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Milton Friedman: Life and Economics

Ian St John

Department of Economics

istjohn@habselstree.org.uk

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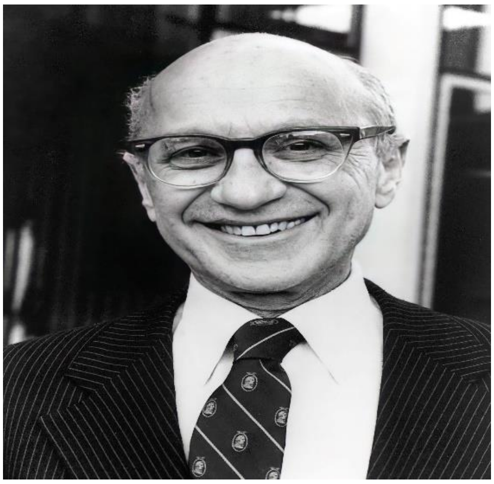
Abstract

This review of the life and work of Milton Friedman is inspired by Jennifer Burns's recent biography, *Milton Friedman: The Last Conservative* (2023), upon which most of the biographical details are based. It focuses upon the two central themes of Friedman's work as an economist and public intellectual: a belief in the benefits of personal freedom as articulated through the price mechanism; and the conviction that inflation and deflation are best understood through the Quantity Theory of Money, and that the chief responsibility of Central Banks is to ensure that the money supply grows in line with real GDP. Friedman acquired both convictions as a student at Chicago University in the 1930s and never relinquished either. Also considered are Friedman's attempts to shape the economic policies of the Nixon and Reagan administrations, as well as various other leading contributions of his career, notably to the study of consumption behaviour and the idea of a guaranteed minimum income. The most controversial aspect of Friedman's political interventions, his visit to Pinochet's Chile, is discussed. The essay concludes that Friedman yielded intellectual and public service by arguing so consistently for the benefits of a free market and carefully managed currency, but that he limited his development by stubbornly resisting challenges to his rigid ideological framework, for example in the form of the role of externalities in economic activity. Having achieved personal 'equilibrium' at Chicago in the 1930s, Friedman forwent the opportunities of dynamic growth, which, for all his achievements, makes his biography worthy but not rich in interest.

If it is true that, while the fox knows many things, a hedgehog knows one Big Thing, then Milton Friedman was more hedgehog than fox – only he knew not one Big Thing, but two. The first thing he knew was that a free-market economy maximises individual liberty and economic efficiency; the second, was that inflation was always and everywhere a monetary phenomenon. These two things were really aspects of a single Big Thing: namely, that a free enterprise economy would naturally produce full employment and an optimal distribution of resources, and, so long as the monetary authorities allowed the money supply to grow in line with real GDP, then there would be neither inflationary booms or deflationary slumps. With the economy remaining in long-run equilibrium and economic growth raising living-standards for all, there was little more for governments to do except uphold the rule of law. Hence Friedman envisaged the state accounting for about 15% of GDP, rather as it had in America before the Great Depression and in Britain in the nineteenth century.

Friedman became convinced of these things early on in his long life. This makes any biography of Friedman rather dull, and although Jennifer Burns recent full-length study, *Milton Friedman: the Last Conservative*, is written with verve and a clear eye upon the need to maintain narrative movement, even she is unable to depict little in the way of personal growth or evolving ideas.[1] Once he had got his thinking straight by the late 1940s Friedman never really changed – mentally or physically, with his suited diminutive stature, studious glasses, and bald head. While the world changed around him, Friedman stayed firm and fixed, repeating his message over and over again to a world, at first uninclined to listen, but later, as events unfolded as Friedman forewarned, more accepting – but never, even in the days of Thatcher and Reagan, quite realising Friedman's ideals. How did Friedman come to know these things about markets and money with such certainty?



Milton Friedman in 1946 and 1976

The Marvellous Market System

Take, first, his belief in the efficiency of the free market in realising the individual and social good. Two things seem relevant here. Friedman was, from childhood, an individualist, always self-sufficient in his own mental world and confident to pursue whatever course he considered right. He was born in 1912 to Jewish parents who had immigrated to America from Eastern

[1] J. Burns, *Milton Friedman: The Last Conservative* (Farrar, Straus, and Giroux, New York, 2023)

Europe in the 1890s. Although Friedman was born in New York, the family soon moved to the middle-class suburb of Rahway. A bright, keen, student, Friedman quickly ascended the familiar rungs of academic success. Mathematics was his early focus, and he entered Rutgers University in 1928 with the intention of majoring in maths and becoming an actuary. But along the way he took a class in economics with Arthur Burns who, although only ten years Friedman's senior, became a father figure and mentor to Friedman (who had lost his father when he was 15), introducing him to Marshall's *Principles of Economics*, Wesley Mitchell's empirical work on business cycles, and his own doctoral thesis (supervised by Mitchell) on *Production Trends in the United States.* Burns remained a close friend of Friedman's for nearly fifty years – until, that is, they clashed over monetary policy during Burns's stint as Chairman of the Federal Reserve. The manner of Friedman's introduction to economics was important: he retained a life-long admiration for Marshall's economic thinking and imbibed from Mitchell and Burns a commitment to detailed empirical research - an approach that would eventuate 35 years later in his greatest achievements as an economist.

This encounter with economics caused Friedman to abandon an actuarial career, and upon graduation from Rutgers he took up a scholarship to study economics at the University of Chicago. Chicago set the tone for the rest of Friedman's life. For one thing, he met Rose Director, a talented Jewish student and one of only a handful of women studying economics at Chicago at the time. They soon became an item and married in the late 1930s, remaining together for over 60 years.

