + \dots = \$1000.00$ , i.e. ten times the original amount.

## Inflation and the Federal Reserve (Chapter 17)

*What is inflation?*

**Price level: Overall level of absolute prices prevailing in an economy.**

Inflation occurs when the average level of prices in the economy increases over time.

If the prices of every single thing increased by the same amount, would that make any difference? (for e.g. convert everything from dollars to cents)

Then why does inflation matter? Even as overall prices level increases, the prices of some commodities may rise faster than others.

As with all commodities, we can think of inflation-adjusted prices for labor-power as well. This is simply the “real wage.”

**Real wage increase = nominal (dollar) wage increase / inflation**

*Costs and benefits of inflation*

Neoliberal economic policy takes a very dim view of inflation. But the social costs of inflation are often exaggerated.

In general, inflation hurts lenders and those with fixed incomes (retirees for eg) and helps borrowers and those with incomes linked to some inflation index (such as the Consumer Price Index or CPI).

For example, if wages increased exactly in pace with inflation, is the standard of living going up, down or staying the same?

To the extent that the power and influence of the rentier class increases in an economy, inflation becomes more and more of an issue. This is because rentier incomes which mostly derive from interest on investments of various kinds, take hit when money loses its value.

Tomorrow we will take a look at the increasing financialization of the US economy and the rise of rentier capitalism.

*Causes of inflation*

Inflation is a complex phenomenon with many possible causes. Several theories have been advanced by economists to explain what causes inflation.

1. Excess spending (demand-pull)
2. Rising labor costs
3. Rising profits
4. Rising raw-material prices (e.g. oil)

### ***The Central Bank or the US Federal Reserve and Monetary Policy***

In most countries the Central Bank is a very powerful institution with immense influence in the national economy. Even though with increasing global; integration of national economies, the power of Central Banks has diminished somewhat, they still exert influence on key economic variables such as:

1. Money supply
2. Rate of inflation
3. Rate of unemployment
4. Exchange rate

Central banks also regulate the private bank lending and act as a “lender of last resort” during crises.

However usually there is no direct accountability to the population. Is this a problem?

“The Keynesian compromise was centred around macroeconomic policy—specifically the idea that central governments could manipulate their spending levels between fiscal deficits and surpluses (fiscal policy) and could adjust interest rates and the availability of credit (monetary policy) to maintain a level of overall demand consistent with full employment.

But when capitalists came to realize that maintaining some approximation to full employment created too much worker power, they then used these same macroeconomic tools, beginning in the late 1970s, to put workers in their place.

The policy mandarins attempted to conceal this aim amid technical euphemisms about ‘monetarist’ central bank operating procedures and the like.

Thus, Michael Mussa of the IMF, reflecting on the onset of austerity macro policies in the us observed that ‘to establish its credibility, the Federal Reserve had

to demonstrate its willingness to spill blood, lots of blood, other people's blood'. Similarly, the then Federal Reserve Chair Paul Volcker himself said that 'the most important single action of the [Reagan] administration in helping the anti-inflation fight was defeating the air traffic controllers' strike'.