

# **Milton Friedman's Intellectual Legacy – a View from his 103<sup>rd</sup> Birthday\***

**by**

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## **I**

Milton Friedman was exceptional in many dimensions, and I'm flattered to have been invited to say a little about his legacy on this, his 103rd Birthday.

I suppose that if you asked the average person nowadays what Milton is still famous for, you'd likely be told that he was the brains (or at least one of the brains) behind that famous composite politician Ronald Thatcher (RT) who, in the 1980s presided over major and lasting changes in the political economy not only of the places they were actually elected to run, but of several others too. And if you then asked whether this was to Milton's credit or not, I dare say you'd get a decidedly mixed set of answers, depending on whom you were talking to.

In today's company, I think that I can probably rely on a comfortable majority in Milton's favour, a verdict which I have no difficulty supporting, though in what follows I shall do him the courtesy due to any real-life economist, as opposed to an air-brushed intellectual icon, of noting a few matters on which his views did not weather too well.

## **II**

Milton was not simply an economist who lent technical support to governments whose philosophy and policy priorities he shared. Like RT he was distinctly right of centre, but, unlike them, he was no conservative, even with a small c, let alone a large one. Consider some of the causes he championed: the legalisation of drugs and prostitution, the abolition of the draft in the US, the negative income tax (though as a replacement for the apparatus of the welfare state, not as a component of it), education vouchers, free entry into the professions, including the practice of medicine, etc. etc.

Milton was as an old fashioned liberal in the original British sense. He always thought and spoke for himself too, but he was nevertheless willing to work with

and support people with whom he had common ground on issues that he found important, even if he disagreed with them on others. This was the basis of his associations with RT. And he was also willing to talk to just about anyone who would give him a hearing, regardless of their political stripe, if he thought there was a half chance that they would actually pay attention to his message for a few minutes. This characteristic that sometimes got him deeply mired in controversy.

He shared with RT a belief in individual responsibility, as well as its corollary, the pursuit of self-interest, as a basis for the social and economic order, but rather than view its exercise as some kind of moral duty, he thought of it as a source of personal satisfaction for the individual. I cannot document the following recollection, and memory can play tricks, but here is something I think I remember: shortly after JFK's January 1961 inauguration, I was at one of Milton's regular afternoon graduate lectures on Price Theory which he began that day more or less as follows: "The new President has said 'Ask not what your country can do for you. Ask what you can do for your country'. Both questions are the wrong one. The first thing you need to ask is what you can do for yourself".

The problem with such a point of view in 1961 was not that there was no sympathy then for self-reliance – who could be against it, considered as a personal trait - but that there was little confidence that it could provide a serious basis on which to organise an attractive economy and society. After all, "self-reliance" might sound OK, but what about "selfishness", or even "greed", and how would it all fit together?

At that time anyone who made a serious political goal of creating more space for individual choice to operate was regarded either as a bit crazy, or, more ominously, under the sway (not to mention probably in the pay) of an unscrupulous few who planned to rise to the economic top of the dog-eat-dog chaos that was bound to characterise a world constructed on such a foundation.

Milton (and his relatively few like-minded colleagues in academia and elsewhere) had to put up with many such patronising insults in the 1950s and 60s. However, they patiently kept on making their case, caught the attention of more and more members of the public, not to mention politicians, eventually including RT, and, with a big boost from an economy that went seriously and obviously wrong in the '70, things changed. Even after RT had left the stage, they stayed substantially changed too.

Not everything worked out as expected, though. The implementation of RT's program went anything but smoothly, and eventually too, after a few earlier warnings, an economy that had embraced large elements of self-reliance and self-interest went haywire in 2007. These traits are no longer as popular as they once were as building blocks of practical political economy.

### III

So what did Milton himself contribute to all this? Where can we find the record of that contribution? And now that we've seen the post – RT world get into trouble, do we need to re-assess its value?

The routine answers here are that Milton, more than any other individual, popularised liberal market economics among those whose political support RT needed; that *Capitalism and Freedom* (1962) and *Free to Choose* (1980) - both produced in collaboration with his wife Rose – provide the record we are looking for; and perhaps that, in hindsight, he was a little too optimistic about how his preferred economic system would work.

But to a historian of economic thought like me, these answers are too easy, and they underestimate the depth of Milton's lasting contribution. They miss the point that, great and gifted a populariser of liberal economics thought he was, Milton was also and above all a creative, original and thoroughly professional economist, whose Nobel Memorial Prize rewarded work in economic science, not policy. His popularising efforts were grounded in his academic accomplishments, and it is the latter that his legacy must still be sought.

