REAL CLEAR MARKETS

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The Ongoing Importance of Milton Friedman

By John Chapman

Milton Friedman is a superb economist. There are not, and never have been, many. -- William R. Allen, Professor of Economics, UCLA

The true test of a scholar's work is the judgment that is made, not at the time his work is being done, but twenty-five or fifty years later. -- Milton Friedman on 'Meet the Press' in October, 1976

Today is the centenary anniversary of the birth of Milton Friedman. Born of humble origin in Brooklyn, New York to two Carpatho-Ruthenian (Hungarian/Ukrainian) immigrants on July 31, 1912, Friedman would go on to become a world-famous economist, the 1976 Nobel Laureate, and perhaps second only to John Maynard Keynes in global influence during the 20th century. Like Keynes, Friedman was famous for being a public intellectual as much as he was technical economist, and in fact with his prodigious output across an active career spanning six decades, he far surpassed the master in the latter capacity. As the 20th century economist most associated with notions of free enterprise, classical liberalism, and limited government, Friedman's life is worth remembering today for whom he was, what he accomplished, and how he might regard the present challenges in the global economy.

As a testament to the broad-based research agenda that undergirded his prolific writings, Friedman's technical work was as impressive as it was wide-ranging; he made notable contributions in monetary theory and policy, price theory, the consumption function and permanent-income hypothesis, Friedman-Phelps Phillips Curve-related macro-policy theorizing and findings, international finance and exchange rate policy, empirical methodology, and statistical theory and its applications. As a policy intellectual, he made his mark as a founder of the Mont Pelerin Society, with time spent at the American Enterprise Institute, the Hoover Institution at Stanford, associations with the Cato Institute and

Heritage Foundation, and as a key advisor to President Reagan for all eight years of Reagan's term of office. And as a writer and speaker in the popular literature and media, Friedman's considerable influence stemmed from his 17-year stint as a columnist for *Newsweek* (often opposite Paul Samuelson), as the author, creator, and narrator of the wildly successful PBS TV-documentary series known as Free to Choose, and as author of several books and monographs written for popular consumption (his two most popular books, *Capitalism and Freedom* and *Free to Choose*, were best-sellers and remain in print and widely read).

Among the many policy changes his positions influenced were those pertaining to lower marginal taxation on capital and income, the military draft, flexible exchange rates, monetary policy rules and Federal Reserve behavior, federal spending trajectory, and educational choice (much to his later regret, Friedman also played an important part in the wartime shift of health care delivery to its centering in the tax-advantaged employer-based insurance scheme that became embedded in the U.S. economy after 1943).

At the University of Chicago, Friedman was an inheritor and then keeper of the long tradition in economic theory of what has come to be known as the Chicago School, built by the likes of Frank Knight, Lloyd Mints, Henry Simons, Ronald Coase, and more recently in addition to Friedman, George Stigler, Gary Becker, and Robert Lucas. The Chicago School is notable for rigorous "neoclassical price theory" (which is a fancy way of saying how supply and demand affect prices and output in individual markets) and its policy concomitant, a commitment to a laissez-faire regime and minimal government interference in markets. While Friedman eschewed intellectual or partisan labels, famously saying once that there was only "good" economics and "bad" economics, he nonetheless was, as an outgrowth of his Chicago association and opposition to Keynesian policies, grouped together with those who adhered to the monetarist label.

The monetarists were key figures on the scene in 20th century economics, as they were the first group of researchers to systematically oppose what became the dominant orthodoxy in theory and policy, Keynesianism. In the landmark *Monetary History of the United States: 1867-1960*, written with his longtime collaborator Anna Schwartz, Friedman showed conclusively that changes in the quantity of money led to shifts in nominal income, and at least in the short run, often in real incomes and output as well. That the line of causality runs from the money stock to impacting nominal GDP - and not the other way around - is now conventional wisdom in economics, but it had enormous policy implications at the time, in the 1960s and ‘70s.

At the time, Keynesian policy-makers felt that shifts in aggregate spending drove changes in the money stock, monetary policy was often ineffective as a policy tool and neutral even in the short run, and that therefore activist fiscal policy should be the predominant tool to use in "managing" the market economy through slumps. Indeed, this view was precursory to the core paradigm of Keynes' instability thesis regarding the market economy: wild shifts in business investment, driven by changing whims as manifested in investor sentiment, caused the boom-bust business cycle that seemed to be an inherent feature of a modern capitalist economy. Keynesian theory of course borrows the capitalist instability hypothesis directly from Marx, and prior to Friedman there had been no effective post-war rebuttal of its logic.

