Add stocks to prices controlled by the Fed, new book by UCLA economist urges

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(PhysOrg.com) -- At a time when both Federal Reserve Chairman Ben Bernanke and the U.S. Congress are trying to limit the reach of the Federal Reserve, UCLA economist Roger Farmer wants to expand its portfolio.

In a new book, the chair of UCLA's economics department credits the kind of measures that Bernanke would now like to relinquish with blunting the impact of the crash of 2008. Had the Fed not taken the extraordinary step of buying mortgages and other unconventional assets, it would have been powerless to influence the economy since its primary means of doing so — manipulating short-term interest rates — had evaporated, Farmer writes in "How The Economy Works: Confidence, Crashes and Self-Fulfilling Prophecies" (Oxford University Press). As with the Great Depression, interest rates now hover close to zero, so the Fed cannot stimulate the economy by lowering them further.

"The Fed," Farmer said, "had run out of bullets."

To avoid a similar situation in the future, Farmer argues that the Fed's portfolio should be expanded to include the stock market itself, he writes. Farmer is not advocating that the Federal Reserve set the prices of individual stocks, he point outs. Rather, he wants the Fed to create and manage a broadly construed index fund similar to the Russell 5000.

Much as it sets the rate for short-term loans today, the Fed would establish the price at which the index fund would sell at a predetermined future date. The announcement alone should be enough to raise or lower the entire stock market, Farmer argues. If not, the Fed could buy and sell funds to steer the market to the desired level, he says. Either way, the Fed would be able to deflate potentially disastrous bubbles or stimulate flagging prices.

The idea isn't as far out as it may seem, Farmer argues. The stock market already moves to the winks and nods of the Federal Reserve's discount rate, he points out. So the market is much more regulated than commonly supposed.

Furthermore, the stock market isn't the infallible barometer of the country's economic health that many believe. In the stock market's current incarnation, dramatic fluctuations have more to do with consumer confidence — skittish, mercurial and irrational — than actual fundamentals, Farmer writes.

And even though these swings may be divorced from the fundamentals, they have real and lasting consequences. Dramatic crashes often lead to the kind of stubborn unemployment experienced during the Great Depression or, for that matter, now.

While classical economics has long held that employment levels are self-correcting following a crash, Farmer argues that, in fact, unemployment comes to rest at a rate that can be arbitrarily high, and it can remain there for a long time, causing unnecessary pain for years.

"The invisible hand," he writes, "has palsy."

By taking hold of the stock market, the Fed can have a calming affect, according to Farmer. The step would blunt dizzying highs but also eliminate dangerous lows, much like putting an individual prone to depression on Prozac.

Provided by University of California Los Angeles