Milton Friedman: The Great *Laissez-faire* Partisan

Milton Friedman died on November 16, 2006, aged 94. As many have noted, Friedman was perhaps the most influential economist of the second half of the twentieth century. Not only did he contribute to reviving belief in the economic efficacy of the market system, he also had a profound political impact through his linking of capitalism and freedom in his famous 1962 book.

That political impact continues. However, Friedman's treatment of capitalism and freedom is deeply colored and has contributed to misunderstanding through its assertion of a simplistic identity between the two. The reality is a complicated tango whereby free markets promote certain vital dimensions of freedom but can also bruise others – including democracy, meritocracy, and equality of opportunity. To paraphrase George Orwell, in market systems we are all free but some are (a lot) freer than others.

In 1976 Friedman was awarded the Nobel Prize in economics for his contributions to scientific economics. These contributions are marked by two characteristics. First, they are imbued with an underlying conservative partisanship characterized by profound animus to government. Second, Friedman achieved public standing through his macroeconomic work, important elements of which have been discredited. In a sense, Friedman is the economist who lost the battle but ended up winning the war, convincing society to adopt his view of the world.

One of Friedman's (1956) most widely recognized contributions is monetarism, which recommends that central banks target money supply growth. Monetarism flourished in the late 1960s and 1970s and was briefly adopted by central banks as a policy framework in the late 1970s and early 1980s. That experiment produced devastating interest rate volatility, prompting central banks to revert to their traditional practice of targeting interest rates.

Monetarism was supported by Friedman's joint work with Anna Schwartz (Friedman and Schwartz, 1960) in which they argued that the Federal Reserve caused the Great Depression through mistaken monetary tightening. This was Friedman's first major salvo in his crusade against government, implicitly blaming government for the Depression. Friedman's claim has always smacked of the tail wagging the dog since the Fed's tightening was modest and brief, suggesting an underlying instability of the 1929 economy. The 1929 stock market was characterized by feverish speculation, and the Fed would indeed have done better to provide easy liquidity when investors rushed to exit. However, that also proves the dangerous instability of financial markets and makes the case for an active government regulatory presence, the very opposite of Friedman's philosophical perspective.

At the theoretical level, monetarism asserts that central banks control the money supply and should aim for steady money supply growth. Friedman even recommended replacing the Fed with a computer that would mechanically manage the money supply regardless of the economy's state. Furthermore, he (Friedman, 1969) suggested the Fed aim for a zero nominal interest rate. If the equilibrium real interest rate is three percent, that policy implies steady deflation of three percent.

These monetarist propositions reflect a flawed understanding of money. Money is a form of credit - an IOU. If central `banks try to control the narrow money supply, the private sector just moves to create other forms of credit. That is why the Fed was unsuccessful in targeting the money supply, and why predicating economic policy on the relationship between the money supply and economic activity is a will o' the wisp. With regard to deflation, Japan's recent experience has confirmed the lessons of the Great Depression. In a credit-money economy generalized deflation is catastrophic and should be avoided.

Monetarism's most famous aphorism is that "inflation is always and everywhere a monetary phenomenon." This saying reflects Friedman's polemical powers, capturing for monetarists what all sensible economists already knew. Inflation is about rising prices, and prices are intrinsically a monetary phenomenon since they are denominated in money terms.

Sustained inflation requires that the money supply grow in order to finance transacting at higher prices. For Friedman, this made villainous central banks the exclusive cause of inflation because of his belief that they control the money supply. However, the reality is that the private sector can also inflate the money supply through its own credit creation activities. Additionally, central banks (viz. the Bernanke Fed) may be compelled to temporarily accommodate inflationary private sector pressures to avoid triggering costly recessions. The implication is that inflation can have different causes, something Friedman denied. Sometimes inflation is caused by excessively easy monetary policy or large budget deficits financed by central banks. Other times it is due to private sector forces, including speculative booms and conflicts over income distribution.

Monetarism asserts that monetary policy is all-powerful. Subsequently, Friedman (1968) changed his view and argued that monetary policy had no long-run real economic impacts. Friedman cleverly termed his later theory the natural rate of unemployment, thereby enlisting nature on his side.

His new theory supported an extreme *laissez-faire* policy agenda that still lives. According to the theory, the minimum wage increases unemployment by driving up wages, and should therefore be done away with. The same holds for unions. No consideration is given to the possibility that these institutions create an income distribution that promotes mass consumption and full employment. Finally, since central banks supposedly have no long run effect on unemployment and wages, they are not responsible for labor market outcomes. Natural rate theory thereby allows the Fed and European Central Bank to take full employment policy off the table while protecting them from charges that their policies may contribute to wage suppression.

The theory of the natural rate of unemployment (also known as the non-accelerating inflation rate of unemployment or NAIRU) asserts that demand adjusts to supply, and supply is independent of demand. It is for that reason monetary policy is supposed to be ineffective since it affects demand. However, there are good reasons to reject natural rate theory. First, the level of demand and the pace of demand growth affect investment (capital accumulation), which affects supply (Chirinko, 1993; DeLong and Summers, 1991). Second, as James Tobin (1972) – Friedman's arch Keynesian rival – pointed out long ago, mild inflation can help grease the wheels of labor market adjustment when there is downward rigidity of nominal wages. That means there is a tradeoff between mild inflation and unemployment, and demand-side policies can reduce unemployment (Palley, 1994). Third, extended unemployment and insufficient demand can erode workers' skills and destroy firms (which are costly to assemble clusters of skills, capital, and social networks), thereby reducing supply.

