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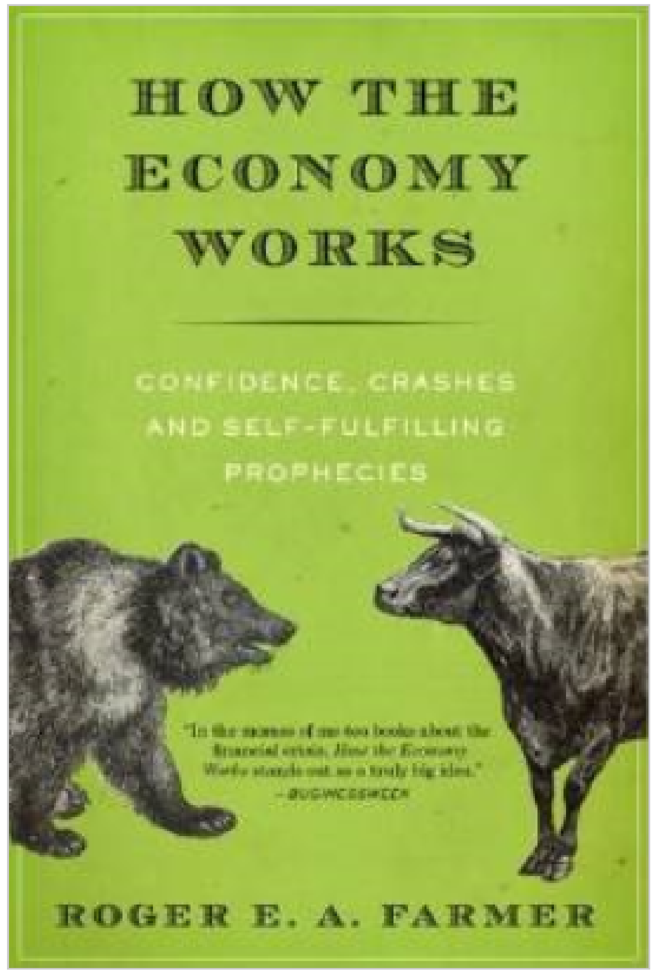
The economy: applying theory to reality

How the Economy Works: Confidence, Crashes, and Self-Fulfilling Prophecies. By Roger A. Farmer, New York, NY, Oxford University Press, 2010, 198 pp., $16.95/paperback.



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One could say that there are two parts to understanding how an economy works: first, examining the history of economic thought and what it has taught us and, second, applying the knowledge gained to avoid, or at least minimize, the painful lessons learned. This paradigm was the one used by author Roger Farmer when he wrote *How the Economy Works: Confidence, Crashes, and Self-Fulfilling Prophecies*. In the first part of the book, Farmer provides a history of economic thought from 1776 to the present in easily understandable terms. In the second, he puts forth an explanation of the causes of the Great Recession of 2008–2009 and a prescription for how to prevent the same type of devastation in the future. Farmer is a Distinguished Professor of Economics at UCLA who served as department chair from July 2008 to December 2012. When he wrote the book in 2010, the United States, although technically out of the recession, was still experiencing slow growth and a high unemployment rate. These factors likely motivated Farmer to write the book.

The Scottish economist and philosopher Adam Smith (1723–1790) is widely regarded as the father of modern economics and the classical theory of economics. Smith believed that markets are largely self-correcting. Probably the best known statement in his book *An Inquiry Into the Nature and Causes of the Wealth of Nations* can be paraphrased as "A businessman who seeks his own self-interest and the success of his operation rather than benevolence is actually helping the economy and society as a whole." Classical economics evolved into two parts: the quantity theory of money and general equilibrium theory. David Hume (1711–1776), a Scottish contemporary of Smith, developed the quantity theory of money, which states that the money supply has a direct, proportional relationship with the price level. General equilibrium theory, based on the laws of supply and demand, was conceived by Léon Walras (1834–1910), a French-born economist, and was first described in its modern form by Alfred Marshall (1842–1924) in his book *Principles of Economics*. Walras's successor at the University of Lausanne (Switzerland), Vilfredo Pareto (1848–1923), is considered the father of modern-day welfare economics, a discipline that analyzes the distribution of goods and its impact on human well-being. Pareto concluded that markets are the best way to allocate resources, an idea that could be interpreted as an endorsement of capitalism as superior to socialism as an economic system.