The writings on monetary theory and history that won Milton this prize changed perceptions – first among economists and eventually among the lay public - about what ways of organising economic and political life were feasible. And they remain profoundly important today, because though they turned out not to tell the whole story, the incomplete one that they did tell, and the basic morals that can be drawn from it, have nevertheless survived in reasonably good condition.

### IV

In the late 1930s, Milton was a staunch supporter of the New Deal by his own account, and in the early post-war years his research was mainly in (by the standards of the time) abstract microeconomic theory and mathematical statistics, work sufficiently attractive to the then leaders of American economics to earn him the John Bates Clark medal in 1951.

The emergence of the radical liberal political economist we now remember from these middle-of-the-intellectual-road beginnings does not seem to have been sudden. Milton was already sufficiently in sympathy with liberal ideas to have been at the first Mont Pelerin Society meeting in 1947, four years before his Clark award, but in 1949, he could nevertheless still publish a fundamental paper on built-in stabilisers which paid more than enough attention to fiscal policy to be regarded as an important contribution to the “Keynesian” macroeconomics of the period.

His first big and visible academic splash as an anything but mainstream political economist was made by his 1953 *Essays in Positive Economics*, particularly its introductory essay – though this is also where he made his “Case for Flexible Exchange Rates”. His simple message - here I follow Thomas Mayer’s “soft” reading of the piece, I am well aware there are many others – was that instead of spending their time arguing about the plausibility or otherwise of the assumptions of their models, economists would be better employed finding out how their predictions conformed to observed reality.

There was empirical economics long before Milton, but in it facts were mainly used to illustrate the workings of theories whose validity had already been allegedly established in other ways: by using introspection to confirm the truth of their premises, and by checking the logic that yielded their conclusions. Milton’s proposal to use facts instead to distinguish worthwhile deductive theories from the rest was quite new to most economists. – though perhaps not to those at the LSE whose brief but fruitful flirtation with Karl Popper, whom Milton had met in 1947, was about to begin.

Novel too was a closely related point on which he insisted: that there might indeed be such things as empirically fruitful theories based on the idea of rational choice, if these were constructed so as to rule out some empirical possibilities rather than to cover all eventualities. Much choice-theoretic research at the time, as he justly complained, aimed to create theories that were potentially compatible with such a wide range of hypothetical facts that they could say nothing specific and helpful about any actual body of evidence.

## V

The mainstream economics of the 1950s took two big propositions for granted: first that the Great Depression which had brought the roaring twenties to an end in the US, and extended the chronic economic disruption already in progress for close to a decade in many other places, had definitively exposed the fundamental

unreliability of the liberal market economy; and second that war-time experience seemed to have demonstrated the feasibility of economic planning.

Keynes's (1936) *General Theory* was read as implying that the depression had been a particularly nasty example of the above-mentioned unreliability, which in turn stemmed from a fundamental flaw in the monetary system that supported it. And, on some readings, this book also seemed to advocate increased reliance on government planning, particularly in the sphere of investment. The troublesome monetary system, meanwhile, was to be prevented from doing harm to the new mixed economy by being kept well in the policy background.

Given these preconceptions, the analysis of markets was of secondary interest. It might be of limited relevance to understanding household behaviour, or even, for those who wanted to limit government's role in investment to determining its overall level, to illuminating the allocative processes that would have to be deployed within this constraint. But since these mechanisms had been demonstrated by experience to be unreliable, interfering with them even where they might still have a place was no major matter. Indeed, it most likely would improve things.

None of this left much scope for self-reliance and individual choice as the foundation of economic life. People can be as self-reliant as you please, but if the institutions that might permit their behaviour to be co-ordinated in a coherent fashion, let alone ensure that it produces desirable social outcomes, are inherently defective there isn't much point in promoting it as an important social norm.

But the principles of Milton's positive economics had subversive implications for this orthodoxy: suppose that the economic theories that supported it were to be confronted with empirical evidence, and suppose further, that alternative theories, either new or old and in disuse, that yielded different implications, were put to a similar test? The orthodoxy in question might survive this competitive process, but then again it might not.

