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The Milton Friedman Century

Milton Friedman was born before the Great War and came of age during the second calamity of the twentieth century, World War II. Those two catastrophes combined with governmental attempts to cure the great depression gave rise to the modern welfare state with its ethos of the state as the solution to everyman's problems. It was an idea widely supported by many intellectuals in the name of progress and prosperity. Friedman, however, never fell into the trap of separating material prosperity from human freedom. To him, they were inexorably linked, a hard-won truth we now take for granted. He took a path less traveled by combining a rigorous attention to economic history, particularly monetary affairs with creative intellectual insights into how markets actually functioned. Despite the quality of his research, he was for many years, a prophet without honor in his own country.

To his students and colleagues at the University of Chicago he was a brilliant teacher, without peer, who pushed to extend economic analysis over an ever-widening spectrum of public issues. Truly, to appreciate Friedman's contribution in the twentieth century, one needs to contrast the willingness of many social theorists and politicians to accept restrictions on freedom as the price of prosperity, particularly prior to the 1970's, with the contemporary, near universal acceptance of the view that measures to increase freedom typically improve economic outcomes. In his view, there was no trade-off between freedom and prosperity, a view that is supported by increasing amounts of empirical evidence. There are no better examples of this revolution in social thought than many of the countries of Eastern Europe who abandoned socialist doctrine in order to encourage both political and economic freedom. Maybe the most striking example is what is now taking place in China and India. Victory has many fathers, but in the battle for free markets and free men, Milton Friedman stands very high.

In the televised version of **Free to Choose**, which he wrote with his wife, Rose Director Friedman, some of the most memorable scenes take place in Hong Kong. The Friedmans pointed to the power of freedom to accelerate economic progress by using the tiny geographic enclave of Hong Kong as an example of what free markets could accomplish. Hong Kong was being inundated by heavy migration from the populous, communist mainland. Many Chinese, fled communism for the possibilities that a free life could offer in Hong Kong. The amazing progress made since those years, based largely on the human capital possessed by its people, is enduring, empirical evidence that markets can and do work. The trick was to let them work. The irony of China itself moving to a market economy in order to create the conditions of progress and prosperity is perhaps the most telling evidence that Milton Friedman was the man of the century. He understood and tried to teach us to take a walk for freedom whenever possible. Many listened and many learned.

He never abandoned his commitment to freedom when many wanted to give it up. He always linked the attainment of economic prosperity to free people operating in free markets. He was the original "bottoms up" thinker---a true democrat despite a widely held view that he was a "right-winger." He believed in mankind's power to think and to act in its own interest without the overweening direction of an all-powerful state. He was an optimist in a pessimistic century.

In the 1960's, the growing power of the Soviet Union and China painted a seemingly attractive picture of what a "top down" system of governance could produce. In short order, both of these giants had recovered from war time devastation and with apparent ease began to challenge the United States militarily and technologically. The Soviets quickly broke the nuclear monopoly the U.S. possessed in 1945 and threatened our supposed technological superiority by being the first to launch a man into space. With the Cold War the dominant political obsession of the 1960's, the attraction of a powerful state commanding the heights was a compelling idea. That attraction was so powerful that it led John F. Kennedy, in his inaugural address, to challenge American youth with a top down rhetorical flourish, hearkening to the great struggles of World War II. “Ask not,” Kennedy intoned, “what your country can do for you. Ask what you can do for your country.” These sentiments were widely hailed at the time by many intellectuals who believed we had entered a new age when freedom would be tested again. In fact, the encroachment of the state grew, partially endorsed by the notion that economists now had the tools to control cyclical fluctuations and that only the state could provide sufficient welfare for many of its people.

Milton Friedman thought this particular piece of Cold War rhetoric set forth a totally inappropriate relationship between man and the state as he said in his 1962 classic, **Capitalism and Freedom**. Kennedy had posed the wrong question. The New York Times obituary put it well.

