Chapter 30

FINANCIAL INSTABILITY AND ECONOMIC INEQUALITY

Principles of Economics in Context (Goodwin, et al.), 2nd Edition

Chapter Overview

This chapter discusses some of the complexities of real-world macroeconomics by introducing you to two of the key challenges of the current century—financial instability and economic inequality. It begins by reviewing the origins and development of the financial crisis of 2007-8 and discussing the policy responses. It then explains the occurrence of such crisis, in general, based on Minsky's theory of financial instability. The role of deregulation and financialization in increasing the vulnerability of both the real and financial sectors in the U.S. economy is discussed in some detail. A description of some of the key factors contributing to the rising economic inequality in the United States in recent decades is presented next. The final section makes some recommendations on addressing macroeconomic instability and economic inequality. The debate over policy responses continues, and this chapter provides you with the background you need to assess the current state of macroeconomic policy.

Chapter Objectives

After reading and reviewing this chapter, you should be able to:

1. Describe the underlying causes of the 2007-08 financial crisis and explain the severity and impacts of the crisis.
2. Describe the major fiscal and monetary responses to the crisis.
3. Understand the role of deregulation and financialization in increasing the vulnerability of the real and financial sectors of the U.S. economy.
4. Describe Minsky's theory of financial instability to explain the occurrence of financial crisis and understand the role of regulation in managing instability.
5. Understand the similarities and differences between the Great Recession and the Great Depression.
6. Describe the trends in inequality in the United States in the past few decades.
7. Identify the underlying causes of rising wage inequality and the role of financialization and macroeconomic policies in contributing to the rise in inequality.
8. Discuss policy measures that might help create a more stable and sustainable economic system.

Key Terms

subprime mortgage
securitization
mortgage-backed security (MBS)
collateralized debt obligation
moral hazard
credit rating agencies
"too big to fail"
wage-productivity gap
skill-biased technical chang

Active Review

Fill in the Blank

1. The process of pooling various kinds of loans, slicing and sorting them according to their risk levels, and repackaging them into financial instruments is known as ______________________________.

2. Mortgages given to people with poor credit are known as ___________________________.

3. The availability of government bailouts for large firms can encourage excessive risk-taking, a phenomenon known as __________________________

4. The major financial reform passed in the wake of the 2007-9 crisis was the ____________________ bill.

5. The law formerly separating commercial and investment banking, which was repealed in 1999, was known as the ____________________________

6. The process of increasing size and importance of the financial markets in the operation of the economy is known as____________________.

7. The theory that unregulated markets will always produce instability and crisis is referred to as the ____________________.

8. In Minsky's theory, the three financial profiles that account for the different margins of safety are ____________________, ____________________, and ____________________.

9. The gap between the growth of labor productivity and the growth of wages, referred to as ____________________, has been ____________________ since the 1970s.

10. The theory that relative wage gains will be greatest for those workers who possess the education and skills to use modern technologies is ____________________.

11. Since the 1980s, the difference in effective tax rates paid by the rich and the poor has ____________________ with the decline in corporate taxes and an increase in payroll taxes.

12. A tax on financial transactions is often referred to as ____________________________, after the economist who first proposed it.

True or False

13. High mortgage rates contributed to the development of the housing bubble.

14. Since the 1970s, a greater proportion of money in the financial system has been directed towards funding productive investment, while investment in financial instruments have declined.

15. The 2008 crisis was referred to as the “Minsky’s moment” because Minsky’s theory of financial instability predicted such a crisis.

16. The Great Recession was less severe than the Great Depression because of the deregulation of the financial system since the 1980s.

17. The expansionary monetary policies implemented by the Federal Reserve since the 1980s have contributed to the rising income inequality in the U.S..

18. The Dodd-Frank bill promoted deregulation of banks.

Short Answer

19. What were some of the factors leading to the housing bubble?

20. What were the major fiscal and monetary policy responses to the crisis?

21. In what ways can unemployment be both a result and a cause of deepening recession?

22. How does Minsky’s theory explain the occurrence of financial instability in the economic system?

23. What are some of the factors explaining the rise of inequality in the United States in the past few decades?

24. How was globalization related to increasing inequality?

25. Discuss some of the ways in which financial resources may be directed towards more socially useful investments.

Problems

1. Refer to Figure 30.2 in the text to describe how interest rates were related to the development and collapse of the housing bubble.

