Outline for lecture 12

ECON 1a, Fall 2008, Warren Gibson

Text chapter 13

- When you consume less than you spend, you are *saving*. When you consumer more than you spend, you are *dis-saving* (borrowing).
- Only three things to do with your savings:
  - Increase your cash holdings
  - Lend them to another consumer. Then your saving cancels his dis-saving.
  - Invest them (the usual use for savings)
- When we invest, we either
  - Buy capital equipment to use in our own business
  - Lend money to someone who will use it in his/her business
  - Buy an equity stake in a business (shares of stock, usually)
- The bond market
  - Larger than the stock market, though most of us are more aware of the stock market.
  - Bonds are characterized by:
    * Their prinicpal amount (e.g., $10,000)
    * Their stated rate of interest (e.g., 5% per annum)
    * Their maturity date (when the loan is to be paid back)
    * Their credit risk: the likelihood of default due to bankruptcy

    * How interest is taxed:
        1. Municipal bonds (issued by cities, counties, states) are *exempt* from Federal income tax and from state income tax
        2. Treasury securities are exempt from state income tax but are subject to Federal income tax.
        3. Corporate bonds are subject to both state and federal income tax.

- The stock market
    - Corporations issue shares of stock which represent part ownership. If XYZ Corp. has 100,000,000 shares outstanding and you own 100 shares, you own one millionth of the corporation.
    - Shares of larger corporations are traded on stock exchanges. The issuing company has no direct interest in the price at which these shares are traded.

- Market for loanable funds
    - *Loanable funds* are funds that people want to loan out so they can earn interest.
    - Analyze loanable funds market using supply and demand (p. 281). Borrowers demand loanable funds and issue bonds in exchange for those funds. Investors supply loanable funds and receive bonds in exchange for those funds.
    - Higher interest rates mean savers want to supply more loanable funds, and borrowers want to borrower less.

  - Taxes on interest paid for loanable funds are punishment inflicted on those who save and invest in this manner. An increase in the rate of tax on bond interest shifts the supply curve to the left.
  - Investment tax credits reduce the cost of borrowing and thus increase demand for loanable funds.
  - Government budget deficits mean some savers are induced to buy government bonds using money that otherwise might have been supplied to the corporate bond market. Thus the supply of funds to loan to businesses drops (shifts right). This is called "crowding out."

- More on government borrowing:
  - The federal government almost always spends more than it collects in taxes. This is called a deficit.
  - The deficit for a particular year is added to the national debt at the start of the year.

- The social security "fix" of 1983, courtesy of Alan Greenspan et. al.
  - Big boost in FICA taxes, SS system has been running surpluses.
  - Surpluses "invested" in Treasury securities.
  - Money used to by Treasury securities is spent on other programs. Nothing is being saved for future SS obligations.
  - Debt held by SS Trust Fund is counted in the National Debt but bonds bought by SS Trust Fund are not counted in deficit. It's a shell game!