Milton and Rose, 1935

Intellectually, at Chicago Friedman was exposed to one of the strongest economics departments in the country, and one focused around the teaching of neoclassical price theory with a mathematical bias. Such courses have since become mainstream, but at that time teaching economics through calculus and diagrams was much rarer. Friedman thus got a thorough grounding in basic theory from the likes of Frank Knight and Jacob Viner. What really distinguished Chicago, however, was the conviction that price theory was more than a technical academic discipline – it was the key to understanding, not just economic behaviour, but all human conduct. The resulting zeal with which microeconomics was taught cast a spell over many of those exposed to it. Friedman lapped it up, absorbed it, and never subsequently doubted the neoclassical principles he imbibed in those years. Here was a notable contrast to Paul Samuelson. Like Friedman, Samuelson was a Jewish scholar who had excelled intellectually with a mathematical bias, and he arrived at Chicago only a year after Friedman. He, too, became a convert to Chicago price theory and the idea that a free-market economy was the best way to organise society. Yet while Friedman remained devoted to the Chicago School, Samuelson, after leaving Chicago for Harvard and then MIT, came to reject much of this Chicago training and proved much more receptive to the new Keynesian economics in arriving in America in the late 1930s – but finding limited favour in Chicago and with Friedman.

Friedman flourished at Chicago and never really left until his retirement. He went on to teach core price theory to graduate students and formed friendships with other young Chicago economists committed to the Chicago ideal that economics was the science of all human conduct. After these young market-orientated economists began gathering in a store room in the economics department numbered Number 7, they became known as the Room Seven Gang – which included, besides Friedman, Rose, Rose's brother Aaron Director, George Stigler, Henry Simons (who had recently published *A Positive Program for Laissez-Faire*), and Allen Wallis (who went on to become Dean of the Chicago Business School and treasurer of the Mont Pelerin Society). Their hero was Frank Knight and they arranged to edit a collection of his essays under the title: *The Ethics of Competition*. Uniting the Room Seven Gang was the belief that the free-market system was not just an elegant model: it was the key to a successful social order. Individuals really should be left free to spend their money as they chose since no one else was a better judge of their interests. Over the coming decades the Room Seven Gang remained centred around Chicago and true to their youthful adulation of the free market. Thus when, in 1959, Ronald Coase arrived at Chicago to outline his theorem on social costs, to the effect that negative externalities could be handled within a free-market system provided property rights were sufficiently specified, Stigler, by now a professor in the Chicago Business School, Director, who was teaching at the Chicago Law School, and Friedman, leapt at the idea. It was, recalled Stigler, an 'exhilarating event!'[1]

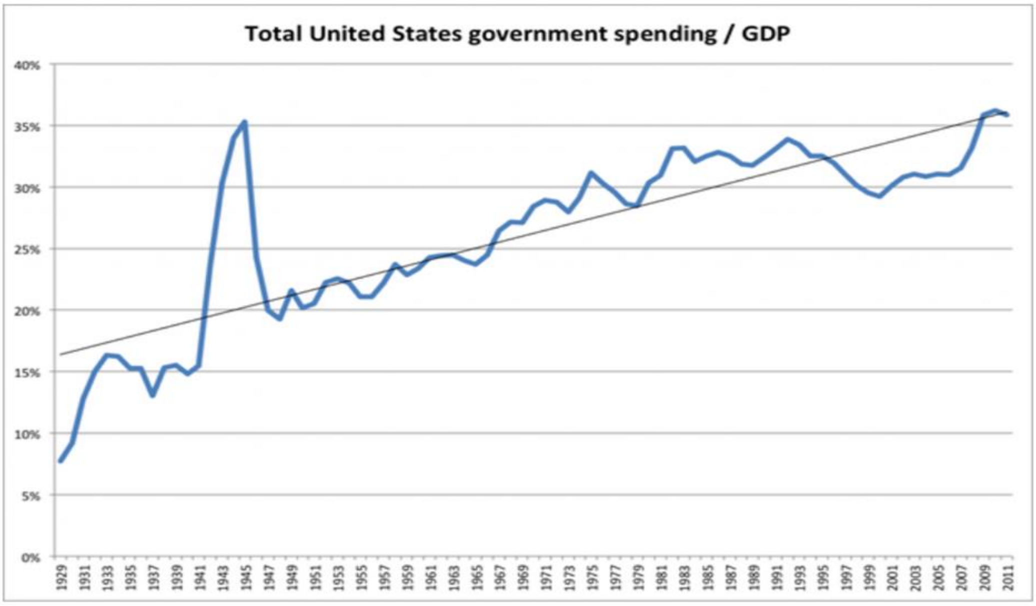
Friedman with George Stigler (left) and John Kenneth Galbraith (right)

[1] *Ibid*., p. 197. Coase was to succeed Director as Professor at the Law School and Editor of the *Journal of Law and Economics*.

Despite the unfavourable headwinds of the social-democratic consensus, during the 1960s Friedman continued to press the case for free-market solutions to economic problems. In 1962 he published, to little notice, a collection of essays on *Capitalism and Freedom*. He took the controversial stance of opposing the American government's 1960s Civil Rights legislation on the grounds that, if someone had racist attitudes, then that was their business and no state had the right to tell you who you should employ or prevent you from joining a racially segregated organisation. For Friedman, the path to improved life chances for black people lay through education, hard-work, and enterprise – just as it had for Jews arriving from Eastern Europe in the 19th century. This was the thinking that ran through Milton and Rose's 1980 television series and book, *Free to Choose*, which reiterated the idea that most of society's ills were traceable to misguided government intervention – in health care, education, drugs policy, housing, and unemployment. The Friedmans policy programme was true to that they had first formulated at Chicago in the 1930s: reduce legislative interference, cut the size of the state, lower taxes, get the state out of education, and the economy would grow, lifting all out of poverty. In the process inequality would probably increase, but this did not trouble Friedman. What he cared for was raising the living standards, health, and educational attainment of the whole population – whether one group's life chances were growing relative to another's did not concern him. Hence when Ronald Reagan, partly under Friedman's inspiration, began cutting top rates of tax in America in the 1980s, Friedman welcomed the growth that ensued. Only towards the end of his life, when he acknowledged that the growing disparity between rich and poor might pose a challenge to the social and political order, did he express any disquiet regarding economic inequality. Friedman attributed modern inequality to the tendency of globalisation to disproportionally reward those with educational assets, and this again led him back to the culpability of the state: it was the state, by claiming a monopoly in educational provision, that had failed to equip so many young people with the skills required in the new age. Thus again, Friedman returned to his long-advocated policy of educational vouchers, such that the state, rather than trying to provide education itself, would provide families with educational vouchers which they could spend on a school of their choice. As in all industries, only a competitive free market in education could yield choice, productivity, and growth.

