Chapter 19

Milton Friedman and Monetarism

Keynesian theory almost swept away Classical theory after World War II. However, Classical theory has recently returned to prominence after some of the luster of Keynesian theory wore off with the failure of fine tuning in the late 1960s, and intractable inflation in the 1970s. Not only has Classical theory made a comeback, it has also figured prominently in two other policy perspectives: monetarism and supply-side economics. Supply-side economics was discussed in conjunction with the Laffer Curve. We will survey monetarism here.

The 1950s were a bleak time for economists who were not impressed with Keynesian theories. What was a non-believer to do in the rising floodtide of Keynesian interventionism? Many older economists retired, abandoning the terrain to Keynesians. But Milton Friedman was a young economist in Chicago, too young to retire and not disposed to that option in any case. Friedman set out to resurrect the classical viewpoint. In this endeavor, he chose to focus on the quantity theory of money.

Friedman's ***New Quantity Theory of Money*** was revised and updated considering the Great Depression and the Keynesian invasion. It became the central tenant of Friedman's monetarism. In addition, most (but not all) economists who call themselves "monetarists" are followers of Friedman, or at least espouse a monetarism like Friedman's. Consequently, the discussion that follows largely reflects Friedman's work.

Friedman: The Economy is usually stable ... if you let it be

Friedman started out by boldly proclaiming that the economy, if left alone, tends to operate at full employment. Fluctuations in economic activity are largely due to random shocks, normal business cycle fluctuations, or bad monetary policies.

Two points about Friedman's proposition should be made here: 1) One should recognize the classical influence immediately; 2) This was a very brash proposition because Friedman was making this claim in the 1950s to a generation who had lived through the Great Depression. If the economy tends toward full employment on its own, the critics asked, why did we have the Great Depression?

This is an understandable question and one that has served as the acid test for new macroeconomic theories. Can your theory explain the Great Depression? If your

new theory cannot explain the Great Depression, then no one is very interested in what you have to say.

Friedman did not get very far with his theory until he provided an answer to this question. His response came in 1963, in a book co-authored with Anna Schwartz entitled, A Monetary History of the United States. This book was an exhaustive survey of fluctuations in the United States economy, especially the role of money and monetary policies in the business cycle. Chapter 8 in the book was titled "The Great Contraction" and dealt with the Great Depression. This was the critical chapter for Friedman and Schwartz, so they had Chapter 8 reprinted and published separately as a monograph (a short book) titled: The Great Contraction. The monograph was designed to give their explanation of the Great Depression maximum exposure.

The Monetarist Explanation for the Cause of the Great Depression

We can only provide a brief overview of the monetarist explanation of the causes of the Great Depression here. The critical points of Friedman and Schwartz's analysis follow.

The economy experienced a "garden variety" recession in the summer of 1929. The first year of the recession was rather unremarkable and it looked like any other recession. This was certainly not a great depression. However, in the autumn of 1930, crops failed in the American Midwest. Worse, regional banks in the affected area began to fail. Small local banks failed as drought-stricken farmers were unable to make loan payments. In turn, the larger regional banks that lent money to the local banks were affected. Large banks in the New York and other financial centers that did business with the regional banks were also pulled into the crisis.

Worse, the entire banking system was dragged into the crisis due to fears of a bank run. When troubled banks fail, it casts suspicion on all banks. This is the inherent vulnerability of a fractional reserve banking system. A run on an unhealthy bank can easily lead to runs on healthy banks. No bank, no matter how sound it is, can withstand a prolonged run. This was, in fact, why the Fed was created. It was to be a lender of last resort when healthy banks experienced runs on the bank.

Friedman and Schwartz argued that the Fed failed to act as a lender of last resort. As more and more banks failed, the crisis spread to larger urban banks. In December 1930, The Bank of the United States, a private bank in New York, failed. Friedman and Schwartz claimed that the bank, although basically sound, was a victim of the Fed's "crime of omission," its failure to act. The Fed allowed deposits to be withdrawn, lowering the money supply and creating panic.

The failure of the Bank of the United States had a profound impact on the banking system and the country. Most people did not know that this was a private Brooklyn bank. They thought that *The* Bank of the United States had failed, and it sent

them into a panic over the safety of their bank deposits. What would you have done with your account at the Bank of Hayward (yes, there was a Bank of Hayward) if you had just heard that The Bank of the United States had just failed? The answer is obvious. However, Friedman and Schwartz argue that the Federal Reserve failed to see this obvious danger and take action to support the banking system. This was the Federal Reserve's first "crime of omission."

According to Friedman and Schwartz, the second crime of omission came in the spring of 1931 when a major European bank failed. Banks in the United States that had banking relations with this bank were put under pressure. Banks began to fail again and once more, the Fed did nothing. This second "crime of omission" was another failure to function as required and uphold the Federal Reserve's principle mandate of acting as a lender of last resort.

The final policy disaster came in the autumn of 1931. The United States was rumored to be going off the gold standard. A full discussion of the gold standard is not possible here but suffice it to say that this monetary mechanism committed countries to back their currency with gold. When countries went off the gold standard, they stopped paying currency holders the amount of gold that they had pegged their currency to. When the gold standard was resumed, the currency was backed once again by gold, but the gold content of the currency was quite often decreased. In other words, people got less gold for their dollars.