> "'What your country can do for you,'' Mr. Friedman said, implies that the government is the patron, the citizen the ward; and ''what you can do for your country'' assumes that the government is the master, the citizen the servant. Rather, he said, you should ask, ''What I and my compatriots can do through government to help discharge our individual responsibilities, to achieve our several goals and purposes, and above all protect our freedom.'' New York Times, 11/17/2006

Thirty years later that had become obvious, but in 1960, to take the stand for freedom and for the individual was “risky business” indeed. Milton Friedman was punished for his views by many mainstream economists and by political liberals and conservatives. Short in stature, he was no less than a devil to the contemporary orthodoxy. His students were often both terrified and enlightened by his Socratic dialogue with them on contemporary events. He continually forced them to probe deeply into their economic thought process as he confronted them with examples of current policies and the conventional wisdom that surrounded those policies. He did not discriminate against students. Colleagues, visiting scholars and major policy officials received similar treatment when faulty logic was at issue.

I remember one occasion when I served as a young economist in the international finance division at the Board of Governors of the Federal Reserve. As I passed by him at lunch with Governor Brimmer, I told him that I was glad he was here because he would do better defending his views than I had done during my brief tenure at the Fed. I then watched Friedman scold the Board for not paying attention to the inflationary threats that could emanate from financing the Viet Nam war underwritten with an uncontrolled monetary expansion. He had a deep fear of inflation, undoubtedly because he knew how the hyperinflation in Germany had undermined the Weimar republic and led to the Nazi terror. He admonished the Board not to lose control of the money supply despite the entreaties of the Administration.

In those days when Bretton Woods and the Gold Exchange Standard stood inviolable, Friedman also strongly argued for flexible exchange rates, a very discomforting thought for many policy makers in international finance. It is said that he warned incoming President Nixon to change the system then when he first became President when there was no crisis rather than being forced to change when a crisis would emerge. In 1971, the crisis did emerge and the U.S. was “forced” to do the right thing. That illustrated the Friedman maxim that a policy economist had to keep reminding policy makers of the right solution even though they often didn’t listen at the time on the grounds that they would accept a solution only when a crisis of sufficient magnitude occurred. It happened in 1971 when the dollar’s link to gold was permanently cut, and it happened again when Paul Volker put on the monetary brakes to slay the dragon of inflation in 1979 and 1980. It is hard to think of these events today without the long campaign he had waged on exchange rate flexibility and the power of monetary policy.

In the late 1950’s and early 1960’s when Milton Friedman became more widely known for his assault on many of the policy prescriptions of the Keynesian temple, he was widely ridiculed, as were economics students at the University of Chicago. We were on the 'fringe,' clearly out of step with prescriptions then in vogue for a highly managed macro-economy. From today's perspective, it is hard to appreciate just how foreign and absurd Friedman's ideas seemed at the time. He had rejected the simplistic notion of the Keynesian consumption function that made consumption depend on current income and implied that fiscal policy was the appropriate tool of contra-cyclical macroeconomic policy. Instead, he developed the notion of permanent income which suggested that consumers would respond to income fluctuations if they thought that the change was permanent, and not just in response to an ad hoc policy disturbance. He thought that a rational consumer would consider a much longer time horizon and base his current consumption on "permanent wealth." In one form or another, the permanent income hypothesis became a principal element of modern macro theory and its implication that monetary policy was a more useful tool than fiscal policy for short term economic fluctuations became widely accepted. For many years, it was a somewhat lonely vigil.

Despite a growing acceptance of the importance of monetary policy, Friedman rejected the notion that monetary policy could or should be used as a precisely tuned instrument of national economic policy. In his classic 1958 statement to the Joint Economic Committee, he took central bank policies to task for presuming that it would know enough in sufficient time to adjust the money supply in a consistent, contra-cyclical fashion. He had come to the view because of his discovery that the lag in effect of a change in monetary policy on the economy was both long and variable. For him, that meant that the Fed was likely to turn off the water just when the fire was hottest and vice versa. To him, that meant that the risks were not worth the presumptive rewards. In the 1960's this was heresy, even though the notion of a long and variable lag in effect of changes in monetary policy is now seen as the beginning of a sensible theory of monetary policy. It led him to a then, much-ridiculed rule-based prescription that the Fed should use a fixed percentage rate of growth of the money supply at a known, annual rate, year in and year out. That rule was based on a kind of Hippocratic view that doing no harm would be a virtue for central bankers since monetary history had shown that a central bank could cause great harm. He didn't rule out the possibility that monetary economists would come to a better understanding over time, but he was skeptical over the efficacy of contra-cyclical monetary policy measures.