Politically the last three decades of Friedman's life were by far the most satisfying. Where the reach of the state had grown inexorably since the New Deal in the 1930s, culminating in Lyndon Johnson's Great Society project in the late 1960s, from the 1970s a counter-movement began, as disillusionment generated by sclerotic growth and rising unemployment and inflation, caused people to question the idea that the state could fine-tune away all macroeconomic problems. Friedman was the most outspoken advocate of the need to roll back the state, cut taxes, and unleash the profit motive as the engine of capitalist progress. Such policies came to be designated 'Supply Side' economics to distinguish them from the Keynesian preoccupation with managing Aggregate Demand. In Britain the Institute of Economic Affairs pushed for market-orientated solutions to the country's problems, and it was at a dinner organised by the IEA that Freidman first met Margaret Thatcher in 1978. The Conservative leader was receptive to Freidman's ideas and upon becoming Prime Minister in 1979 embarked upon a policy of de-regulating markets, reducing union power, selling off state assets, and cutting taxes. Reagan soon followed suit in the United States. Friedman welcomed these initiatives and felt vindicated by the faster economic growth that followed. Equally gratifying was the collapse of the Soviet Union in 1989 and the moves of China to embrace market reforms and export-led growth. The free-market ideology advocated by Friedman and his fellow young enthusiasts in Chicago's Room Seven seemed finally to be becoming the blue-print for the global economy.

Yet Friedman was not wholly reassured. Yes, Thatcher and Reagan had slowed the growth of the state, but they had not reversed it. He was right to worry. Where Friedman thought state spending should be about 15 percent of GDP, the share had reached over 30 per cent by 1990, and although dipping a little in the 1990s, just after Frieman's death in 2006 and the 2007 financial crisis, it began a surge that would take it above 35 percent. Indeed, since the 2007 crisis and the emergence of the idea that the world faces an existential threat from climate change (an externality even the Coase Theorem cannot resolve), belief in the superiority of free market capitalism has been in retreat around the globe. It was, perhaps, Friedman's good fortune to slip away just before the reaction against his teaching acquired greatest traction.



Source: Lessons From the Decades Long Upward March of Government Spending (forbes.com)

The Quantity Theory of Money

Friedman's advocacy of the free market was not the most distinctive of his two big ideas; it was the second that really defined him as an economist: namely that fluctuations in such macroeconomic variables as inflation and unemployment are nearly always attributable to fluctuations in the money supply. How did Freidman arrive at this insight? At Chicago in the 1930s he was exposed to the conventional Quantity Theory of Money in the lectures of Lloyd Mints. The Quantity Theory is based on the simple identity:

$$MV = PT$$

where M is the stock of money, V the frequency with which money is used, P is the overall price level, and T is the physical output of the economy. The Quantity Theory usually assumes that V and T are constant, in which case an increase the money supply M will lead to an increase in the price level P. In 1933, as the Great Depression ground on and banks failed, Chicago economists – notably Simons, Paul Douglas, Mints, and Knight – drew up a plan for using monetary policy to end the crisis, calling on the Federal Reserve to raise the money supply, guarantee bank reserves, take the dollar off the gold standard, and oversee banking reform separating retail and deposit banking from investment banking.

Friedman, then, was early exposed to the idea that monetary policy was central both to the Depression and the means to escape from it. Yet it was these very events of the 1930s that led to the eclipse of monetary explanations of economic phenomena after government attempts to promote recovery through easy money and low interest rates seemed to have little effect – leading Keynes to put forward the idea of a Liquidity Trap, whereby once the supply of money was sufficiently high, and the rate of interest correspondingly low, any increase in the supply of money caused people to simply accumulate ever-larger cash balances and not spend it. Monetary policy, it seemed, was unable to account for the traumatic economic events of the 1930s and, as an alternative, Keynes presented the case for a new approach based on Aggregate Demand. In the US a generation of younger economists, grouped around Alvin Hansen and Seymour Harris at Harvard, and including Tobin, Samuelson, and Galbraith, embraced Keynesian explanations of economic fluctuations, focusing on investment spending, export demand, government spending and taxation, and saving. Burns makes it clear, however, that Friedman was never attracted to Keynes's ideas – though she says little by way of explanation and doesn't trace Friedman's engagement with Keynes's work. She merely remarks that when Keynes's *General Theory of Employment, Interest, and Money* appeared in 1936, Friedman 'barely noticed' it.[1]

What is important is that Friedman, unlike many of his contemporaries, did *not* become a Keynesian during the late 1930s and early 1940s, and this meant that when, in 1948, Arthur Burns (Friedman's old teacher and friend), was appointed head of the National Bureau of Economic Research and invited Friedman to investigate the role of money in business cycles, Friedman jumped at the chance. Burns didn't just point Friedman's career in a new and ultimately decisive direction; he facilitated it in another critical way, by providing Friedman with a research assistant in the form of Anna Schwartz. Like Friedman, Schwartz was born in New York to Jewish parents and graduated in economics from Colombia University. She spent the later 1930s working with Arthur Gayer and W.W. Rostow on a large-scale study of business cycles in nineteenth century Britain. After the war she arrived at the NBER, where she was tasked with studying the role of money in American economic history, and in particular compiling time-series for money supply and bank deposits. Thus, Schwartz was already engaged in the study of money and the American economy when Friedman arrived. But Friedman was a professor, whereas Schwartz was yet to complete a doctorate; Friedman was best friend of the director of the NBER; and, of course, Schwartz was a rare woman in the generally male world of economics. In the circumstances, it would have been quite predictable for Friedman to have assumed a domineering and patronising demeanour towards Schwartz

[1] *Ibid*., p. 99.

and relegate her to the status of research assistant. Yet Burns emphasises that Friedman always had a respectful attitude towards female colleagues and treated them as equals. Rather than laying down a programme of work for Schwartz, Friedman acknowledged her experience, complemented her on a memorandum she had written on methods of measuring bank deposits, and asked her for a list of readings in monetary economics. Thus began Friedman's half-a-century long intellectual partnership with Schwartz – a collaboration that played a pivotal role in establishing Friedman's academic credentials and helped restore money to a central role in explaining economic developments.

