

Milton Friedman: Perspectives, Particularly on Monetary Policy

Robert J. Barro

Harvard University

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When my son Jason was an economics Ph.D. student at Harvard in the 1990s, he said: “I have observed that only two economists can push you around, Milton Friedman and Gary Becker.” I agreed but argued that it was a good thing. Everyone needed heroes, and Gary had only Milton. Milton had no one, except Ronald Reagan in the 1980s, but Reagan did not really qualify as an economist. Arthur Burns may once have been the economist hero—as an instructor at Rutgers, he apparently helped to persuade the undergraduate Milton not to be an actuary. However, Burns’s exalted status ended in 1971 when he went over to the dark side by endorsing Richard Nixon’s outrageous price controls. Milton tells me that Frank Knight was also his “god,” presumably between 1932 and 1935 when Milton was a graduate student at the University of Chicago and after 1946, when Milton joined the Chicago faculty.

Long-time friend George Stigler, shown with Milton in the first photo, told the story of how Milton got his faculty appointment at Chicago. The two were together in 1945-46 on the faculty of the University of Minnesota. Stigler says (in his *Memoirs of an Unregulated Economist*):

“In the spring of 1946 I received the offer of a professorship from the University of Chicago, and of course was delighted at the prospect. The offer was contingent upon approval by the central administration after a personal interview. I went to Chicago, met with the President, Ernest Colwell, because Chancellor Robert Hutchins was ill that day, and I was vetoed! I was too empirical, Colwell said, and no doubt that day I was.

So the professorship was offered to Milton Friedman, and President Colwell and I had launched the new Chicago School. We both deserve credit for that appointment, although for a long time I was not inclined to share it with Colwell.”

It was not until 1958 that Stigler left Columbia to accept the lucrative Walgreen Professorship and was then reunited with Milton in Chicago.

The only person to rival Milton for policy influence in the 20th century was John Maynard Keynes, who had a strikingly different view of the role of government. Keynes advocated more government intervention into what he perceived as poorly functioning private economies caught up in the global depression of the 1930s. In contrast, Milton—particularly in his work with Anna Schwartz—put the primary blame for the U.S. depression (as well as the 1937-38 recession) on government failure, especially the Federal Reserve’s monetary policy. Hence, the existence of the Great Depression posed no dilemma for Milton’s broad preference for small government, and he found in the Fed’s failures to prevent deflation an argument in favor of monetary rules. As the world evolved—with price stability becoming the major mission of central banks and free markets and property rights becoming the key policies to promote economic growth—Milton surely won the intellectual and policy battles.

High esteem by the economics profession was not always Milton’s status, and he had to endure a long march from pariah to priest. This transition culminated in the Nobel Prize in Economics in 1976, a great choice that confirmed the widespread impact of his economic ideas. In contrast, in the mid 1960s, when I started as a graduate student in economics at Harvard, my professors viewed Milton as a right-wing, Midwestern crank. (The Harvard economics department is much better now than it was then!) Surprisingly,

Milton was most notorious for his work on money, especially for the dictum that “inflation is always and everywhere a monetary phenomenon.”¹

Milton laid out his views on money in “The Quantity of Money—A Restatement” (an essay in the 1956 book, *Studies in the Quantity Theory of Money*) and the epic *A Monetary History of the United States* (written in 1963 with Anna Schwartz). The *Monetary History* explores money-supply determination under different regimes, including the gold standard. Friedman and Schwartz argued that much of the historical variation in money supply was independent of shifts in the demand for money. They used this finding to argue that the positive association between nominal money and real economic activity reflected substantial causation from money to the real economy, rather than predominantly the reverse.

The odd thing from a current perspective is that Milton’s stress on monetary disturbances was viewed in the 1960s as anti-Keynesian. It is true that Keynes in his *General Theory* deemphasized monetary disturbances as a source of business fluctuations, and he was also skeptical about the role of monetary policy as an anti-recession device. However, particularly since the 1980s, self-styled New Keynesians have embraced activist monetary policy as a centerpiece of counter-cyclical policy. Thus, Milton’s stress on the business-cycle effects of monetary shocks now fits comfortably—maybe too comfortably—with Keynesian thinking.

Milton refined his views on money in his 1967 presidential address to the American Economic Association (AEA). “The Role of Monetary Policy,” which appeared in the 1968 *American Economic Review*, is probably the most important contribution ever to come from this format. Usually, presidential addresses and similar

¹ This quote is from his 1968 essay “Inflation: Causes and Consequences,” *Dollars and Deficits*, p. 29.

speeches cannot be forgotten too soon. A key result—which, along with work by Edmund Phelps, foreshadowed the 1970s Bob Lucas-led revolution on rational expectations macroeconomics—was that only unanticipated movements in money and the price level mattered for real economic activity. However, Milton’s monetary framework implied a potentially important role for activist monetary policy in smoothing out the business cycle. Systematic monetary changes had substantial short-term real effects, and wise interventions could improve the functioning of the macro economy. Implicitly, the private market was working badly, beset by sticky prices and wages in the short run, and the monetary authority could help by stimulating the economy in recessions and cooling things down in booms. No wonder that this part of Milton’s monetary ideas would be embraced by Keynesians in the 1980s.