He stuck to his view well into the Greenspan years even though he ultimately remarked that Greenspan's actual policies based on judgment rather than a fixed rule had done much better than would have been the case in using the Friedman's rule. Ironically, the current Chairman, Ben Bernanke, is a devoted student of Friedman's research in monetary history and policy, and well knows the Fed's older history of failures. Bernanke's own predilection is for a kind of "rule-based" policy format, although one focused on targeting inflation targeting rather than monetary aggregates, but he is well aware of the dangers that a long and variable lag in effect of monetary policy changes can cause. Again and again, Friedman's lessons of the 20th century have come to play a larger role for policy makers in the 21st.

In later years, Friedman seemed less focused on his previously favored monetary aggregate (M2) as the appropriate instrument of monetary policy, recognizing that changes in financial markets had eroded much of M2's previous centrality. But he was always worried that a central bank ruled by men rather than rules was an accident waiting to happen. He conceded that Alan Greenspan's long tenure at the Fed had shown it was possible that a central bank could be run by men rather than a rule, but he worried that Greenspan himself was a singular exception. That speaks to his dedication to the evidence and contradicts the frequent charge that he was doctrinaire. On the contrary, he was always willing to look at the evidence, which is truly the mark of a scientist, as opposed to a propagandist. His work on stagflation demonstrated the point once again.

By the late 1960's, he had produced a theoretical exposition as to why the Philips Curve did not offer a true policy tradeoff between inflation and unemployment as was then widely believed. The original Friedman paper had floated about the Money Workshop at Chicago in the mid 1960's, but its time was still to come. In 1968, his Presidential address to the American Economic Association spelled out his reasons that no true tradeoff existed between inflation and unemployment. It took the Stagflation of the 1970's to demonstrate its relevance. The Nobel citation in 1976 gave him credit for enlarging our understanding of the true policy options open to a central bank and cited his work on stagflation.

This year, the Nobel in economics went to Edmund Phelps who had arrived at a similar conclusion independently, as Friedman was kind enough to recognize in his Nobel acceptance speech in 1976. The notion that expectations were crucial in determining how an economy would respond to a central bank that tried to "inflate" to cure unemployment is now old hat. At the time, however, it was a very new hat worn by few. That expectations would come to play a critical role in modern economic theory might seem obvious, now, but in the late 1950's when this "Theory of the Consumption Function" and in the 1960's "natural rate of unemployment" were first mooted, that was not widely accepted.

Friedman had always been innovative about the role of expectations in economics, both empirically and theoretically as well. His classic 1948 paper with Jimmy Savage, brought the "expected utility hypothesis" into the mainstream of economics. It would be hard to do modern economics without recognizing the critical role "expectations" play. In fact, it was a Friedman student and later Nobel Prize winner, Robert Lucas, who with his "rational expectations" model finally changed the foundations of Keynesian economics and the econometric policy modeling that underlay its policy prescriptions.

Milton Friedman opened many doors in economics, and those doors continue to lead to new insights and better economic policy approaches well into the 21st century. His views on human capital clearly inspired and motivated the work of Theodore Schultz and Gary Becker, both Nobel Laureates, who extended the purview of economics over an ever-widening field of social phenomena. Once called the dismal science, economics has invaded nearly all of the other social sciences and much of that invasion was inaugurated by Friedman's early efforts. Even in his 90's he was producing credible pieces of economics, a remarkable feat given the change that many of his ideas had wrought in the practice of economics and econometrics.

At first blush, many of his ideas seemed fanciful. He argued for a volunteer army, for a negative income tax, for a private postal system, for flexible exchange rates, for abolishing rent controls and minimum wages. He opposed licensing of various professionals and occupations that restricted markets or restricted entry into various professions or the provision of services by unlicensed practitioners. His affirmative action policy was based on the operation of free men operating in free markets and he allowed few restrictions on private property. The only one that comes to mind was that he was strongly opposed to allowing human beings to be treated as property. He opposed drug laws when it was fashionable to think that such restraints were necessary for human welfare and long before narco-terroist states threatened the liberties and safety of many people around the world. He believed that the drug laws were a "subsidy" to organized crime, a view now widely held but feared by many politicians. And, he opposed our intervention in Iraq—which might come as a surprise to many on the left today.