Anna Schwartz

Thrown into the study of money and its role in the economy, Friedman's career assumed the profile it would retain until his death. He began lecturing on money and banking at Chicago, and as early as 1948 published an article on 'A Monetary and Fiscal Framework for Stability'. Friedman and Schwartz got to work on their study of the role of money in the American economy, a project which grew rapidly in scope as Schwartz, a keen historian, extended the time-frame of the work. Schwartz did most of the hard graft, constructing time series for cash reserves, currency supply, bank deposits, and saving deposits – an incredibly onerous task given the decentralised nature of the American banking system and the absence of computers. Friedman, busy teaching at Chicago, responded to her findings, gave suggestions, and developed theory to explain the data. What was the theory? Quite simply, it was that variations in the money supply better explained variations in the price level than did fluctuation in aggregate expenditure. Friedman first made this case in a 1952 article in the *American Economic Review*, in which he looked at variations in inflation during three wars: the American Civil War and the First and Second World Wars, claiming that it was shifts in monetary policy that best explained the trajectory of prices. Thus was fired the first salvo in the campaign to topple Keynesian explanations for economic activity structured around investment, consumption, and government taxation and spending.

Friedman continued to build a case for the Quantity Theory of Money during the 1950s, repeatedly turning to the study of history to press his case – drawing on the methodology he had learnt from Mitchell and Burns of the NBER in the 1930s. In 1956 he edited a collection of essays entitled *Studies in the Quantity Theory of Money*. Besides a series of historical studies of inflationary episodes, such as the American Civil War and German Hyperinflation, Friedman provided an introductory essay updating the theory behind the relationship between money and prices in the light of Keynes theory of liquidity preference. According to Friedman, the Quantity Theory was 'in the first instance a theory of the *demand* for money. It is not a theory of output, or of money income, or of the price level.' Money is demanded like any other durable good – it is an asset, the stock of which yields a flow of services from which wealth-holders derive utility. The actual demand for money will depend on a person's total wealth, the yield on other assets (financial assets like government bonds as well as real assets like cars and houses), and tastes and preferences. Essentially, Friedman begins from a position of equilibrium, where a person has allocated their total wealth across a range of assets, ranging from money, through financial assets, to durable goods and property and so forth, in such a way as to maximise their total utility. Now suppose the government increases the money supply, so the individual finds themselves holding more money than they planned. There is now disequilibrium in the money market: in their portfolio of assets, people are holding too much money. They respond by spending more money on financial assets, physical goods, and services. The result is now an excess demand in the market for goods and assets. The effect on these goods and asset markets will depend on the elasticity of supply. If the supply of goods and assets is elastic (e.g. if there is significant unemployment) then output might rise in response and real GDP will increase. But if supply is inelastic (e.g. the economy is at full employment, which is the general assumption Friedman made) then the extra money spending will result mainly in inflation. The money value of assets and goods will rise, lowering their rates of return, until the individual is back to equilibrium, where his or her demand for money is once again at a desired level in relation to their holdings of other goods and assets. This was the 'Transmission Mechanism', the process by which a change in the money supply impacts on the value of assets and goods in the real economy. Friedman believed there was a direct transmission between money supply and demand for goods and hence prices. The key to using the theory in this way was the idea of a *stable demand for money*. Friedman argued that the variables determining the demand for money were few and stable and that empirical study showed the demand for money *was* stable, in which case variations in the supply of money would lead people to adjust their spending on assets and goods, and so a relationship between the money supply and the value of output can be established. An increase in the money supply will lead to an increase in output or prices or both. The effect of this was to put changes in the money supply once again at the heart of explanations of the level of economic activity, from which it had been previously removed by the Keynesian revolution.

The empirical evidence for this theory was provided in 1963 when Friedman and Schwartz finally published their monumental *Monetary History of the United States 1867-1960*. This book, more than any other, established Friedman's reputation as an economist and rehabilitated the Quantity Theory as a key – perhaps *the* key – factor in explaining of macroeconomic variables in the economy. In their famous chapter on 'The Great Contraction', Friedman and Schwartz overturned conventional narratives, arguing that the Depression, far from discrediting monetary explanations of the business cycle, was in fact the most powerful evidence for their importance. According to Friedman and Schwartz, the Depression was caused by a collapse in the money supply, which was itself due to the inept policies of the

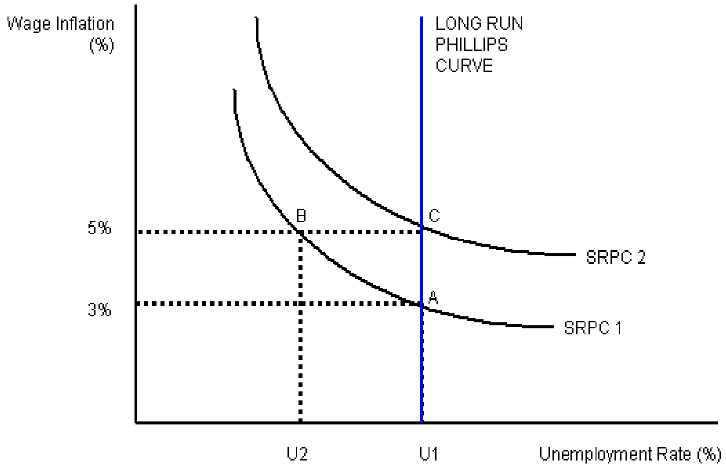
Federal Reserve Bank. In 1928 it began to tighten monetary policy in response to the stock market boom. The money supply, which had grown 3.8% between 1927 and 1928, grew by only 0.4% in 1929, pushing up interest rates, and this contributed to the downturn of 1929. The downturn of 1929 would always have been significant, but what made it far worse was monetary policy: the Federal Reserve allowed the stock of money to fall between August 1929 and October 1930 by failing to buy government bonds. As the supply of money fell, people cut back their spending and withdrew their money from banks – which began to fail. Between November and December 1930, 564 banks failed, including the Bank of United States, the largest bank ever to shut its doors. Over the period 1930 to 1933, 9,000 banks failed, one third of all the banks in America. As banks failed, bank deposits were lost and the money supply fell still further – by about a third 1929-1933. It was this collapse in the money supply that explained the severity of the Depression, and if the Federal Reserve had taken steps to increase liquidity to the banking system then the economy would have recovered sooner – probably in 1931. This argument was a counter-blast to Keynesian theories of the Depression and did much to substantiate the claim that the supply of money, not autonomous spending, was the key variable explaining trends in the value of output in the American economy. Not surprisingly, Friedman's ideas have come under attack – notably by Peter Temin, who argues that the data on interest rates especially suggest that what pushed the economy into Depression between 1929 and 1931 was a fall in autonomous spending, and the contraction of the stock of money was a product, not a cause, of the fall in the value of output.[1]