Friedman's arguments about unions and minimum wages always causing unemployment are also flawed. According to conventional economic theory, a modestly higher wage can actually increase employment if employers have monopsony power. Likewise if hours of work are flexible (Palley, 1995, 2001), a modestly higher hourly wage can induce firms to increase the number of jobs and have individual workers work fewer hours but at greater intensity. These positive employment effects arise even before taking account of the positive impact on demand that comes from paying workers more, thereby enabling them to consume more.

In many regards, natural rate theory has become a religious doctrine within the economics profession. When predictions of the natural rate turn out wrong (as they repeatedly have), proponents just assert that the natural rate has changed. That has led to the most recent incarnation of the theory in which the natural rate is basically the trend rate of unemployment (see Staiger, Stock, and Watson, 2001). Whatever trend is observed is natural – case closed.

Not only have contrary theoretical arguments been disregarded, so too have empirical arguments. Thus, it has been widely established that monetary policy and anticipations of future monetary policy affect economic activity, contrary to natural rate theory (Mishkin, 1982). Yet despite this, natural rate theory continues to be the dominant theory of contemporary macroeconomics as evidenced by its place in textbooks.

Another sensible route of inquiry would be to examine the theory's assumptions for plausibility and reasonableness. However, Friedman's (1953b) early work on economic methodology blocks this route by asserting that realism and plausibility of assumptions have no place in economics. With most economists blindly accepting this position, the result is a church in which entry is conditional on accepting particular assumptions about the working of markets.

The theory of consumption is another area in which Friedman (1957) contributed. His permanent income theory of consumption sensibly argues that household consumption and saving decisions are made on the basis of households' assessments of their long term sustainable income, and not just on the basis of today's income. However, Friedman also asserted that all households save the same proportion of their sustainable income. This proposition is manifestly false, as shown by the behavior of the super-paid. It also has clear conservative implications. Since all save the same proportion, transferring income from higher paid to lower paid households generates no economic stimulus. Progressive taxes can still be justified on ethical grounds, but not on economic stimulus grounds.

Lastly, Friedman (1953a) was an early proponent of flexible exchange rates. Whereas the argument that flexible exchange rates facilitate macroeconomic adjustment has worn well, Friedman's arguments against the dangers of destabilizing speculation have not. In line with his ideological predisposition for markets and against government intervention, Friedman ruled out destabilizing speculation. His argument was there exists a fundamental equilibrium price, and if prices depart from this speculators see a profit opportunity and drive prices back. However, experience has shown that exchange rates and asset markets are prone to speculative bubbles, and it has been extremely difficult to find a relation between exchange rates and fundamentals – whatever they are (Taylor, 1995).

While such findings do not support fixed exchange rates, they do support a case for sensible exchange rate management by well-informed officials who can do a better job than speculative casino markets. Yet, the triumph of Friedman's anti-government economics means that this sensible policy approach has been ignored by U.S. policymakers.

Turning to economic policy, Friedman's impact has been huge. In some instances that impact has been for good, in others for bad. In my view, his "small" policy recommendations were often sensible, but his "big" policy recommendations and economic philosophy were flawed. It is this contradictory feature that makes writing about Friedman difficult and prone to confusions. Good economics involves walking a tightrope between infatuation and despair with markets. Friedman erred on the side of infatuation and thereby lost his balance.

Friedman's greatest impact concerns his contribution to changing the economic policy mindset – call it the atmosphere in which policy is developed. Friedman believed in market solutions over regulation, and that is today's dominant philosophical frame. Likewise, though deeply flawed, the theory of the natural rate is today's dominant frame for monetary policy. Additionally, it promotes a dangerous agenda pushing downward wage flexibility that risks a return of deflation. Furthermore, Friedman (1961) was a critic of fiscal policy, arguing that it was ineffective and prone to long implementation lags that could make for instability. Here too policy has moved in a Friedman-ite direction, with policymakers turning away from fiscal policy.

As noted above, Friedman was an early advocate of flexible exchange rates, believing fixed exchange rates to be a form of government price control. Among industrialized countries, flexible exchange rates have now become the dominant form of exchange rate arrangement. However, developing countries (e.g. China and India) have not followed Friedman's advice, and they appear to have done well not doing so.

Another policy success was Friedman's opposition to interest rate ceilings on bank deposits, and such ceilings have now been largely done away with. Friedman (1962, p.36) was also against the military draft in the U.S. and for a volunteer army, a policy that has also been adopted. Additionally, Friedman (1980) proposed a negative income tax whereby the government would pay very low-income households (hence negative tax), and a variant of this proposal has been established in the U.S. in the form of the Earned Income Tax Credit. Finally, Friedman (1962, p.89) was for vouchers in education whereby the government would issue vouchers to parents that could be used to pay for schooling. This proposal has not been adopted because it would contribute to further self-selection by the rich out of public schools, thereby further financially hobbling the public school system. However, it remains a perennial policy favorite of political conservatives, and thereby continues to impact the education debate.

