Milton Friedman

Milton Friedman, who has died aged 94, was one of the greatest economists of all time. He may come to be included in the same category of pre-eminent figures as Adam Smith, Ricardo, Marx and John Maynard Keynes. When he began his main work, while professor at Chicago University in the 1950s and 60s, Keynesian orthodoxy dominated almost all academic macroeconomics, and much of public policy in this field. By the time Friedman’s project was almost complete, in the 1970s and 80s — with a Nobel Prize in 1976 — that orthodoxy had been shattered.

His preferred alternative, that monetary policy should be subject to rules designed to achieve price stability, had largely replaced the earlier Keynesian proposals, which used demand management, mostly in the form of fiscal policy, to aim for that level of unemployment which would offer the best trade-off between inflation and unemployment. Friedman was one of the first to show that that trade-off was illusory.

It had been a hopeful illusion. For a brief period in the 1950s and 60s, it had seemed that the use of Keynesian theory, operating in the context of macroeconomic models that had sprung up under the influence of national income statistics and computer technology, would allow economists to guide politicians to steer the economy optimally via discretionary intervention. Friedman instinctively took the view that government intervention was more likely to harm than good, and that the most government could do was to set an appropriate structure of rules — especially the rule of law — and leave the rest to competition and the freedom of the individual to choose in a system of free markets.

Ironically, one of his earlier studies, and perhaps his finest econometric contribution, removed a perceived threat to the maintenance of Keynesian full employment. In Keynes’s model, saving was a positive function of income, and, from both cross-section studies and casual empiricism, it was obvious that the savings ratio would rise inexorably, making it more and more difficult to generate matching investment, and leading eventually to potential stagnation. But the long-term time series data of the savings ratio showed no such tendency to rise.

Friedman reconciled these facts in A Theory of the Consumption Function (1957) by showing that income distribution was much influenced by temporary fluctuations in income. For example, whether one was at the highest level of earnings in one’s life cycle, or alternatively retired. People would naturally save a large proportion of temporary high incomes to be consumed later, when income might be temporarily low. The distinction between temporary and permanent economic conditions has since remained one of the main concepts in macroeconomics.

Friedman was not, however, an outstanding technician; he was relatively sparing in his use of mathematical models and, towards the end, his use of econometrics ran into criticism. Nor was he primarily a historian. Yet, with his colleague Anna Schwartz, he wrote the finest ever book on economic history, A Monetary History of the United States, 1867-1960, published in 1963. Schwartz was a stickler for historical detail, which combined with Friedman’s vision of a unifying structure for tracing the effects of monetary developments on the economy, led to an entertaining work that changed our view of how the macroeconomy worked.

Before it, most people had ascribed the great depression to the Wall Street crash and/or to real factors such as a sharp drop in consumption. Friedman and Schwartz made a convincing case that it was inept monetary management by the Federal Reserve Bank that was the main culprit. Similarly, other major economic shocks, such as the US crises of 1893, 1907 and 1919, and the post second world war inflation were primarily monetary in causation and character.

But his great achievement was to show why government intervention to try to set output and employment at a higher level than would happen naturally was ultimately self-defeating and damaging. In the macro-models of the time, Keynesian demand-side equations had been supplemented by a supply side equation, the Phillips curve, linking nominal wage and price increases to the level of unemployment (the lower unemployment, the higher inflation); and economists and politicians sought to set the unemployment level so as to achieve their preferred combination of output and inflation.

In his 1967 presidential address to the American Economic Association, on ‘The Role of Monetary Policy’, Friedman noted that economic agents, wage earners, firm managers, etc., were primarily concerned with real incomes and real profits, not just nominal outcomes. Because contracts are set in nominal terms, they would agree to a nominal wage, or set a price which, conditional on their expectations of future of inflation, would get them their desired real outcome. So the short-run Phillips curve was conditioned on agents’ inflationary expectations. If the government then used this (short-run) relationship to try to achieve a lower unemployment?higher inflation outcome than private sector agents had been expecting as the norm, then, after some lag, expectations would adjust upwards. So long as governments insisted on keeping unemployment below its natural rate, actual and expected inflation would chase each other upwards in an unending vicious spiral.

That was indeed what seemed to be happening in the 1970’s, the decade which brought the optimism about controlled economic expansion to a shuddering halt. It was in this period that ‘monetarism’ as an approach — and Friedman as its leading exponent — were at their most influential. Country after country, including a somewhat reluctant British Labour government in 1976, embraced...
monetary targets and renounced the belief in an ability to spend their way out of difficulty.