To go from Milton’s monetary framework to an argument for monetary stability, one needs additional features, such as the “long and variable lags” stressed in *A Program for Monetary Stability*. Even more important is the distinction between rules and authorities emphasized by Henry Simons (and subsequently analyzed in a large literature on rules versus discretion). Models with these features can explain why monetary activism often causes more harm than good, even when (or, rather, especially if) monetary shocks have major real effects. Thus, these extensions can reconcile Milton’s conceptual framework with the constant-growth-rate rules for monetary aggregates that he favored in practical policy advice.

Milton has been very successful with the broad proposition that monetary policy activism tends to be mistaken. However, his well-known, specific proposal—that a monetary aggregate such as M1 or M2 grow at a pre-specified rate such as 2 or 3% per

year—has problems. In fact, this area is the only one I know of where Milton has pretty much reversed his previous position. The problem is that the real demand for money is not that stable, most dramatically in the current, high-tech financial environment, but also over the longer history. Therefore, a constant growth rate for any monetary aggregate does not ensure anything close to inflation stability. One way or another, a monetary policy aimed at inflation stability has to allow the nominal quantity of money to adjust to shifts in the real quantity of money demanded.

Inflation targeting, whereby nominal interest rates react strongly to deviations of inflation from target, has been pursued in an implicit form by the Federal Reserve since the mid 1980s and in explicit forms by New Zealand and about 20 other central banks since 1989. (Aside from the U.S., notable holdouts from explicit inflation targeting are the central banks of the E.U. and Japan.) As part of the targeting process, nominal money adjusts automatically to shifts in real money demand. (In technical jargon, the nominal quantity of money is endogenous.) Inflation targeting in various forms has been enormously successful, resulting in a great reduction in the mean and variability of inflation in advanced countries and parts of the rest of the world.

It's true that the interest-rate reaction functions of many central banks, including the Fed, encompass responses of interest rates to variable other than inflation. Notably, in the U.S., interest rates tend to rise when the labor market is tight, and vice versa. I am unsure whether this part of monetary policy is useful—but it is apparently not so harmful and does not compromise much the objective of achieving low and stable inflation. In any event, although the refinements since the 1980s in monetary policy are important, the

general spirit of the new approach fits with Milton's idea that the major mission of central banks is to ensure low and stable inflation.

One thing I learned from Milton's *Memoirs* is that his influence was achieved mainly through the force of ideas, not by direct participation in the policy process. Except for work in 1935-37 in New Deal Washington (when Milton had no academic job opportunities) and during World War II, Milton avoided government service. His key advice to academic economists: "... by all means spend a few years in Washington—but only a few. If you stay more than two or three years you will become addicted and will be unable effectively to return to a scholarly career." My only disagreement is that two or three years in Washington are too many.

In any event, Milton probably would not have been an outstanding policymaker. His main output in Washington during World War II involved work on the establishment of income-tax withholding. It may be that no other law has done more to enlarge the size of the federal government. Certainly Milton regrets the existence of income-tax withholding, but he also says (no doubt correctly) that this institution would be present even if he had never set foot in Washington.

Also in the *Memoirs* is verification of a well-known story about Milton's concern as 1967 AEA president about the association's accumulation of a substantial surplus. He worried that the money would be spent on some ill-advised project designed by a social do-gooder. Therefore, he successfully proposed the startup of a new journal (the *Journal of Economic Literature*) without an increase in membership dues. The resulting budget deficit used up the endowment in a reasonably quick and nearly harmless manner. I remembered this episode when I was AEA vice president in 1998. Again, the association

had accumulated a large surplus, and I worried about the potential ill-advised uses. My proposal at the time (when the AEA already had three journals) was to cut the membership dues until the endowment declined to a reasonable level. However, lacking Milton's talents at persuasion, I failed miserably in this proposal. The problem of the large surplus was not solved until the stock-market decline at the end of the Internet boom in 2000. (I am told that the problem has now recurred, and the association is responding by starting up four new field journals.)

