Amazon Exclusive: A Q&A with Author and Professor Roger E.A. Farmer

Q: Why does the stock market matter to every American?

Farmer: In the 1930s, stock market wealth was much more concentrated than it is today. Middle and low income Americans held their savings in banks and it is for that reason that the collapse of the banking system in the 1930s was so devastating. In the 21st century, most middle class Americans own pension plans that invest in the stock market.

US wealth is roughly two-fifths houses and three-fifths factories and machines that are indirectly owned by households through their ownership
of financial intermediaries such as bank accounts and pension rights. When the stock market plummets but recovers quickly, as it did in 1987, the effect on private households is minimal. When the stock market falls, as it did in 2000, but house prices keep rising, the effect is again small since households can borrow against housing wealth to maintain consumption. When houses and stocks fall together as they did in 1929 and again in 2008, the effect can be devastating.

Q: From an early age, the American student learns the basics of math and science, but the fundamentals of economics are often not part of his or her core curriculum until college. Do you think economics should be a core component of a student’s primary education? Farmer: Economic literacy is as important to citizenship as literacy in mathematics and the physical sciences. It has two components—an understanding of economic history and an evaluation of historical events using the tools of economic logic. How the Economy Works is accessible to high school students and it combines the elements of economic history and economic science in a way that should make it attractive as supplementary reading in high school classes in history, civics and economics as well as in introductory college courses.

Q: What are you hoping readers will take away from this jargon-free exploration of the current economic crisis?

Farmer: I hope that the reader 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 irreversibly 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.” (Francis Bacon, Essays, 11. 1884 Of Great Place).

Q: What is the difference between the Classical and Keynesian approach to macroeconomics?

Farmer: Classical economics sees the economy as self-correcting. Keynes thought that the stabilizing mechanisms in the private market system are nonexistent or, at best, very slow. In How the Economy Works, I put it like this:

The classical Norwegian economist Ragnar Frisch likened the economy to a child’s rocking horse. The horse is regularly buffeted by shocks. Think of a child hitting the horse with a stick. According to Frisch, these blows are like major economic events. A war in the Middle East. A hurricane in the Midwest. An airline pilots’ strike. After each shock, unemployment might rise temporarily as the economy readjusted to the blow but it would quickly return to its equilibrium level just as the rocking horse will come to
rest if left alone. This is a good physical analogy to the classical idea of a self-correcting economic system.

Keynes had much less faith in the free market. In Keynesian economics the economy is like a boat on the ocean with a broken rudder. Gusts of wind represent major economic events. A war in the Middle East. A hurricane in the Midwest. An airline pilots' strike. After each shock, unemployment rises or falls permanently and there is no self-correcting mechanism to return it to a unique equilibrium: Just as a sailboat will be becalmed wherever it comes to rest, the unemployment rate can end up anywhere. The classical economists saw the economy as a stable self-correcting system. Keynes did not.

Q: The Great Depression occurred on the heels of the Roaring Twenties. Did the crisis of 2007/2008, after nearly a decade of prosperity, mirror what happened so many decades before?

Farmer: The 2007/2008 recession was preceded by a decade of prosperity, as was the crash of 1929, but so were many other recessions. What makes the current crisis like the Great Depression is that in 2008, as in the Great Depression, the Fed ran out of ammunition. The interest rate reached a fraction of a percentage point in 1934 and could not be lowered further. The same was true in most western economies by 2008/2009.

Q: What changes in Fed regulation do you think are needed to ensure that we don’t repeat the economic mistakes of the recent past?

Farmer: Many contemporary commentators have argued for greater bank regulation as a second tool of policy to help prevent financial crises. This follows from misdiagnosing the problem.

The current crisis was triggered by a self-fulfilling drop in confidence that caused housing and stock market wealth to fall simultaneously. The fall in wealth caused households and firms to cut back on demand and firms to lay off workers. The crisis was alleviated by two government actions. Central banks throughout the world bought long-term bonds and mortgage backed securities in an effort to lower their yields. National treasuries engaged in large expansions in government expenditures based on Keynesian theory.

The central bank purchases of long bonds was a good idea and was responsible, I believe, for boosting the value of the stock market and preventing a further collapse in the housing market. The expansion of government expenditure, financed by borrowing, was not a good idea and will leave our children and our grandchildren with a huge debt to foreigners.

Going forward, we need to institutionalize the policy of quantitative easing as a substitute to fiscal policy. The Fed should manage the short rate to
target inflation. The Fed, in conjunction with the treasury, should manage a second asset price to target unemployment. Ideally, that second price would be the growth rate of a stock market index but the price of long bonds is a good substitute.

(Photoby Magnus Pettersson)

**Personal Review:** *How the Economy Works: Confidence, Crashes and Self-Fulfilling Prophecies by Roger E. A. Farmer*

How The Economy Works provides an overview of economic theory with a focus on Classical and Keynesian Economics, describes the economic situation as of 2008-2009, and then concludes with the author's plan for getting us out of the dire situation we are in as of this time. I learned a lot about the history of economics from this book. The author spends most of his time on theories presented in the 20th century although there is some mention made of 19th century thinkers. The author includes photographs and brief biographies of most of the people he writes about. The chapters on Classical and Keynesian Economics really clarified the differences between these two ways of thinking for me. I also learned a lot about our contemporary situation from this book. It would only be possible for an economist to judge the author's solution for the present predicament however, I can attest that the solution is clearly explained. Throughout this book the author weaves back and forth between the contrasting notions of Classical and Keynesian Economics and intermixes these ideas with his own belief that confidence in the markets is very important (a belief he shares, in part, with Keynes). The author believes that Classical and Keynesian Economics can be reconciled, in part, by considering confidence in the markets as one additional influence among the many motivating influences that are already being considered by Classical Economists. I think this book is worth reading not only for the author's exposition of the ideas of Keynesian and Classical Economics, but also for his explanation of our current situation and finally for an example of how a working economist thinks about how to keep the world's economy functioning.