

WHAT WENT

An acclaimed new book by UCLA economist Roger Farmer explores the evolution of the most severe economic

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UCLA economist Roger Farmer was in England at a conference on “The Great Moderation”—the idea that the economy had become much more stable since 1980—when the bottom started to fall out of the market.

Mervyn King, the governor of the Bank of England, was supposed to be the host of the event, but he never turned up, and Rachel Lomax, the bank’s deputy governor, disappeared many times throughout the evening. The next day, Farmer, who has served as the chair of UCLA’s department of economics since July of 2009, learned that the Bank of England was negotiating with Northern Rock, the first financial institution to collapse in the current economic crisis.

*In his new book for general audiences, *How the Economy Works: Confidence, Crashes and Self-Fulfilling Prophecies* (Oxford University Press), Farmer attempts to make sense of the bewildering series of events that followed.*

What caused the current recession?

Stock market wealth accounts for roughly three-fifths of all tangible wealth in the United States. The other two-fifths is in houses. In the fall of 2008, people lost confidence in the value of both of those types of assets at the same time. They stopped spending, firms laid off workers, and the drop in wealth was self-fulfilling.

How is this crisis similar to the Great Depression?

There have been 10 recessions since World War II, including the current one. In every previous recession, the Fed immediately cut interest rates to stimulate demand. But now the Federal Funds Rate—the interest rate on overnight loans—has fallen to zero. The Fed has run out of ammunition, it can’t lower the rate any further. The same thing happened in the 1930s.

Do you think the Fed was right to bail out the banks?

Yes, I do. I understand that always bailing out banks provides incentives that encourage risky behavior, but the consequences of not bailing them out would have been much worse.

What is your opinion of President Obama’s stimulus plan?

Government as a whole responded to the crisis in two ways: one is the fiscal stimulus, which in my mind is just robbing Peter to pay Paul. The other is unconventional monetary policy or “quantitative easing.”

The reason that mortgage rates are historically low right now is because the Fed has been putting money into the mortgage markets by buying the debt of Fannie Mae and Freddie Mac. In my view, quantitative easing was more important than fiscal policy in preventing a deeper recession and it has been largely responsible for the recovery of the stock market over the last year.

When will the economy rebound?

I think the recession will be called over formally sometime in July, August or September of last year. But employment will not return to its 2007 level until 2012 or 2013.

The stimulus plan did provide some short-term benefit. The patient is on medication, and we’ve seen some improvement. When we remove the medication, we’re risking a relapse.



WRONG?

downturn since the Great Depression, and proposes how similar crises can be avoided.

What are the chances of a double-dip recession?

The chances are 50-50. If inflation starts to pick up in our major trading partners such as China, there is a danger that it will be passed onto U.S. consumers. If inflation picks up in the U.S. when unemployment is at still at 8% or 9%, the Fed is going to face a difficult dilemma. There will be pressure to raise short term rates to help prevent inflation. That will choke off the nascent recovery. But if the Fed does nothing, we could easily get back into a situation five years from now with high unemployment and high inflation together. The same thing happened in the 1970s. It can happen again.

What do you recommend for the modest investor?

For anyone who is young, this thing is going to blow over long before you need the money. But for anyone close to retirement, I would be extremely dubious about having money in anything risky at all.

How can we prevent these kinds of crashes in the future?

In the build-up to this crisis, I agreed with the people who said that the market was overvalued and should be dampened in some way. But I don't agree with the method that they had for doing it, which was to raise the short-term interest rate.

The Fed should control fluctuations in the stock market by buying and selling blocks of shares; the best way would be to trade an index fund like the Russell 5000. They should do this independently of their control of the overnight interest rate by paying for stock purchases with newly created Federal Reserve debt. That provides a mechanism to insulate changes in the money supply from changes in share purchases.

But isn't that a managed economy?

Yes. But, we've never lived in a totally laissez-faire economy—and certainly not since the inception of the Fed in 1913. Since then, we've been actively intervening to maintain one price—the short term interest. What I'm proposing isn't that different from what already is going on now. It's a simple extension of quantitative easing. I'm advocating that we actively intervene to maintain two prices, not one: an overnight interest rate and the price of a stock market index.



Roger Farmer

With China and other countries owning so much of our debt, and us having such a large trade deficit, to what extent can anything we do inside our country help to cushion our economy?

Trade is important to the U.S., but exports account for less than 15% of our Gross Domestic Product. So much of what we do is still internal to us. I hope that if the kind of stabilization I propose is seen to be effective in our country, it will be copied in other countries. And wild euphoric swings in markets that have deleterious effects on employment will, I hope, become a thing of the past.

How vulnerable are we to another big financial crisis?

People often talk about contagion in financial markets. When a small event occurs in one market, it causes a loss of confidence in other markets as people panic. They all jump out the window together. One situation to look out for is default on Greek debt.

Although Greece is a small country, if it defaults, there's a real concern that some other larger countries, particularly Spain, could follow. If that happens, it could easily feed into contagion and panic in U.S. markets. Confidence matters independently of fundamentals!

What are you hoping readers will take away from your exploration of the economic crisis?

I hope readers will understand three things: first, that the current crisis is just the latest in a series of crises that have plagued market economies since the inception of capitalism. Second, that politics and economics are irrevocably entwined and that government responses to financial crises have a symbiotic relationship with the evolution of the history of economic thought. Third, that the correct response to the crisis is to learn from it, and to develop new tools. In the words of Francis Bacon, "He that will not apply new remedies must expect new evils; for time is the greatest innovator." 