This gets to the heart of the contributions Friedman made as a public intellectual and highly influential policy advocate. By showing the nature of monetary/output causality in a conclusive way, Friedman not only proved that inflation was a monetary phenomenon, "anywhere and everywhere," but more broadly he showed that monetary instability, and not the crazy whims of investors and their animal spirits, was the main source of economic downturns and depressions. As such, Friedman advocated a "rules-based" Federal Reserve for much of his career, in which increases in the quantity of money would be pre-set at a certain growth level (say, 3-5% per year, in line with income and output growth), as opposed to a Fed which engaged in discretionary activism.

This debate about "rules versus discretion" in turn permeated most all else about his pursuits in public policy, and Friedman was in the end so successful because his policy prescriptions were rooted in both rigorous theory as well as significant empirical observations. That a capitalist economy was inherently unstable and in need of activist (viz., discretionary) government intervention was disproven by neoclassical price theory, in which prices shift to clear markets and quickly move resources to their highest and best use, based on changing consumer preferences and production technologies. And one of Friedman's great talents was to so cogently explain this in an extemporaneous and audience-friendly way, often mixing in "empirical observations" to confirm his point, that his ideas about the superiority of markets and limits of activist government - indeed, to the point where he was able to illustrate the harm caused by government intervention - were manifestly influential in the rise of Reaganism after 1980.

That is to say, in the years running up to the advent of Mr. Reagan, Friedman had a material impact in changing the climate of opinion in the United States in favor of market-oriented solutions to policy challenges (or to say it differently, Friedman was able to show that it was government failure that led to an unstable economy, not market failure). In the dominating era of Keynes, Friedman's ability to articulate clear explanations of market phenomena, often on the fly in public forums, and in a way "common men" could apprehend his thinking and logic, was instrumental in paving the way for Reagan. Would there have been a Reagan in 1980, and eventual recovery and prosperity, if there had been no Friedman? Probably, but to apprehend the necessity of considering the question is to understand how important Friedman's impact was on recent U.S. history.

What would Friedman make of the present global torpor? He would of course have been saddened by the debacle led by Fannie and Freddie, both of which he long railed against as corrupt government-sponsored enterprises, and how it was fueled by a hyper-activist Federal Reserve, which poured gas on a global fire. For him the Great Recession would have been confirmation of many of the sub-texts of all his work: the folly of government interventionism in the face of insoluble problems with information and incentives; the waste and corruption endemic to big government programs, even those with the most charitable of intentions; the critical importance of a dependably-valued currency that does not distort asset prices in financial markets any more than it does consumer prices; and the importance of avoiding burdensome government spending and regulations that strangle entrepreneurial initiative and "crowd out" productive private investment.

Professor Friedman would likely approach the challenge of convincing the American public of the folly of current policy in the same manner as he did in so many other policy controversies: paint a convincing picture grounded in both theory and empirical reality - but happily, in a way most people would easily understand. He was fond of pointing out "natural experiments" in public policy, for example, such as the different outcomes in economic performance between East and West Germany, the People's Republic of China and Taiwan, or North and South Korea, where "all else" could be held constant except the political regime and the associated policy mix. His central point was always the same: the larger the government's activist footprint in the economy, the smaller is the capacity of the economy to grow, and hence the slower the standard of living can progress. In spite of government's best intentions, this is an ironclad law of economics, bearing repeating in the current moment.

Mr. Friedman was not perfectly consistent in his advocacy of laissez-faire: for most of his career he was in favor of central banks running fiat currencies, mediated by international freely-floating exchange rates. And he agreed with Keynes' critique of gold as a "relic." But even here, at the end of his life, he questioned the efficacy of central banking and any sort of activist monetary policy, and spoke not unfavorably of a role for gold or return to some form of commodity money. And he had great respect for the emerging Austrian school of economists, notably Lawrence White of George Mason University and George Selgin of the University of Georgia, both of whom argue in favor of the abolition of both the Fed and deposit insurance, and a return to commodity money as it arises in a system of freely competitive banking firms. He clearly had come to recognize the folly of too-big-to-fail moral hazard wrought by the Fed and modern policy, and was sympathetic to White's and Selgin's scheme to eliminate this with market-generated monetary and banking institutions.

All in all, however, the venerable philosophy that underlies the free market economy has never had a better friend or more articulate spokesman than Milton Friedman. One hopes that the great cause to which he devoted his life, the liberalism of the 19th century, is not yet an historical artifact. RIP at age 100.

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