Thus, on Friedman and Schwartz's telling, it was not capitalism that failed in 1929 – it was the Federal Reserve Board. There was nothing inevitable about the Great Depression, and a better conducted monetary policy would have averted the entire debacle. The old Chicago Plan for monetary reform had been correct after all, and what was needed was not a Keynesian economic revolution but simply a commitment by the Central Bank to increase the money supply in line with the growth of real GDP – say by 4 per cent per annum. Notwithstanding its weight, cost, and complexity, *A Monetary History of the United States* became a best seller and put Friedman and the money supply at the centre of economic thinking in America.

It was now that Friedman became a public intellectual. He was syndicated to write a regular economics column in *Newsweek* magazine. *Capitalism and Freedom*, published initially to general indifference, now began to gain readers. As established Keynesian economists like Samuelson, Solow, Tobin, and Modigliani responded to Friedman's ideas, the great Monetarist/Keynesian fault line in modern macroeconomics emerged. In 1967 Friedman used his presidency of the American Economic Association to attack another central pillar of the Keynesian orthodoxy – the Phillips Curve. The Phillips Curve purported to show that there was a trade-off between rates of inflation and unemployment in an economy: if the government wished to reduce unemployment it could do so only at the cost of increased inflation and *vice versa*. Such a model promoted the idea that a government could fine-tune an economy, using fiscal policy to move up and down the Phillips Curve according to the government's economic priorities. Friedman, who believed that an economy tended towards full employment and that fiscal policy could not by itself cause inflation, would have none of this. Instead he proposed

[1] P. Temin, *Did Monetary Forces Cause the Great Depression?* (W.W. Norton, New York, 1976)

his most influential theoretical idea: namely, that an economy would always tend towards an equilibrium level of unemployment – which he called the *Natural Rate of Unemployment*. If a government wished to push unemployment below this rate in the short-run it could do so by increasing the money supply, and yes, this would result in an uptick in inflation as the Phillips Curve predicted. But this new, lower, level of unemployment would not last. Once people realised that inflation had accelerated and their real earnings had fallen they would push for higher money-wages or leave the labour force altogether. Unemployment gradually edges back towards the Natural Rate and in the long-run real output hasn't increased at all. However, the money supply *has* increased with the result that all prices have risen. Quite simply, any attempt by a government or central bank to push unemployment below the natural rate will only lead to higher prices. The long-run Phillips Curve is vertical – there is no trade-off between unemployment and inflation after all. This is illustrated in the below diagram.



Friedman's Long-Run Phillips Curve and the Natural Rate of Unemployment

In this diagram the Natural Rate of Unemployment is U1 and at first, with the short run Phillips curve SRPC1, inflation is stable at 3% per annum. The government then increases aggregate monetary demand in an attempt to reduce unemployment to U2. More money means more spending: firms experience rising demand, their prices rise, they recruit more labour at higher money wages, and unemployment indeed falls to U2. But things are deceptive! General inflation accelerates from 3% to 5%. Firms begin to realise that though *their* prices have gone up, so have everybody else's. Their costs have risen. Workers thinking they are getting a higher wage find that prices have risen in the shops and their *real* wage hasn't risen at all. Workers induced to enter the labour market because they thought real wages had risen drift back into unemployment. Those workers remaining now expect inflation to be 5% and to protect themselves money wages will now rise by 5%. Firms pass on these pay rises and cut back their hiring of labour. Unemployment increases back towards U1. Thus, the attempt to move the economy from A to B ultimately ended up moving it to C, with constant real output and a faster rate of inflation. The same thing will happen if the government tries to move up the new short run Phillips curve SRPC2. The level of unemployment always gravitates back to the Natural Rate U1, and hence the long run Phillip's curve is vertical. Thus, every attempt to reduce unemployment through increased spending or printing more money will simply cause inflation.

It was an audacious argument and caught Keynesian economists on the back-foot. And as the 1960s gave way to the 1970s events seemed to bear Friedman out. As unemployment rose, governments found that increasing spending failed to reduce unemployment but *did* increase inflation, just as Friedman predicted. The era of 'Stagflation' elevated Friedman's standing as an economist at the expense of his Keynesian rivals.

Friedman and Monetary Policy

From the late 1960s Friedman ceased to be an active academic economist. Instead he became a critic of US economic policy, seeking influence through a series of politicians and public figures – Barry Goldwater, George Shultz, Richard Nixon, Arthur Burns, and eventually Ronald Reagan. As governments sought to rein-in inflation with a series of policies – price controls, tax increases, incomes policies, interest rate rises – Friedman's message was simple and continually reiterated: to control inflation all you had to do was control the growth of the money supply. Money alone caused inflation and if the money supply grew at a stable rate in line with the growth in GDP then inflation would end. Friedman was optimistic that when, in 1970, his long-term friend Arthur Burns became governor of the Federal Reserve his policy ideas would be implemented. Burns seemed sympathetic at first, and the Federal Reserve, in addition to measuring M1 (made up of currency in circulation and money in checking bank accounts) began to estimate Friedman's preferred measure of money supply, M2, which included savings deposits. Friedman congratulated Burns on 'the excellent changes that you have been producing at the Fed. I'm not surprised but I am delighted.'[1]

Friedman, Richard Nixon, and Arthur Burns

But the honeymoon was brief. Faced with rising inflation, Burns turned to the old policy of wage and price controls to stop rising prices. This contradicted everything Friedman believed in and, on the night after hearing the news, Friedman couldn't sleep and got up and wrote Burns an emotional letter, conveying his disappointment and sense of betrayal. 'Never in my wildest dreams', he wrote, 'did I believe that the central bank virus was so potent that it could

[1] Burns, *Milton Friedman*, p. 322.

corrupt even you in so short a time … Incomes policy, in any shape + form, is bad economics + entering the wedge for still worse economics.'[1] Shortly afterwards Friedman attacked the policy in *Newsweek* and continued to deluge Burns with critical comments and advice, so that Burns stopped replying to Friedman's letters. The breech was never healed, bringing an end to Friedman's oldest friendship.