In sum, Milton Friedman's political economy helped provide a corrective to the excessive disregard of markets and the price system engendered by the Great Depression, and his advocacy of the power of economic incentives abides. However, it is important to recognize that Friedman was not a lone defender of markets. Keynes, himself, always held an enormous regard for the market system – what he termed the Manchester System (Keynes, 1936, p.379). Leading American and British Keynesians also shared that regard, but they saw deeper limits to markets that necessitated a greater role for government if capitalism is to work for ordinary people. For Friedman, minimalist government – a policeman, a judge, and a jailer to enforce property rights and contracts – was all that is needed.

Today is an era of free market triumphalism, spawned by geo-political success in the Cold War versus Soviet communism. Yet, the structure of today's economic arrangements is a far cry from the economy of the 1930 or Milton Friedman's minimalist government. Countries use central banks to conduct activist monetary policy, and government is a huge stabilizing component of total demand and also redistributes income from rich to poor. Today's relative success therefore rests on a model that uses markets but is also profoundly different from that advocated by Friedman. Indeed, there is accumulating evidence that movement toward the hands-off minimalist model advocated by Friedman can trigger dangerous instabilities and resentments, as evidenced by the clash over the Washington Consensus free market policy agenda in Latin America and globalization more broadly.

This speaks to the analytical correctness of market Keynesians, not Milton Friedman. However, there is a widespread mistaken view that history has proved Friedman right. This poses grave political dangers going forward, and Friedman's partisanship is implicated in this.

In some parts of the world government is too powerful and market forces need promoting. In other parts market forces are too powerful and workers and government are on the defensive. In yet other parts, government is simultaneously too powerful and also undeveloped. That poses the paradox that government needs to be reined in and also developed. Elsewhere, the reverse may hold with markets forces too powerful and markets simultaneously under-developed. Economic success requires mastering these paradoxes and attaining the right balance, but this is outside the scope of Milton Friedman's vision that offered misleading comfort in the certainty of idealized *laissez-faire* markets. By all accounts, Milton Friedman was a considerate person and he was a revered teacher. However, his fame rests on his ideas, and those ideas suffer from an excess of *laissez-faire* partisanship.

References

Chirinko, R.S., "Business Fixed Investment Spending: Modeling Strategies, Empirical Results, and Policy Implications," Journal of Economic Literature, XXXI (December 1993), 1875 - 1911.

DeLong, J.B. and Summers, L., "Equipment Investment and Economic Growth," Quarterly Journal of Economics, 445 – 502, 1991.

Friedman, M., "The Optimum Quantity of Money," in The Optimum Quantity of Money and Other Essays, Chicago: Aldine, 1969.

----------------, "The Role of Monetary Policy, American Economic Review, 58 (May 1968), 1 – 17.

----------------, Capitalism and Freedom, Chicago: University of Chicago Press, 1962.

----------------, "The lag in Effects of Monetary Policy," Journal of Political Economy, 69 (October 1961).

----------------, A Theory of the Consumption Function, National Bureau of Economic Research, Princeton: New Jersey, 1957.

----------------, "The Quantity Theory of Money – A Restatement," in Studies in the Quantity Theory of Money, Chicago: University of Chicago Press, 1956.

----------------, "The Methodology of Positive Economics," in Essays in Positive Economics, Chicago: University of Chicago Press, 1953a.

----------------, "The Case for Flexible Exchange Rates," in Essays in Positive Economics, Chicago: University of Chicago Press, 1953b.

Friedman, M., and R. Friedman, Free to Choose: A Personal Statement, New York: Harcourt, 1980.

Friedman, M., and A. J. Schwarz, A Monetary History of the United States, 1867 – 1960, Princeton, NJ: Princeton University Press, 1963.

Keynes. J.M., The General Theory of Employment, Interest, and Money, London: Macmillan, 1936.

Mishkin, F.S., “Does Anticipated Monetary Policy Matter? An Econometric Investigation,” Journal of Political Economy, 40 (1982), 22 – 51.

Palley, T.I., “Labor Markets and Unemployment: The Targets and Instruments Framework,” Eastern Economic Journal, 27 (Winter 2001), 83 - 84.

------------, "Labor Markets, Unemployment, and Minimum Wages: A New View," Eastern Economic Journal, 21 (Summer 1995), 319-26.

------------, "Escalators and Elevators: A Phillips Curve for Keynesians," Scandinavian Journal of Economics, 96 (1), 1994.

Staiger, D., Stock, J.H., and Watson, M.W., “Prices, Wages, and the NAIRU in the U.S. in the 1990s,” National Bureau of Economic Research, Cambridge: MA., June 2001.

Taylor, M., “The Economics of Exchange Rates,” Journal of Economic Literature, XXXII (March 1995), 13 – 47.

Tobin, J., "Inflation and Unemployment," American Economic Review, 62 (1972), 1-18.