Milton followed through on these implications, and post-war conventional wisdom came off badly. His unique achievement was thus to establish - perhaps re-establish is a better word - not just within the discipline of economics itself, but in political discourse too, an intellectually viable basis for taking self-reliance and self-interest in the organisation of economic life seriously. And he accomplished almost all of this in the 1950s and 1960s, thus clearing the intellectual way for RT and associates, long before they assumed power.

## VI

Milton's most famous pronouncement on monetary matters is surely "Inflation is always and everywhere a monetary phenomenon", nowadays almost a commonplace, but anything but in 1970 when he seems first to have put things this way. But this claim was but one part of an altogether broader and even more unorthodox (for its time) vision of the role of money in the economy, which he had already summarised in his famous December 1967 Presidential Address to the American Economic Association.

He began the second part of this lecture with a well know passage from John Stuart Mill's (1848) *Principles*:

"There cannot . . . be intrinsically a more insignificant thing, in the economy of society, than money; except in the character of a contrivance for sparing time and labour. It is a machine for doing quickly and commodiously, what would be done, though less quickly and commodiously, without it; and like many other kinds of machinery, it only exerts a distinct and independent influence of its own when it goes out of order"

And then, he referred explicitly to his own studies in monetary history, and elaborated Mill's all-important second point, one which critics of 19<sup>th</sup> century classical economics even today, are sometimes inclined to ignore:

"But money has one feature that these other machines do not share. Because it is so pervasive, when it gets out of order, it throws a monkey wrench into the operation of all the other machines. The Great Contraction is the most dramatic example but not the only one. Every other major contraction in this country has been either produced by monetary disorder or greatly exacerbated by monetary disorder. Every major inflation has been produced by monetary expansion – mostly to meet the overriding demands of war which have forced the creation of money to supplement explicit taxation"

Milton's treatment here of inflation is very like that of Keynes, who in 1923 had published a well know tract on the role of money in generating inflation, and in 1941 a seminal pamphlet on the inflationary dangers of war-finance and how to deal with them. The first of these was Milton's favourite Keynesian book - he always tried to make sure his students read it - while the other, at second hand, and without Milton initially being aware of the source, had exerted a major influence on his own first studies of inflationary problems.

But Keynes's and Milton's views on the Depression were similar only to the extent that both of them treated it as a monetary event. The specific roles that they attributed to money were quite different, and so were the implications they drew from their analyses about how economic life might feasibly be organised.

This is neither the time nor place to expound an economic model, let alone one created by Keynes of all people. Suffice it simply to state his 1936 conclusion about economic policy: namely, that depressions including the Great one, stemmed from a basic flaw in the configuration of the market economy's monetary and financial system that could not be fixed and had instead to be permanently over-ridden by state intervention.

Just how much of the monetary system could safely be left in place, and precisely how much state intervention was needed to replace what was disabled, depended on which passages of the *General Theory* you read, and/or on whom among Keynes's many interpreters you trusted, but the generally dirigiste thrust of his story was beyond question.

It is hard to say what Keynes himself, whose admirable intellectual flexibility (like Milton's) was nevertheless notorious, might have made of this story's applicability to the post-world-war II era once it had arrived. But by April 1946, he had worked himself literally to death in helping to ensure that it might be happier than the post-world-war I period that had prompted his work in the first place, and he was not around to comment.

He had many disciples and successors, though, who argued that it remained applicable, and for whom its critique of the market economy in general, and the role that money played in it in particular, provided the foundations for the economic theories and policies that they promoted in the decades that

## VII

Keynes's analysis, though untidy, was logically coherent, and his conclusions followed from his premises in a way that any aficionado of Milton's positive economics could only approve of. But it hadn't really been put to the empirical test. The main evidence cited in his theory's support was usually the very fact of the Great Depression itself. Not surprisingly, then, even before the war, but particularly in its immediate wake, empirical difficulties began to surface.

From the outset, the consumer expenditure – income relationships, that underlay the famous “multiplier”, and which Keynes thought were governed by a simple but “fundamental psychological law in which we can have great confidence” – shades of today’s behavioural economics! - gave trouble. When these relationships were confronted with data, they turned out to be altogether more complicated than advertised.

Work finally brought to full fruition in Milton’s (1957) *Theory of the Consumption Function*, where his skills as a theorist and statistician were fully displayed, sorted out this mess by replacing “psychology” with a carefully worked out analysis of forward-looking self-interested behaviour that cast serious doubt on the stability of the multiplier, and by thoroughly testing the results using then state-of-the-art econometric techniques. This analysis would become an important building block in the theory that underlay Milton’s own alternative view of the market economy’s workings – whose details, you will be relieved to hear, are also off limits for this talk.

