Department of Economics Boston College

EC 202.05

Macroeconomic Theory

Supplement 3

Professor Sanjay Chugh

The following article, which appeared in *The Economist* on July 28, 2012, hypothesizes about what the late Nobel Prize winning economist Milton Friedman's views may have been on the current state of world economies.

THE ECONOMIST
JULY 28, 2012

Free exchange

The Chicago question

What would Milton Friedman do now?

Jul 28th 2012 | from the print edition

MILTON FRIEDMAN, who would have turned 100 on July 31st had he lived, remains as relevant now as he was during his long life. The Chicago economist was a critic of the over-mighty state (which has only got over-mightier since his death in 2006). He was a passionate critic of public-school monopolies (which remain as resistant to reform as ever). He was the quintessential engaged intellectual: he wrote fluently in the popular press (the closest modern equivalent is his ideological opposite, Paul Krugman); acted as an adviser, in the United States, to Barry Goldwater and Ronald Reagan, and, abroad to Margaret Thatcher and Augusto Pinochet, Chile's dictator; and championed the legalisation of drugs and prostitution and the abolition of the draft.

His one-liners remain memorable, particularly about bossy bureaucrats, for whom he felt a short man's angry disdain. "If you put the federal government in charge of the Sahara desert, in five years there'd be a shortage of sand"; "Nothing is so permanent as a temporary government programme". Many of his policy ideas continue to resonate, such as that of giving parents vouchers which they can spend at a school of their choice.

So what would he have wanted economic policymakers to do now? One part is obvious: unleash the deregulation the world needs. But there is also a more technical but bitterly contested question—to do with the role of central banks. The subject on which he thought hardest was central banks and the slump. So it is only reasonable to ask on the 100th anniversary of his birth what he would have urged policymakers to do about the worst economic slowdown since the Depression.

In "A Monetary History of the United States", co-written with Anna Jacobson Schwartz, Friedman argued persuasively that the Federal Reserve was an accomplice in the Depression, thanks to its failure to reverse a stunning fall in the money supply. Schwartz, who died in June, wrote in 2007 that the book initiated a "counter-revolution" in monetary thought that heavily influences policy today. In 2002, the new Fed governor, Ben Bernanke, hailed the two, saying of the Depression, "You're right, we did it. We're very sorry. But thanks to you we won't do it again." What should be done instead is less clear. Some economists, including Mr Krugman, argue that Friedman would have supported Mr Bernanke's efforts to boost the economy and may have urged him to go further. Others say Mr Bernanke has abused Friedman's legacy. On August 1st Mr Bernanke must weigh these competing views when the Fed meets to consider a third round of "quantitative easing" (QE), the purchase of bonds with newly created money.

In the 1930s low interest rates were interpreted as a sign that monetary policy was loose. Friedman and Schwartz showed that inflation-adjusted interest rates were a better indicator and that money was in fact tight. When bank panics further shrank the money supply, the Fed's refusal to respond made the Depression great. Friedman and Schwartz argued that money supply would have responded to QE.

The Depression shaped Friedman's distinct view of the macroeconomy, dubbed monetarism. Monetarism holds that money-supply changes influence real economic variables such as employment in the short-run but only inflation over time: "inflation is always and everywhere a monetary phenomenon." Dangerous falls in money supply are the responsibility of the central bank. So, too, is runaway money growth. When his "Monetary History" was published in 1963, a Keynesian view held sway: that inflation was a supply-side creation, driven by input costs.

Friedman blamed monetary policy. Rapid money growth raised demand above the economy's supply potential, leaving "too much money chasing too few goods". A monetary response was necessary and sufficient to cure inflation. Converts including Paul Volcker, as chairman of the Fed, rose to the challenge, tightening policy and squeezing inflation from the economy.

Today, critics of Fed easing point to Friedman's preference for stable money-supply growth, to help establish central-bank discipline. John Taylor notes that money growth was quite rapid during the recent recession. Hawks also cite Friedman's anti-inflation crusade. To Allan Meltzer, "The Fed's plan to increase inflation [through QE]…is a large step away from the policy that Milton Friedman favoured." It is more like old Keynesianism, which held that faster inflation could buy a permanent drop in joblessness. Friedman rejected this. He contributed to the “natural rate hypothesis”, that efforts to push employment above an economy’s limits simply bid up wages, raising inflation.

Yet Friedman also considered variables other than prices. A characteristic of both the contraction of the 1930s and the Japanese stagnation of the 1990s, he noted, was the drag of tight money on nominal GDP. Reversing this would “have the same effect as always,” he said: “output will grow, and after another delay, inflation will increase moderately.” He grew flexible, as well, concerning money-supply rules. In 1984 he wrote that slow, steady monetary growth was “not a necessary implication of monetarist theory”. And when an economic crash in 1990s Japan gave way to a feeble recovery and deflation, Friedman recommended a monetary “kiss of life” in the form of QE.

Always and everywhere an argument

America’s nominal output tumbled during the recession and its growth remains below the trend seen in recent expansions. It is plausible that Friedman would blame monetary policy for this shortfall. Low inflation-expectations might indicate a large output gap and room for more monetary stimulus. It falls to Mr Bernanke and his counterparts to judge whether they have done all they can or are exposing themselves to the withering criticism of some future Friedman.

Economist.com/blogs/freeexchange