In spite of the many "panics" of the 19th century, classical economists continued to view their negative consequences as temporary. They held to their belief that excessive unemployment could occur only in the short term, while prices and wages were adjusting into long-run equilibrium. By contrast, John Maynard Keynes (1883–1946) was skeptical of the self-correcting nature of classical economics, especially after the onset of the Great Depression. Keynes claimed that very high unemployment could persist for a long time for no reason other than the lack of public confidence in the stock market and the economy. To counteract it, he argued that government should borrow money and use it to stimulate aggregate demand, a view that clashed with that of classical economists, who argued that every dollar spent by government was one less dollar spent by households. The persistent high unemployment throughout the decade of the 1930s appeared to prove Keynes's claim: President Franklin Roosevelt's massive government investment and spending programs were in response to, and in accordance with, Keynes's recommendations. On the basis of the number of pages he devotes to John Maynard Keynes and the depression of the 1930s, one could infer that Farmer considers Keynes to be the most influential economist in history; in fact, he wrote "The influence of Keynes on economics and politics was profound." Although Farmer doesn't call himself a conventional Keynesian, he does write about his belief that massive government spending during the Great Depression and World War II succeeded in lowering unemployment rates over that timeframe. Furthermore, Farmer claims that, had the government (or, probably more accurately, the Federal Reserve, because it is supposed to be an independent agency) not played an active role in the economy in the years following World War II, the number of unemployed would have been greater and the unemployment rate would have been more volatile.

In 1958, Alban W. ("Bill") Phillips (1914–1975), a New Zealander, came up with what is now known as the Phillips curve to track the relationship between unemployment and inflation. Simply stated, the idea behind the curve is that there is a tradeoff between higher levels of unemployment and higher levels of inflation. Keynesian economists embraced the curve, which they saw as empirical evidence in support of their argument for the importance of government intervention in the choice between fighting inflation and fighting unemployment.

In the 1960s, University of Chicago economist Eugene Fama developed the "efficient market" hypothesis. Fama noted that financial markets summarize and make available all of the information participants need to make quick and efficient decisions. As a result, one cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis. Classical economists agreed with his hypothesis—in particular, that value is determined by the market and fundamentals such as household preferences, the number of skilled and unskilled workers, and the state of technology; Keynesians countered that investor confidence is the most important factor. Farmer opines that both are right if investor confidence is considered as one of the aforementioned fundamentals. For example, Pfizer stock would likely rise if the company were expected to market an important new drug soon. However, Farmer finds fault with both camps in other respects. In his view, Keynesians are wrong for emphasizing fiscal policy over monetary policy to fight unemployment whereas classical economists are wrong in their blind allegiance to the self-correcting mechanism of the economy and in marginalizing the role of confidence.

Keynesian fiscal policies continued to be widely accepted throughout the 1940s, 1950s, and 1960s. But they encountered resistance in the 1970s, when both unemployment and inflation were unacceptably high, a condition that became known as “stagflation.” Because of the apparent failure of the Phillips curve to explain stagflation, a new theory arose known as the “natural rate hypothesis.” The theory had first been espoused in 1968 by two American economists: Edmund Phelps of Columbia University and Milton Friedman of the University of Chicago. They viewed the unemployment rate as a function of factors such as the productivity of workers and the time and trouble spent by workers in searching for jobs. The natural rate hypothesis has dominated economic thinking since the 1970s, and it greatly influences current Federal Reserve actions. Farmer, however, has a problem with this hypothesis because he claims that it cannot be tested: “A theory that cannot be falsified by a set of observable facts is not science, it is religion.”