But the empirical challenge to Keynesian economics that really attracted public attention emerged in the US in the late 1940s and early 1950s. Then the central policy problem turned out to be not how to prevent the economy sinking back into Depression, as many of Keynes’s local disciples had confidently predicted, but how to offset incipient inflationary pressures that became acute with the outbreak of the Korean War. And even more disturbing, it became hard to resist the conclusion that monetary policy, which at that time had been assigned the task of keeping interest rates down and then pushed well into the background, probably had something to do with this.

## VIII

It is one thing for a reigning economic orthodoxy to get some things wrong, and quite another for it to become discredited. There are always alibis for problems, and facts by themselves are never quite enough to change the majority of minds. To quote Milton: “It takes another theory to beat a theory”. And he provided one.

His alternative was a particular extension of the venerable (its modern origins lie in 16<sup>th</sup> century Spain) Quantity Theory of Money which had dominated monetary economics in the fifty years before World-War I, but had already been facing a considerable amount of intellectual competition before the “Keynesian Revolution” seemed finally to have disposed of it.

Milton's own presentations of this theory over the years created considerable confusion among his readers, not all of which was their fault, but for today's purpose, it is sufficient to note its predictions (a) that the main determinant of the long run rate of growth of what we would now call nominal GDP (NGDP) was the long run rate of growth of the money supply ("appropriately" defined), (b) that cyclical variations in NGDP were predominantly the consequence of changes in money growth, but (c) that the system had sufficient capacity to generate effects running from income to money and that these cyclical interactions could sometimes be recursive and cumulative, rather than unidirectional.

Contrary to common criticisms, Milton took considerable pains to explain many details of the transmission mechanisms at work here. To the very end of his life, though, the most he would say about the forces that divided up cyclical variations in NDGP between quantities and prices was that the initial impact of changes in money growth fell mainly on quantities, and that price effects began to dominate later, as quantities recovered from the initial shock and began to return to their long-run sustainable levels, which were determined by other, "real" factors.

This basic apparatus provided an explanation of inflation in terms of excessive money growth, but also of recession (and even depression), in terms of sudden contractions of this self-same variable. Put this way, it all sounds too simple by half. But this is where Milton's commitment to empiricism comes in.

Over two decades or more, his theoretical structure was put to the test in a program involving literally dozens of studies of a bewilderingly wide range of times and places, carried out by himself, his colleagues, associates and graduate students. Some of these were econometric, while some, notably the magisterial *Monetary History of the United States*, and its two associated volumes, employed the descriptive statistical tools and institutional analysis of narrative economic history.

No doubt some of these studies, considered in isolation, were less convincing than others, but collectively their impact was enormous. Largely avoiding naïve mono-causality in their specific analyses, the role of money in driving both inflation and cyclical fluctuations nevertheless ran as a common thread through them.

And crucially for today's topic, those involving the Great Contraction suggested that this catastrophe was not the consequence of an inherent flaw in the configuration of the market economy, but of a colossal policy failure on the part of monetary authorities who had permitted an ordinary cyclical downturn to evolve

into an eminently preventable cumulative collapse, driven by the same mechanisms as had been at play on a lesser scale on many other occasion.

The sheer weight of all this work shifted the balance of mainstream economic opinion away from the post-war Keynesian consensus about the inherent and fatal weaknesses of the market and towards the view that an economy based on the pursuit of individual self-interest, far from being doomed to inevitable collapse and chaos, would work just fine, only given the right monetary policy. And just as this new consensus was beginning to form in the late 1960s, what came to be called “the great inflation” began to get under way, providing yet more evidence in its favour.

## IX

As noted earlier, Keynes did not live to see his ideas translated into actual economic policy. Milton was not so lucky in this respect, and the experience must have been trying, because his case for the reliability of the market economy rested on the “right” monetary policy being in place, and here there were serious problems.

His original prescription, developed mainly in the 1950s, had been to institute a steady rate of growth of the money supply. But at that time the monetary policy problem was to maintain the stability that had already been achieved after the upheavals of the Korean War. When his ideas finally got their turn, in the later 1970s, the policy problem was to restore stability to a system that had strayed into double-digit inflation, a very different and much bigger challenge.