2. Refer to Figure 30.6 in the text to describe how the distribution of bank assets changed between 1984 and 2017.

3. As suggested in Exercise 1 in the text, you can find information on housing prices at The Federal Housing Finance Agency website www.fhfa.gov. To find the required data, go to www.fhfa/gov/DataTools/Tools and select HPI Motion chart. Then check off the states you want to view (it is possible to view multiple states at the same time). Select the third tab at the top right (with graph symbol) to get a historical view of the rate of change in state housing prices from 1991 to the present. What do you observe? (Note that the chart shows quarterly rate of change, not absolute price levels, so overall prices start to fall when the line goes below zero.)

4. As suggested in Exercise 2 in the text, you can find data on the Great Recession at the Federal Reserve Economic Database http://research.stlouisfed.org/fred2/ To find data on unemployment rates, go to Current Population Survey/Unemployment Rate/Civilian Unemployment Rate/Seasonally Adjusted (do not select Natural Rate of Unemployment on the main Population, Employment, and Labor Markets page – this does not show total unemployment). Drag the cursor over graph to see the data on unemployment during the last four recessions. How does the Great Recession compare to previous recessions?

Self Test

1. Factors contributing to the housing bubble included:

   a. Unprecedented access to credit.
   b. Rising unemployment.
   c. Low interest rates.
   d. Both (a) and (b).
   e. Both (a) and (c).

2. During the recession of 2007-9:

   a. The U.S. economy lost nearly 9 million jobs.
   b. About 11 million homeowners faced foreclosure
   c. Manufacturing unemployment rose from 4.3% to 12.1%
   d. U.S. consumer spending declined and business profits fell.
   e. All of the above.

3. The underlying causes of the financial crisis of 2007-8 included all of the following *except*:

a. Increasing bank size.
b. Increasing inequality.
c. Excessively contractionary monetary policy.
d. Deregulation
e. Short-term corporate incentive.

4. Comparing the Great Depression and the Great Recession, we can say that:

a. The Great Recession was more severe in terms of unemployment.
b. The Great Depression was more severe in terms of unemployment.
c. Both were preceded by bubbles in asset values.
d. Both (a) and (c).
e. Both (b) and (c).

5. Government responses to the 2007-9 recession included all of the following *except*:

a. Stimulus spending by state and local governments.
b. Bailouts for key financial institutions.
c. Stimulus spending by the federal government.
d. Expansionary monetary policy.
e. “Quantitative easing” or security purchases by the Fed.

6. The Dodd-Frank bill does all of the following *except*:

a. Sets up a Consumer Financial Protection Bureau.
b. Relaxes bank regulation.
c. Institutes minimum lending standards.
d. Empowers regulators to aggressively pursue financial fraud, conflicts of interest and manipulation of system.
e. Requires greater disclosure by ratings agencies.

7. Regulations put in place after the Great Depression include all of the following *except:*

a. Glass-Steagall Act
b. Dodd-Frank Bill
c. Regulation Q
d. Restrictions on banking across state lines
e. Imposition of several capital and leverage requirements on the financial sector

8. The increase in size of banks since the 1980s is explained by:

a. Loosening of restrictions on capital across borders
b. Riegle-Neal Interstate Banking and Branching Act
c. Financial Services Modernization Act
d. (b) and (c) only
e. (a), (b) and (c)

9. Which of the following statements is TRUE?

a. The frequency of bank mergers increased steadily from 1980 to 2000, and has declined since then.
b. Deregulation of the financial sectors has helped reduce the risk-taking behavior of banks.
c. The Dodd-Frank bill reinstituted the separation between commercial and investment banks.
d. Non-financial firms have become increasingly financialized through increasing investment in financial instruments.
e. All of the above.