It is easy to see what a rumor like this would do. If you had dollar denominated bank deposits and feared that the United States did not have enough gold to stand behind the dollar, what would you do? You would immediately convert your dollars to gold. If you and everyone else did the same, the United States would not have enough gold to back the currency and would have to go off the gold standard. The rumor would become a self-fulfilling prophesy.

To convince people that the United States was not going off the gold standard, and to attract gold to the United States, the Fed raised interest rates by contracting the money supply. This was the biggest reduction in the money supply that we have ever experienced, before or since.

This was also a disastrous mistake, Friedman and Schwartz argued. It was, they claimed, a "crime of commission." This was a crime of commission rather than omission because this time the Fed did something that was very harmful to the economy.

Friedman and Schwartz argued that the Great Depression started out as a business cycle downturn but was worsened by crop failures and other random shocks, which then turned into a disaster due to terrible mistakes made by the Federal Reserve.

The New Quantity Theory

Armed with an explanation for the Great Depression, Friedman made rapid headway. He updated and modernized (in view of the Great Depression) the old quantity theory: ***velocity*** was not constant; it was only ***very stable***. Classical economists had never argued that velocity was constant. They argued that velocity changed slowly over time in response to institutional factors, and that velocity was constant with respect to a change in the money supply during "normal times." We saw in the very "abnormal" German hyperinflation that velocity was certainly not constant. More importantly, Classical economists never argued that it should have been constant during this horrendous inflation.

Friedman's re-statement is best seen as an attempt to clarify and bolster the Classical position on velocity by presenting the argument in different terms. His insistence on using the term 'stable' is more a repackaging rather than a departure from Classical theory. Friedman's re-statement is designed to make two points: 1) velocity is stable with respect to changes in the money supply, as long as policy makers do not create a mess like the Great Depression or the German hyperinflation; and 2) velocity will change over time, but in a predictable fashion. Policy makers (the Federal Reserve) will know what it is at any point in time and can treat it as a constant for monetary policy purposes provided, again, that they have not created an abnormal situation that will cause velocity to change abruptly.

Has velocity shown the stability that Friedman predicted? Velocity is not constant, nor does it increase at a constant rate. However, until 1980, it did exhibit a remarkable predictability – not perfect predictability to be sure, but enough to make a case for Friedman. However, after 1980, the predictability disappears, and velocity becomes very erratic and unpredictable. This created a crisis in the Monetarist camp and coincided with a decline in support for Monetarism. The reason for the decline in support for Monetarism is obvious. However, the reasons for the instability of velocity are still being debated. Likely, financial deregulation has been responsible for the volatility in velocity after 1980.

The New Quantity Theory also postulates a different effect of monetary expansion on short run prices and output. According to Friedman, when the money supply changes, output will only be constant in the long run. In the short run, output and\or prices change will occur. For example, if the money supply were to increase by 10 percent, then nominal GDP would increase by 10 percent. This increase could come from a combination of output increases and price increases that amounted to a combined 10 percent. However, in the long run, the 10 percent increase in the money supply would, ceteris paribus, only increase prices by 10 percent. We are ignoring here growth in the economy from factors other than the increase in the money supply.

Like the earlier classical quantity theory, the new quantity theory argued that changes in the money supply affected the economy directly, not through changes in interest rates. The dispute between Monetarists and Keynesians about whether money affects the economy indirectly, or directly, through interest rate changes is often called

a debate over the **transmission mechanism** (just like the car part!). Really, it's a debate over whether to watch money supply growth or interest rates.

To counter the Keynesian tide, Friedman spent a lot of time countering the notion of a fiscal policy multiplier. He claimed that the multiplier was unstable and unknowable, since one never knew how large it was or whether it had changed. Friedman countered Keynes' consumption function with his own permanent income hypothesis. We discussed the idea behind the permanent income hypothesis in the discussion of Classical economics above. To Friedman, the reaction of consumers to a change in income depended on whether they viewed the income change as permanent or temporary. This meant that the multiplier, which depends on the MPC, is not stable or even knowable. Consequently, Friedman argued against the use of expansionary fiscal policies to "fix" recessions.

Monetarist Monetary Policy

If you have followed the monetarist argument up to now, you may think that you know the policy that monetarists recommend control the money supply to fix economic problems (such as recessions) as they arise. If this is what you thought, you were wrong. There is one last piece of the monetarist argument that argues against this kind of monetary policy.

Friedman claimed that changes in the money supply affected the economy with a lag or a delay. By itself, this would not be too troublesome. We could simply have the Fed adjust for the lag. But the problem, according to Friedman, was far more intractable. The lags were variable lags. One could never know how long the lag was: 6 months? 12 months? 18 months? 2 years?

How can the Fed correct a recession if it can't tell how long the lag is? The answer is: it can't! Due to the variable lags, Monetarists argue that discretionary monetary policies will likely make a recession worse rather than better.

So, what is the solution? Monetarists argue that monetary policy should follow a ***rule***. The money supply should be increased at a constant, even predetermined rate. The rate of increase should be enough to accommodate a growing economy. Would a five percent increase be reasonable? Friedman thought it was, but he was always quick to point out that the rate of increase was not the main point.

The main point, Friedman argued, was the need to put monetary policy on a rule basis rather than a discretionary basis. The fundamental goal of monetarists has always been to restore laissez-faire. In this regard, monetarism is very much in the classical tradition.