Only with the appointment of Paul Volcker to the Federal Reserve by Jimmy Carter in 1979 did Friedman's moment seem to have come. Volcker announced that, to curb inflation now running at 20 per cent, he was going to use the monetarist policy of bearing down on the money supply, rather than the traditional Fed policy of raising interest rates, just as Thatcher's Conservative government in Britain proposed to do the same thing. The age of Friedman's Quantity Theory had arrived.

Paul Volcker

Unfortunately, the duration of the policy's implementation proved the inverse of the years Friedman had spent pushing for it. In one sense Friedman was vindicated: no sooner had the Federal Reserve and the UK Treasury announced their determination to target the money supply than inflation began to fall. The Great Inflation of the 1970s and early 1980s was vanquished and inflation did not return as a major problem until the 2020s. Ironically, however, this triumph over inflation appeared to owe little to Friedman's Quantity Theory. The problem was that it proved exceedingly difficult to actually control the money supply. For one thing, what, exactly, was money? Various definitions were proposed, ranging from notes and coins, to cash plus checking accounts, time deposits, and so on. Friedman and Schwartz had concluded from their study of monetary history that M2 was the measure which best explained variations in inflation. But it was precisely at this moment that money supply measures began behaving erratically in ways not seen before. In the first months of 1980, M1 fell 15 per cent. In the first four months of 1981 Friedman's beloved M2 rose by 12 per cent. With money supply fluctuating wildly it was not plausible to use it to control inflation. Despite his earlier words, Volcker fell back on interest rates to control inflation. In 1981 Federal Reserve interest rates

[1] *Ibid*., p. 324.

hit 22 per cent. Predictably, such high rates triggered a recession and unemployment rose to 10 per cent. But Volcker was adamant that inflation was the number one enemy and did not relinquish the policy of high interest rates, and in 1982 announced that the Fed was no longer seeking to control the money supply, using interest rates instead. The policy worked: soon inflation had been halved to 10 per cent and by October 1982 was at 5 per cent. The Volcker Shock had worked – but it did not do so through monetarist means. Money supply continued to grow rapidly (for example M2 grew by 8% in 1987, nearly treble the rate of growth of real GDP) and Friedman predicted an upsurge in inflation. It did not happen. The British experience mirrored events in America. Inflation had been tamed but not in the way Friedman had argued for and the money supply, far from the staring role anticipated, had been relegated to the corner, like an unpredictable and slightly embarrassing relative.
Friedman's advocacy of the market mechanism and the Quantity Theory of Money defined his reputation as an economist – a reputation acknowledged by his award of the Nobel Prize for Economics in 1976. Yet there were several other important aspects to his academic and polemical career that should be noted.

Friedman Receiving the Nobel Prize for Economics, 1976

The Methodology of Economics

First, as will be apparent, Friedman was an empirical economist in the tradition of Mitchell and the study of business cycles at the NBER. Friedman was not an abstract theoretician; his economics was always grounded in the study of economic data and the search for trends. This was reflected in his influential 1953 book *Essays in Positive Economics*, in which he argued that the function of theory was to predict economic reality, and the only test of a theory was how well it did that. A theory that did not conform to the facts ought to be discarded, however elegant, and a theory with no practical applications was irrelevant. This led Friedman to be critical of the emerging trend towards mathematical economics and econometrics. Although Friedman began his career as a mathematical economist, he soon switched away and Burns recounts in detail Friedman's campaign against the Cowles Commission for Economic Research, founded by the businessmen and economist Arthur Cowles in 1932, to make economics a more rigorously scientific discipline. The Commission became based at Chicago from 1939, where it promoted the application of advanced mathematical analysis to economic problems. Perhaps the most famous monograph to emerge from its work was Kenneth Arrow's 1951 *Social Choice and Individual Values*. Unfortunately, the Commission's mathematical approach to model building and statistics was just what Friedman hated, considering it not real economics at all. Maybe he also resented a locus of authority within Chicago outside of his growing influence. Whatever the motive, Friedman began attending their regular seminars and repeatedly questioned the usefulness of the papers presented. Why, he asked, was one variable included and not another? How was one to choose between competing models? Above all, he posed his 'naïve test': could the commission show that its models predicted the future better than simply saying the future would be the same as the past? Behind the scenes Freidman urged one of the Commission's patrons, the Rockefeller Foundation, to withdraw its funding. Eventually the atmosphere at Chicago became so toxic the Cowles Commission elected to relocate to Yale University, where it remains to this day. Friedman won the battle, but hardly the war: given that the Cowles Commission was pioneering the very approach to economics that would since become dominant, Friedman's personal vendetta against it shows that his iconoclasm could sometimes be perverse.

Tax Policy and the Guaranteed Minimum Income

Second, there was Friedman's early work on taxation which developed out of his employment at the US Treasury during the war. The Treasury was concerned about the inflationary effects of rapidly growing government spending. While many in Roosevelt's administration favoured price controls, the Treasury preferred to counter inflation by reducing consumer demand through tax increases. To render tax increases more effective in cutting demand, and make them more palatable, it was proposed that the government begin deducting income tax at source. Hitherto, Americans had personally filed income tax payments four times a year – which made any tax rises especially obvious and hence unpopular. It also meant that the impact of any tax rise on consumption was delayed. Thus, the Treasury wished employers to deduct taxes at source. Friedman argued strenuously for the plan, conducting research among large employers to confirm its feasibility and writing papers explaining its operation. Although Congress approved the tax rises, it was not yet ready to endorse taxation at source, which began only after Friedman had left the Treasury. Even so, Friedman's role in creating the modern income tax system is not one his free-market supporters like to boast about!