10. The ‘efficient market hypothesis is based on all the following assumptions *except:*

a. Individuals are rational decision-makers.
b. Markets are perfectly competitive.
c. Individual decision-making is influenced by their expectations.
d. Individuals possess complete information about the market price of assets.
e. (a) and (c)

11. According to Minsky, during an economic expansion

a. financial firms move from speculative financing to hedge financing.
b. financial firms become more confident and take higher risks.
c. financial firms move from hedge financing to Ponzi financing.
d. financial firms become stronger.
e. Both (b) and (c).

12. Which of the following statements is FALSE?

a. Data from 1948 to 2017 shows that corporate profits have always grown faster than wages.
b. Over time, the labor productivity in the U.S. has declined.
c. The wage-productivity gap has narrowed in the last three decades.
d. Union membership rate in the U.S. has gradually increased since the 1970s.
e. All of the above.

13. The theory of skill-biased technological change proposes that:

a. relative wage gains will be the greatest for workers who possess the education and skills to use modern technologies
b. technological change leads to a decline in wages
c. technological change increases worker productivity and their wages
d. as technology replaces workers, the bargaining power of workers declines
e. technological change could increase unemployment rates

14. Which of the following explains financialization as a factor in rising inequality in the U.S. economy?

a. Wages in the financial sector has grown much faster than wages in other sectors.
b. A greater share of income has gone to those who own assets, most of whom tend to be wealthier individuals.
c. Executive pay has increased sharply due to a change in corporate pay structure, where a larger proportion of executive pay has come in the form of stock options and bonuses.
d. Workers' bargaining power has declined as corporations have shifted their reliance on earnings through financial channels.
e. All of the above.

15. Since the 1980s,

a. top marginal tax rates have increased.
b. payroll tax rates have declined.
c. effective tax rates paid by the rich and poor has narrowed.
d. spending on welfare has increased.
e. All of the above.

16. An expansionary monetary policy could increase inequality because:

a. low interest rates increase asset prices which are mostly owned by the rich
b. low interest rates increase labor income faster than business income
c. middle-income savers lose returns on savings when rates are low
d. (a) and (c) only.
e. (a), (b), and (c).

17. Which of the following statements about the impact of macroeconomic policy on inequality is TRUE?

a. The impact of fiscal policies of the last few decades on inequality is ambiguous.
b. Fiscal policies of the last few decades have contributed to a rise in inequality.

c. Monetary policies of the last few decades have contributed to a rise in inequality.
d. The impact of fiscal policy on increasing inequality is less clear than the impact of monetary policies.
e. There is clear evidence that the equalizing effects of monetary policy is greater than its disequalizing effects.

18. Policies to reduce inequality include all the following, *except*:

    a. Lowering corporate taxes.
    b. Increasing minimum wages.
    c. Strengthening labor unions.
    d. Increasing investment in human capital.
    e. Providing support to low-income workers.

19. Which of the following might help direct financial resources to more socially useful investments?

    a. Increasing payroll taxes.
    b. Encouraging companies to engage in stock buybacks.
    c. Promoting regional and community financial institutions.
    d. Increasing investment in financial assets.
    e. All of the above.

20. Proposals for regulate the financial system include:

    a. A financial transactions tax.
    b. An increased sales tax.
    c. A lower sales tax.
    d. A general reduction in business taxes.
    e. A general increase in business taxes.

Answers to Active Review Questions

1. securitization

2. sub-prime mortgages

3. moral hazard

4. Dodd-Frank

5. Glass-Steagall Act

6. financialization

7. financial instability hypothesis

8. hedge, speculative, and Ponzi

9. wage-productivity gap, increasing

10. skills-biased technical change

11. narrowed

12. Tobin tax

13. False. It was *low* mortgage rates that feed the growth of the housing bubble.

14. False. Role of finance in funding productive investment has declined while a greater portion of money has gone to investment in financial instruments.

15. True.

16. False. The Great Recession was less severe than the Great Depression because of the existence of government regulations, automatic stabilizers, and the imposition of expansionary monetary and fiscal policy during the 2008 crisis.