Whereas Friedman had done a devastating job in dismantling what became known as ‘naive Keynesianism’ (in contrast to the various strands of new Keynesianism that reformulated the analysis), his positive proposals have been less successful. He had earlier reinterpreted the demand for money as an exercise in portfolio choice, for example in his paper ‘The Quantity Theory of Money — A Restatement’, in the book of essays *Studies in the Quantity Theory of Money* (1956), which he edited; though this was not, in reality, that much of a break with Keynesian ideas. Anyhow, Friedman believed that the demand for money would be a predictable function of a few variables, and that that functional relationship would remain stable over time; indeed early econometric work in the 1960’s suggested that this might be so — though Friedman’s empirical studies, for example his article on ‘The Demand for Money’, in the *Journal of Political Economy* (1959) again ran into economic criticism.

On that basis, Friedman argued, in *A Program for Monetary Stability* (1960), that the growth of money should be kept constant. Even if there were some unpredictable fluctuations in the demand for money, the resulting disturbances to nominal incomes would be much less, he believed, than would result from attempts at discretionary management by central banks. As a natural liberal, Friedman tended to doubt whether the powerful could be trusted to increase the welfare of the people.

Perhaps more importantly, he demonstrated in ‘The Effects of a Full Employment Policy on Economic Stability’ in *Essays in Positive Economics* (1953), that, in order to enhance welfare, the authorities had to be able to predict events with significantly more than 50 per cent accuracy. Given the difficulty of forecasting, and the ‘long and variable lags’, as described in ‘The Lag in Effect of Monetary Policy’, in *The Optimum Quantity of Money and Other Essays* (1969), between adjusting monetary instruments and their effect on the economy, the likelihood that intervention, even if undertaken with the purest motives, would prove beneficial was slim.

In his advocacy of this regime change — to bring about a shift from discretion to a rule for monetary growth — he was conspicuously unsuccessful. Demand for money functions, which had previously seemed stable, commonly broke down once used as an intermediate monetary target. Alternative definitions of the money stock often pointed in different directions, causing ‘broad money’ monetarists to argue with ‘narrow money’ monetarists. While central bankers in the 1970’s and 1980’s termed themselves ‘pragmatic monetarists’, they remained determined to conduct monetary policy by discretionary variations in short-term interest rates.

Friedman refused to get caught up in a discussion of which monetary aggregate was in some normative sense the best one to use. His methodology, outlined in ‘The Methodology of Positive Economics’ in *Essays in Positive Economics* (1953), was that you should use the method that works best, that best explains and predicts final outcomes in terms of the most parsimonious set of explanatory variables.

This approach also was controversial. But it was a dangerous exercise to argue a point with him. He was a brilliant and incisive debater, and his skill in argument was phenomenal. Along with George Stigler, he led intellectual discussion among economists at Chicago. It was, perhaps, in his application of logic to macroeconomic analysis that he was supreme. His command over detailed fact was, however, occasionally less sure than his analytical ability, as evidenced, for example, by his claim that Japan was an example of a liberal economy. He was also a naturally kind and approachable person, of small stature — a bit like a genial gnome — and he was prepared to change his mind when convinced.

He believed that government intervention did harm, and that the best economy would be a liberal free-market economy, as expressed vibrantly in *Capitalism and Freedom* (1962). In his more political writing on this topic, he was much helped by his wife, Rose, who wrote both *Free to Choose* (1980) and *Tyranny of the Status Quo* (1984) with him. They had a long and devoted marriage; they supported each other and took great joy in being together.

Friedman was born in Brooklyn. Although his name will always be associated with Chicago, he gained his BA at Rutgers University, New Jersey, in 1932 and his PhD from Columbia University, New York, in 1946, though he did receive an MA at Chicago in 1933. Between 1933 and 1941 he worked on research at the US national resources committee and the national bureau of economic research. During the second world war, he worked first for the treasury and then for the division of war research at Columbia. But it was at Chicago, where he returned as professor of economics in 1948 and stayed till 1983, that he became an outstanding figure.

He found in the economics department a congenial atmosphere, with a tradition of a preference for rules over discretion, and a liberal distrust for government intervention. Henry Simons and Lloyd Mints directly, and Frank Knight and Jacob Viner at one remove, had continued to base their macro-monetary analysis on the quantity theory of money, in contrast to the IS/LM Keynes/Hicks model. While at Chicago, he found and encouraged a pre-eminent group of colleagues, of whom, perhaps, Stigler was the other greatest star, with more Chicago economists receiving Nobel prizes than from any other centre.

After retiring from Chicago, Friedman moved to the Hoover Institute in California, where he continued to work, travel and teach almost up to his death. He is survived by Rose and his son and daughter.

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