Freidman was also an unlikely pioneer of the idea of a universal basic income. In 1939, during a conversation with the economist Gunnar Myrdal, Friedman suggested that all families should be guaranteed an income just sufficient to meet their nutritional and housing needs – which Friedman believed could be set objectively. In this way no family in the United States could be said to live in absolute poverty. He worked up the idea in a paper, but it was never published. Yet it was a proposal Friedman frequently returned to. Attending the foundation meeting of the Mount Pelerin Society in 1947 (a society formed by Hayek to press the case for free market liberalism), Friedman presented his argument for what he now labelled a 'negative income tax'. Just as the state took a share of your income when you earnt above a certain threshold, so it should pay you money if your income was below some minimum amount. Why did Friedman favour such a plan? One reason was poverty. Friedman was conscious that traditional free-market approaches to the economy had been discredited during the 1930s by the fact that so many people were found to be living in desperate poverty. If the free-market was to regain popularity it needed a safety net that would catch anyone who failed to prosper under such a system and a guaranteed income would supply this. Second, it would allow the government to sweep away the labyrinth of specific benefits that had evolved over the years – food stamps, housing credits, child support and so on. Instead, it would simply pay everyone a basic income and allow them to spend it as they wished – thereby cutting bureaucracy and extending freedom. Third, it would increase the supply of labour, as when people received means-tested benefits they were often reluctant to take a job since this could mean losing benefits, leaving them worse-off than before. Lastly, in a curiously Keynesian argument, Friedman said that a guaranteed income would stabilise consumption spending in downturns.

Friedman reprieved the idea in his 1962 book *Capitalism and Freedom*, and in 1966 the policy was taken up by the Johnson administration as part of the president's war on poverty, with James Tobin now a supporter of the idea. For a while it seemed the policy might be implemented – but it was denounced by free-market liberals and conservatives who castigated it as 'paying men to do nothing', the money being frittered away in gambling and alcohol, and in any case the government was soon running into money-troubles and there simply wasn't the revenue to fund such a scheme. Yet the idea of a guaranteed minimum income remains current and several countries have talked of introducing such a scheme – most of which would, no doubt, be surprised to learn of Friedman's role in its origins.

The Consumption Function

Friedman's interest in the concept of an objective minimum standard of consumption arose out of work he had done on household spending during the 1930s. In 1935 Friedman, like many other young economists, took a job in Roosevelt's New Deal administration. He was allocated a role in the National Research Committee on Consumer Spending, and this led him to work with Simon Kuznets at the NBER on wage data. One product of this was Friedman's doctoral dissertation on why doctors were paid significantly more than dentists – a fact he attributed to barriers to entry erected by the medical profession. The thesis was not well received by the NBER and he struggled to get it accepted and arrange for its publication. In the 1950s Friedman returned to the study of consumption in the context of critiquing the Keynesian concept of the Consumption Function. According to the Consumption Function, a person's consumption spending was a function of their current income: if you gave a person more money, they would spend a portion of it; and if you reduced their income then their spending would fall by a proportion of the reduction. The fraction of a change in income that people spent Keynes call the Marginal Propensity to Consume and this played a vital role in his wider theory – for example, helping to determine the multiplier effects of an increase in government spending. Hence in challenging the Consumption Function, Friedman was also challenging a central pillar of the Keynesian edifice.

What Friedman argued, on the basis of conversations with two female economists who were studying household spending, Dorothy Brady and Margaret Ried, was that people's consumption decisions were not based on their *current* income but rather their expected *long run average* income – what Friedman called their *permanent* income. Giving a poor person more income would not simply cause them to spend it since their spending plans were based on their long-term income expectations, as well as personal contingencies in their own life, such as age, wealth, location etc. Consumption spending was more complex than Keynes assumed and one couldn't simply say that an increase in incomes would cause spending to increase by some ratio. Hence the multiplier theory was questionable too. Friedman's *A Theory of the Consumption Function* was published in 1957 and was one of his most important contributions to mainstream economic thought and the critique of Keynesian economics.

Friedman in Chile

Throughout his career Friedman engaged closely with right-wing politicians, from his early links with Goldwater through to his role as an adviser to Nixon, Shultz, and Reagan, as well as his contacts with Margaret Thatcher. But the political involvement that caused him most controversy was his relationship with the authoritarian Chilean regime of General Pinochet. As Burns relates events, Friedman's direct role in shaping the economic policies of the Chilean government following the overthrow of the Marxist leader Salvador Allende was minimal, and she portrays his contacts with Pinochet as essentially naïve and insufficiently critical – rather like those 'fellow travellers' of the Left who journeyed to the Soviet Union in the 1930s and professed to have found a new civilisation. There *was*, however, a direct connection between the Pinochet regime and economists at the University of Chicago. In the 1950s an exchange programme was established between the University of Chicago and the Catholic University of Chile, whereby Chilean students would travel to Chicago to be taught economics – which meant, of course, a thorough grounding in neoclassical Price Theory. Leading the programme was Arnold Harberger (who celebrated his one hundredth birthday in July 2024), a specialist in welfare economics and taxation policy, whose wife was Chilean. Harberger was determined to challenge the import-substitution model of development prevalent in Chile, with its concomitant tariffs, subsidies, and exchange controls, and replace it with a free trade, market-orientated, model.

Arnold 'Al' Harberger

The Chicago students who pressed this *laissez-faire* approach to policy became known as the Chicago Boys. The socialist policies of Allende were anathema to the Chicago Boys and they welcomed Allende's overthrow in 1973, several taking posts in the new government, determined to push through market reforms. To bolster their standing they invited Friedman, the most famous of Chicago economists, to visit Chile, and he arrived for a six-day trip in 1975. During the visit he delivered some university lectures and had meetings with former Chicago students, government officials, bankers, and General Pinochet himself. Friedman took little convincing that the cause of high inflation was the excessive printing of money and he urged upon Pinochet a 'shock programme' to end inflation by cutting spending and monetary growth. Friedman's authority probably helped persuade Pinochet to launch his National Recovery Programme along Friedmanite lines a month later, by which time Friedman had left the country.