17 False. The impact of monetary policy on inequality is not clear.

18. False. The goal was to regulate the banks, though it has been watered down to a great extent through intense lobbying by the financial sector.

19. Factors leading to the housing bubble included a period of low interest rates, unprecedented expansion of credit including sub-prime mortgages, and speculation in the housing market driving prices even higher.

20. After the immediate responses of bailouts for endangered financial institutions, the Federal government instituted large-scale stimulus spending to prevent a collapse in aggregate demand and to promote economic recovery. At the same time, the Federal Reserve engaged in an extraordinarily expansionary monetary policy, purchasing hundreds of billions of dollars' worth both of Treasury bonds (traditional expansionary policy) and other financial assets ("quantitative easing").

21. As the economy goes into recession, more people are laid off. Unemployed workers have less income to spend, leading to a decline in consumption. This lowers business profits, which in turn promotes further cutbacks and layoffs. The process creates a vicious spiral of unemployment and lower consumption that feeds on itself and deepens the recession.

22. Minsky's theory argues that uncertainty about the future and expectations of market participants play a key role in influencing the value of assets. When the economy is just recovering from a crisis investors will be cautious and maintain large safety margins. However, as the economy gains strength, investors will become more optimistic and pursue risky ideas which weakens the financial system and makes it more credit-dependent and vulnerable to crisis.

23. Rising wage-productivity gap due to decline of unions, globalization and trade, and technological change. The financialization of the economy and the fiscal policies of the past few decades have also contributed to the rise in inequality.

24. Globalization has lowered the bargaining power of workers as corporations have had to ability to look around the world and also relocate their production facilities to hire low-cost workers (mostly in developing countries). Additionally, competition from low-priced imports has also eliminated many jobs, especially in the industrial sector, and pushed many middle-income workers to move to lower-income jobs.

25. Promoting smaller regional and community financial institutions that support local home-buyers and businesses. Institute small tax on financial transactions to discourage speculations and prevent the formation of asset price bubbles. Restrict companies from buying back their own stocks and encourage them to invest in their employees through tax incentives. Encourage cooperative based organizations that focus on improving the well-being of workers.

Answers to Problems

1. A steep decline in interest rates after 2001 contributed to inflating the bubble in housing prices. The fact that interest rates rose in 2005 and 2006 may have been a precipitating factor in the bursting of the bubble. Once the bubble burst, with a steep decline in housing prices, interest rates also fell as the Fed moved back to an expansionary policy to respond to the crisis and ensuing recession.

2. Bank assets became increasingly concentrated in the largest banks, with the share of assets held by banks with assets over $250 billion went from about 5% to over 50% between 1996 and 2017. The relatively large banks with assets between $10 billion and $250 billion increased from being less than 30% in 1984 to almost 50% between 1994 and 2000, and then declined to just over 30% in 2017. Meanwhile the share of the smallest banks, those with less than $100 million in assets, fell from about 14% to about 0.5% between 1984 and 2017. The shares of intermediate-sized banks also declined, with the share of banks having assets between $100 million and $1 billion going from about 26% to about 7%, and the share of banks having between $1 and $10 billion going from about 32% to about 10% between 1984 and 2017.

3. In general, all states show the pattern of a housing price run-up prior to 2006, with a significant price crash by 2008. After 2008, the rate of decline slows, but the rate of change remains below zero for most states until 2011. The fluctuations are more extreme for states such as Florida and Nevada than, for example Connecticut and Illinois, indicating that the crisis was concentrated in specific housing markets (but, as the text notes, spread nationwide due to the complexity of mortgage finance instruments).

4. The Great Recession was much more severe than the previous three recessions, with an increase in unemployment of over five percentage points. The FRED graph also shows that unemployment continued to rise after the formal end of the recession, then declined only slowly, falling below 7% only at the end of 2013, and falling even lower to about 4% in 2017.

Answers to Self Test Questions

1. E	11. E
2. E	12. E
3. C	13. A
4. E	14.E
5. A	15. C
6. B	16. D
7. B	17. B
8. E	18. A
9. D	19. C
10.C	20.A