Milton is often cited, starting with *Time* magazine in December 1965, for the famous quote: "We are all Keynesians now." However, we learn from the *Memoirs* that the quote was taken out of context to change the meaning. The full statement reconstructed by Milton in a letter to *Time* in 1966 is: "In one sense we are all Keynesians now; in another, nobody is any longer a Keynesian." Milton explains that the first sense refers to the rhetoric and style of macroeconomic analysis—Keynes essentially invented macroeconomics as a distinct field. The second sense applies to substantive implications; specifically, to the idea that (almost) no one now advocates the simplistic policy activism recommended in Keynes's *General Theory*. Although the second observation is more significant, the first one got most of the press.

Milton also mentions a Keynes quote attributed in the 1960s to Richard Nixon: "Now I am a Keynesian in economics." This quote may help to explain the awful economic policies that Nixon carried out as President. Aside from price controls, his administration featured a sharp rise in federal spending, especially for Social Security, a large increase in inflation, the Endangered Species Act, the establishment of the Environmental Protection Agency, and the 55-mile-per-hour speed limit. A misery index

based on inflation, unemployment, real GDP growth, and nominal interest rates reveals that Jimmy Carter was the only President with worse outcomes in the post-World War II period. As I have argued elsewhere, Nixon surely deserved to be impeached, but more for economic policy than for Watergate.

One minor omission from the *Memoirs* is the famous photo that George Stigler (an avid photographer) took of Milton receiving a speeding ticket from a policeman in Chicago. Although Milton apparently found it rational to break the law by speeding, this second photo shows clearly that he was cooperating fully with the local authorities.

I cannot resist noting some intriguing personal linkages between Milton and me. First, we both have Hungarian parental origins from territory that is now part of the Ukraine. (My mother was from Munkacs, now Mukacevo; Milton's parents were from Beregszasz or Berehovo.) Second, I have the name Friedmann in my ancestry, although from my father's origins in Transylvania. Finally, in 1982, at the start of my second faculty position at the University of Chicago, I purchased the house at 5731 S. Kenwood Avenue that Milton occupied from 1950 to 1962. (Milton once asked me about the fine workbench in the basement, and I told him that it was still there in 1984.)

Despite all these linkages, I regret that Milton's personal advice to me has not always been of the same quality as his policy advice. For instance, when I was Milton's colleague in 1974, I received an invitation to attend the Hong Kong meeting of the libertarian Mont Pelerin Society. Since Milton was a founding member of the Society, I naturally solicited his opinion about whether I should attend. He replied that the Society ought to be abolished. He said (along the lines of a speech he gave at the 1972 meeting) that the Mont Pelerin Society came into being after World War II to serve the needs of

persons in countries where dialogues with fellow libertarians were impossible. The Society was highly successful in meeting this need through the 1960s. However, with the development of alternative institutions and the spread of global communications, Milton argued that this function was no longer necessary by the early 1970s. More generally, Milton thought that institutions have a tendency to live on or expand long after their missions were accomplished. Thus, he suggested that the Mont Pelerin Society declare victory, go out of business, and thereby set a great example for other organizations that ought to fade away. My candidate list—which I think Milton would endorse—includes the International Monetary Fund, the World Bank, and the United Nations.