Volumes have been written about what went wrong with money growth targeting in the 1970s and early ‘80s, and why. Suffice it to here to agree that it wasn’t up to this more difficult task. Instead of the gradual winding down of inflation that its supporters had envisaged, viciously sharp money-growth contractions provoked deep recessions in a number of place, which, fairly or not, did nothing positive for Milton’s reputation; nor did his widely publicised 1984 prediction of the imminent return of double digit inflation – “a major blooper” as he later referred to it.

At the time it seemed to many that Milton’s legacy would not survive all this, and indeed much of the bitter hostility to the market economy nowadays found on the political left has its origins in the brutal economic experience of the early RT years. Milton had not prescribed a shock, but others, apparently trying to pursue his preferred policies certainly delivered one, and his reputation suffered. But, taking a longer view, the verdict is less simple and has a positive side to it too.

To begin with, those recessions of the early 1980s did break the back of double digit inflation, and they were surely the consequence of monetary policy. Nor, painful though they were, did they last as long as many Keynesian critics had predicted. The experience of the early 1980s, that is to say, did not leave much doubt in most minds that inflation had after all been a monetary phenomenon.

It was not Milton's overall vision of the role of money in creating economic instability that was undermined by this experience, therefore, but his proposals about how to avoid such events. These needed a basic rethink, and they got it from several quarters in subsequent years.

Milton's own inclination was to drift towards "free banking" ideas, which are still alive and well in certain academic circles, but have as yet made no impression on practical policy. Policy makers, however, slowly and unsteadily found their way to replacing rules for money growth with rules for the inflation rate, and surprisingly to many, these turned out to work rather well. The very foundation of these regimes is, however, the idea that inflation is indeed the business – in some versions the only business – of monetary policy; and fact that they are often referred to as "monetarism without money" is a clear acknowledgement of how much they owe to Milton efforts to change our views about this matter.

## X

By inference the "Great Moderation" that began sometime in the later 1990s was very much a part of Milton's legacy too, its successes but also perhaps its excesses, which certainly preceded and arguably also precipitated the Great Recession from which much of the world has not yet recovered. Even on Milton's birthday, we can't avoid the question of his posthumous responsibilities here, not least because he has already been found guilty in many quarters.

Let me begin his defence then, by acknowledging that he isn't here to speak for himself, and also by insisting that we just don't know what so imaginative and flexible a thinker would have made of recent events. All we can do is ask whether there are things in the record he left that could either have warned or misled anyone who cared to pay attention to it during that "moderation's" later years, and here I think the balance is in Milton's favour.

To begin with, anyone who has read the relevant chapters of the *Monetary History of the United States* must know full well that Milton was well aware that a robustly expanding economy characterised by no – let alone low – inflation could

nevertheless collapse into a sharp downturn. That is what happened in 1929. Those who characterise him as having touted stable price level behaviour in a relatively unregulated economy as a cure-all for economic instability are simply wrong. He didn't.

What he had argued with respect to the Great Contraction was that an ordinary downturn became a catastrophe because the authorities allowed the banking system to collapse under its initial shock, when they could have saved it. In fact he didn't have very much that was definite to say about what had first brought on the downturn in question – in my view, a weakness in his analysis that a little more attention to Hayek might have repaired - but that is a topic for quite a different talk.

On this occasion it is more appropriate to point to the positive implications of his analysis of the Great Contraction for recent years: namely that, should such events transpire again, no matter what their initial cause, the Fed should not stand by, but should act single-mindedly and with as much force as might be necessary to keep the monetary system working. Specifically, the policy he advocated for the early 1930s was what we would now call vigorous quantitative easing. After some initial hesitation, this is just what the Fed did this time around, and, in dramatic contrast to the early 1930s, what looked like another incipient catastrophe stopped in its tracks and eventually reversed.

Was this cause and effect, or just a coincidence? Well, I would be willing to argue the former case, given enough time to go into the complex and still very controversial pros and cons of US monetary (and fiscal) policy since 2008. And let me concede that the case is not open and shut. Many very well informed commentators – including Milton's long-time collaborator the late Anna Schwartz - were highly critical of the Fed.

But we don't have time for this debate, and this isn't the right occasion for it either. So let me simply recall the confession and promise made by Ben Bernanke on an earlier (90<sup>th</sup>) birthday celebration for Milton: namely, that that the Fed had indeed caused the Great Depression, and would not do it again. And let me also assert that, in my view, that 90<sup>th</sup> birthday promise seems (maybe only just) to have been kept. Not an insignificant contribution to the legacy we are celebrating today.