The reasoning behind his opposition to the current war in Iraq offers an interesting insight into how he saw the process of attaining a democratic society. He didn't think it could be imposed from above. It had to evolve from below. He recognized the tyranny of Saddam Hussein, but believed democratic society was only sustainable with support from a population who drew no distinction between free markets and free men. This is one of the few areas over which he and Rose disagreed. Milton saw our intervention as aggression and was uncomfortable with aggression as a device to spread "freedom." It is, to be sure, an arguable point, but his view illustrates quite decisively his optimism and his faith in the human capacity to make essentially wise choices in the long run. Contra Keynes, in the long run we are not dead. We are on a long road to freedom and along that road, free markets and free choice are essential.

In spite of his life long effort to overturn many of the policy nostrums of Keynesian economics, Milton Friedman thought Keynes was one of the most important economists of the 20th century. That may also seem to be a surprise, but it is not. While I never had the chance to discuss why he thought so, it seems pretty clear that Friedman respected the power of ideas, and the immense attraction of new ways of thinking about economic problems. The primary issue was whether a model gave good predictions. It reflected his own philosophy of science and why he thought economics was as much a science as were the physical sciences. Keynes built his model around assumptions about human behavior, as all models are built and that model generated predictions. Friedman always believed that you judged a scientific theory not on its assumptions, which were bound to be "wrong" in some sense, but on the ability of the model to predict. What was wrong about the Keynesian model is that it all too frequently gave incorrect predictions about policy outcomes. But, he recognized that Keynes, in his earlier work on monetary theory, and even much of the work in the General Theory that was subsequently overturned, had created a milestone along the road of economic science. By testing the theory, economists gained insight and knowledge. Keynes raised the bar and subsequent research raised it higher. That is what science is all about. Even if he didn't say it, surely Milton Friedman could have repeated Newton's famous quote, "If I was able to see further, it was because I stood on the shoulders of giants." For Friedman, those giants were Adam Smith, Alfred Marshall, George Stigler (his colleague, friend and fellow Nobel Laureate at Chicago), and, no less, John Maynard Keynes.

The many accolades contained in the eulogies for Milton Friedman often refer to Keynes owning the first half of the 20th century and Milton Friedman, the man of the second half of the century. That is a "fair-minded" characterization, but in my view, not an entirely accurate one. Underlying Friedman's view of economics and social policy is the connection between men free to choose and the outcomes for a society so organized. Keynes was interested in policy, but not very interested in the institutional setting in which policies were attempted. Friedman had a much broader view, of man and of economics.

In the 21st century, we have come to learn of the many failures of economic development in many poor countries and the failures of the welfare state in many advanced countries. The linkage between these two conditions is the markets that undergird the choices open to people. Free markets and free choice are inseparable and free men need both.

Much of his later years were devoted to his view that education was too important to be left solely in the hands of the state. Primary public education had been until recent years largely a state monopoly, and vast amounts of government expenditure went into the education industry. Yet, the results have not been inspiring and Friedman believed that the importance of human capital would continue to grow. Since increasing amounts of economic evidence had shown the close linkage between education and lifetime earnings---the returns to education---he came to believe that a democratic society could become unstable if income and educational disparities continued to widen. For that reason, he became a vociferous advocate of educational vouchers that would bring "choice" to families searching to educate their children. But vouchers issued by the state that allow parental free choice as to schools is a direct threat to the existing primary educational establishment. No industry likes more competition, and education is an industry. Any businessman understands that it is much nicer to be a monopolist and that it can lead to a quieter life. State supported education does not wish to see its primacy displaced, and it wages a vigorous fight against school choice supported by vouchers. It has been a very slow fight despite the Milton and Rose Friedman Foundation that supports vouchers. Here again, we see Milton Friedman, pushing free choice and free markets, precisely because of his fundamental belief in freedom. It is not only efficiency that counts. Free choice is the proper foundation for the social order.

Milton Friedman was a daring and innovative economist. He was a visionary thinker with an optimistic view of what was possible for men and women who were given truly free choices. The twentieth has been dominated by man's struggle to be free, and Milton Friedman was its greatest exponent. He never lost hope and he gave the 21st century an amazing legacy to protect. The 20th century was Milton Friedman's century.