Also in the 1970s, a pathbreaking movement known as the “rational expectations revolution” emerged, led by the University of Chicago’s Robert Lucas. Rational expectations economics consisted of two parts: a development of general equilibrium theory called real business cycle theory and a development of the quantity theory of money called new Keynesian economics. Farmer finds the latter name unfortunate because he believes that the theory has more in common with Hume than with Keynes. He also believes that its explanation of the persistently high unemployment rate during and after the Great Recession is inadequate.

Farmer next devotes an entire chapter to central banks, which, in the United States, are represented by the Federal Reserve System. The primary role of the Fed is to manage the nation’s money supply, which it uses to combat both high unemployment and high inflation. Although some conservative politicians and libertarians have called for the dissolution of the Federal Reserve, Farmer provides a strong defense of it, claiming that the economic history of the 20th century would have been catastrophic without the interest rate actions of the Fed.

Throughout history, there have been a number of meteoric rises and falls in commodity prices. Famous examples of these “bubbles” include the 17th-century Dutch tulip craze and the rapid rise and fall of Internet stock prices during the 1990s (often associated with companies that had not even generated any revenue). Likewise, during the decade of the 2000s, many homes were purchased with subprime loans and no money down, solely on the expectation that prices would continue to rise. Farmer faults the repeal in 1999 of many of the provisions of the 1933 Glass–Steagall Act for the real estate meltdown, permitting commercial banks to move into investment banking and purchase riskier assets such as mortgage-backed securities. He also believes that mortgage-backed securities were one of the main triggers of the 2008 financial collapse. Like the Keynesians, Farmer emphasizes the important role of investor confidence, both in the stock market and in the economy in general. He feels the same about how one views one’s present wealth and the expectation of future wealth. In 2007 and 2008, when the real estate bubble burst, investors lost confidence first in home prices and later in the stock market. Per Farmer, the fear this generated led to a vicious cycle of declining net worth and increasing unemployment (hence, the “self-fulfilling prophecy” portion of the book’s subtitle).

So, what is Farmer’s recommendation for an economic recovery plan? He believes that fiscal policy might help, but it should not involve an increase in government expenditures. However, he also believes that fiscal policy acts more slowly than monetary policy, which he clearly prefers. Since 1951, the Federal Reserve has reacted to recessions by lowering the interest rate it charges to commercial banks. Following the 2008 financial crisis, central banks throughout the world engaged in an unprecedented set of new and unconventional policies known collectively as quantitative easing. This strategy involved the purchase of a kind of asset other than government bonds, namely, mortgage-backed securities. Farmer believes that quantitative easing was the right approach, but that it should have gone further. He proposes *qualitative* easing, which he defines as a change in the composition of the central bank's assets. Specifically, he would have the central bank prevent large stock movements, both up and down, from adversely affecting the economy. The bank would assert this control by the use of an index fund, the intent of which would be to manage the value of national stock market wealth by targeting the rate of growth of the fund. The Fed would announce a price path for its index funds, and the central bank would stand by ready to buy and sell the funds each day at the announced price.

I very much enjoyed and benefited from reading this book. The author's coverage of the history of economic thought is thorough, is easily understood, and flows well from one school of thought to the next. Although Farmer's solution to economic downturns is, to an extent, simply an expansion of policies that the Fed has already used (many would say successfully), it is nonetheless worthy of consideration. That is not to see it as a sure thing, however: because no country has ever implemented his policy, it is entirely possible that it is considerably more difficult and risky than Farmer seems to think.

Being a real stickler for grammatical correctness, I was a bit irritated by the misuse of commas in several places in the book. Some of these "miscues" could lead the reader to a misinterpretation of the sentence in question. Farmer also writes, "The economy has been four times less volatile since World War II than before the war"; it should have been "one-fourth as volatile." There is also one factual mistake: Farmer says, "In the United States, the Obama administration passed legislation in the fall of 2008 to enact an $800 billion fiscal stimulus…." In actuality, President George W. Bush supported a $700 billion stimulus plan in October 2008, while President Obama's $800 billion stimulus plan was enacted in February of 2009. These errors, however, do not detract from the overall excellence of *How the Economy Works*. I look forward to reading any future books or articles by Farmer, be they on economic history or on his qualitative-easing proposal.