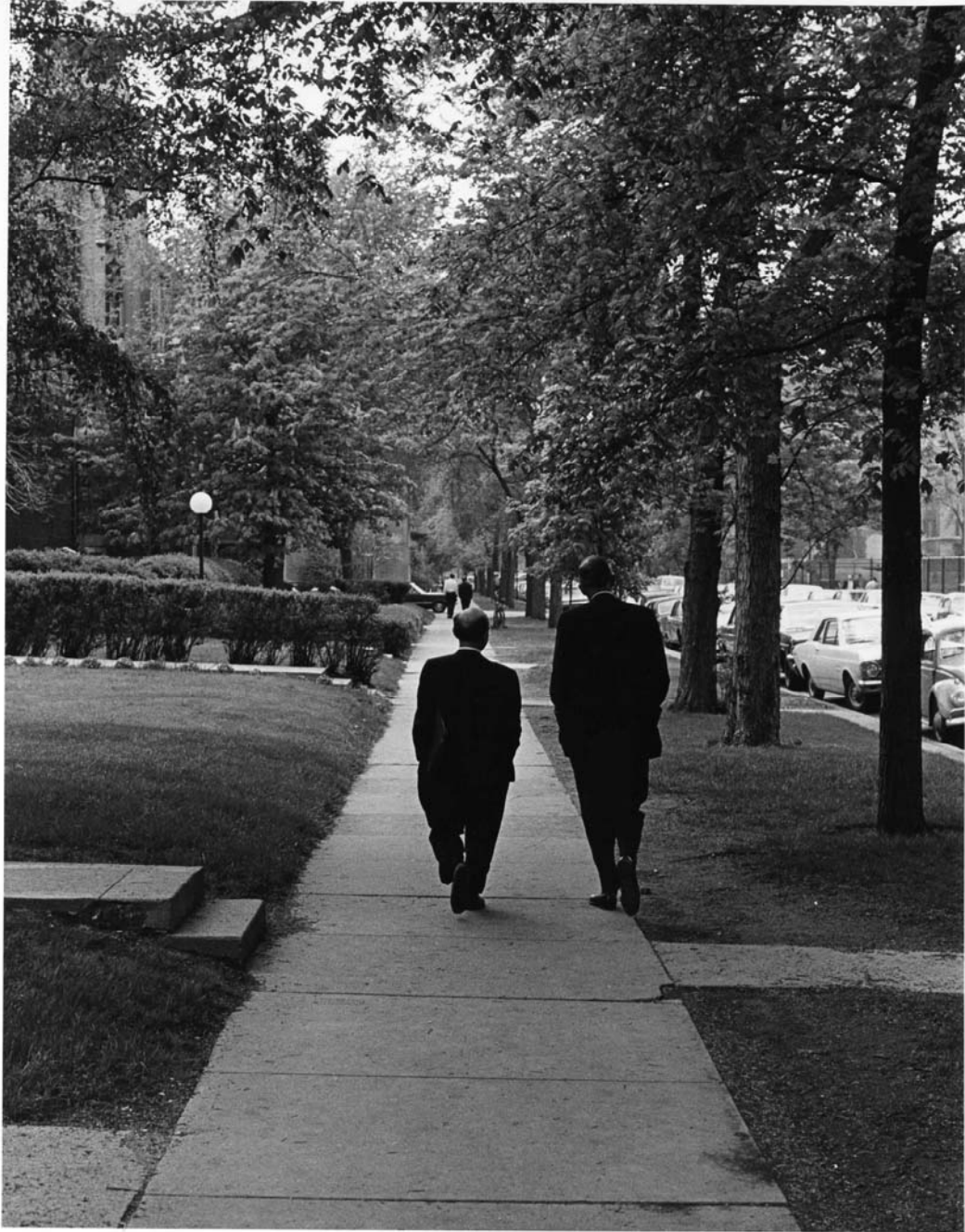
The problem with Milton’s cogent analysis of the Mont Pelerin Society and institutions more broadly is that I took it as personal advice not to attend the 1974 meeting. Therefore, I turned down the invitation. This was a mistake because I missed out on numerous exciting meetings of the Society until I first attended in 1992 in Vancouver. (I was, I believe, the only non-founding member ever to be voted into the Society without having previously attended at least two meetings. George Stigler, who organized the Vancouver meeting but died shortly before it, convinced the membership committee that I had participated in two prior meetings.)

One of the best things about the University of Chicago environment is the workshop system, and Milton was still running the famous Money and Banking Workshop in 1972-75. He conducted the workshop in a “page-one/page-two” format. Instead of allowing the speaker to present the paper, Milton began by asking “Does anyone have comments on page 1?” The speaker was then allowed to respond to the comments on page 1, and so on for subsequent pages.

In a 1973 workshop, I presented my paper, published in the 1974 *Journal of Political Economy*, about Ricardian Equivalence for budget deficits. (In the model, taxes and budget deficits had equivalent economic effects, along the lines expressed by the classical British economist David Ricardo. However, I should mention that no one in the 1973 workshop noted the connection between my paper and Ricardo.) This was the only time I witnessed a seminar attended simultaneously by the three great pillars of the Chicago School—Milton, George Stigler, and Gary Becker. At one point, Gary and I got involved in a heated dispute on a technical point in the paper. I recall Milton putting his head down, deep in thought for at least a full minute, while the room was silent. Given Milton’s mental quickness, this prolonged deliberation was quite unusual, and there was an atmosphere of thick tension in the room. Finally, Milton lifted his head and declared, in an incredulous way, that Gary was wrong (a nearly unprecedented event) and that I was therefore right. For some reason, Gary lacks any recollection of this event.

Milton moved to San Francisco and joined Stanford University’s Hoover Institution in 1977. He wrote the *Memoirs* with Rose at Hoover, and his mind has remained remarkably nimble even into his nineties. On one occasion, Milton remarked how surprised he was still to be alive at such an advanced age, that somehow it was a contingency for which he had not planned. Nevertheless, we can all only be grateful for this outcome.

More generally, we are all fortunate that Milton had the good humor and self-confidence to persevere in the face of many years of scorn by left-wing economists and journalists. The tables were turned on his detractors many years ago, and—to paraphrase his misused quote about Keynes—we are all Friedmanians now.



Milton and George Stigler at the University of Chicago

Taken on University Avenue after lunch at the Faculty Club, 1965-70?

(photo courtesy of Stephen Stigler)



Milton Receiving a Traffic Ticket on Calumet Expressway, Chicago

Taken by George Stigler in 1972, probably on the way to a tennis match.

(photo courtesy of Stephen Stigler)