It is clear that the broad thrust towards market-based, monetarist, policies in Chile pre-dated Friedman's arrival and owed more to the long-term influence of the Chicago teaching to which Chilean students had been exposed. The money supply *was* growing at over 100 per cent a year and needed to be stopped if inflation was to be tamed. Harberger was far more influential in shaping Chilean economic policy than Friedman. Even so, the optics for Friedman were bad and caused him to be viewed in a more controversial, even toxic, light. The fact that he had been prepared to engage in policy discussions with the officials and military leaders (including Pinochet himself) of a regime that had seized power by force and killed thousands of its own citizens suggested sympathy with its actions. It was especially jarring given that Friedman's whole philosophy was grounded in the vital importance of individual freedom. Friedman was bitterly attacked by Allende's former foreign minister, Orlando Letelier, the whole controversy taking an even darker turn when, in 1976, Letelier was blown up in his car in Washington DC by agents of the Chilean government. Friedman never apologised for his trip to Chile, pointing out that no one criticised his visits to the Soviet Union and China – regimes that oppressed and killed on a larger scale than Pinochet. He remarked:

> I must say, it's such a wonderful example of a double standard, because I had spent time in Yugoslavia, which was a communist country. I later gave a series of lectures in China. When I came back from communist China, I wrote a letter to the Stanford Daily newspaper in which I said, 'It's curious. I gave exactly the same lectures in China that I gave in Chile. I have had many demonstrations against me for what I said in Chile. Nobody has made any objections to what I said in China. How come?

Yet he found the protests and hatred his visit provoked stressful and unpleasant: even as he rose to collect his Nobel prize in 1976 a student in the gallery shouted 'Friedman go home! Vive Chile!'[1] According to Burns, Friedman did learn from the experience that freedom was a holistic concept and that even economic freedom required, for its full realisation, political freedom too. For someone reared on the doctrine that economics was the science of *all* human conduct, this was a concession indeed.

Conclusion

Lord Melbourne, the Whig Prime Minister, once remarked after an evening spent with the historian Thomas Macaulay: 'I wish I was as certain of one thing as that man is certain of everything.' Had Melbourne enjoyed the good fortune of meeting Friedman, he would no doubt have remarked as he walked away: 'I wish I were as certain of one thing as that man is

[1] *Ibid*., p. 351.

certain of two things.' In fact, Friedman's certainties were all wrapped up with one fundamental conviction: namely, that the best way to organise economic affairs was through the free market system, which, by the actions of billions of individual consumers and producers around the world, generates a spontaneous order which allocates resources efficiently according to the preferences of consumers and the costs of producers. Anyone who has studied economics will be familiar with the arguments for the efficiency of the market system. The difference with Friedman was that he took the theoretical model of the free market as vindicating his devotion to the ideal of individual freedom. To label Friedman 'the Last Conservative', as Burns does, is quite odd. Friedman was a classical liberal, not a conservative, and he was hardly the last conservative or free-market liberal. How Friedman came to be so wedded to the importance individual liberty is one of those psychological idiosyncrasies that can never be properly explained. Yes, it could be attributed to Friedman's origins as the son of Jewish immigrants who rose from hardship to prosperity through personal hardwork; unfortunately, many of his intellectual opponents, such as Samuelson and Solow, had precisely the same origins and came to very different conclusions. Friedman just so happened to have a reverence for the market system, and of course a belief in neo-classical economics promoted his career at Chicago, just as it later gave him a platform to realise his ambitions for influence and notoriety.

Friedman's attachment to the Quantity Theory of Money followed from his neo-classicalism. The whole point of Chicago price theory was that the free-market was a self-regulating system transcending the individual wit of man. The system operated efficiently and effectively by nature, and government intervention could only compromise its operation and therefore ought to be kept to the minimum – the so-called 'night watchman' state. It was simply inconceivable that free market capitalism could implode and require saving by the state. Hence, there was no call for Keynesian demand-management policies and any attempt to apply them would only make things worse, not better. The one Achilles Heel of the free market was its reliance on money authenticated by the state. Given that money made the entire system of price and exchange possible, to have governments controlling the printing presses was tantamount to having their finger hovering over the nuclear button – they could conceivably blow the entire thing up, as they did in Germany and Austria with hyperinflation after World War One. The solution, as developed by the nineteenth century classical economists, was that money should remain neutral in the economy, something forming a background to all economic transactions but never stepping, itself, into the limelight. The operating principle for ensuring this result was supplied by the Quantity Theory of Money: provided the money supply grew in line with the real output of the economy then overall prices would remain stable and money would be neutral indeed. Problems began when money supply was allowed to grow faster than real output, in which case inflation would occur, or when money supply grew less fast than output, in which case there would be deflation. These were the two scenarios the monetary authorities had to avoid: all they had to do was ensure that the money supply grew steadily and predictably with the real economy. Only when they failed to do this, either allowing the money supply to contract as it did after 1929, leading to the Great Depression, or allowing money supply to grow rapidly, as it did in the early 1970s, leading to the Great Inflation, would disaster ensue.

Such was Friedman's intellectual framework for nearly all his adult life. He shone a clear, sharp, light on current affairs which never flickered or dimmed. This was his great merit as an economist and polemicist: he articulated truths the world needed to be reminded of. But his light was of one tincture only, and his truths were not the *whole* truth. Just as any student learns the efficiency properties of perfect competition, so they learn the inefficiencies of the free market in terms of pollution, asymmetric information, monopoly, and irrational behaviour – and to know these things makes it hard to fetishise the free market as the best of all possible worlds. Similarly, Friedman had to come to terms with the fact that while increasing the money supply can cause inflation, it is also possible for there to be monetary growth and low inflation, and in any case controlling the money supply proved to be impossible. The world, to put it shortly, is replete with nuance, and Friedman – certainly as depicted in Burns's biography – was devoid of nuance. Friedman appears as a kind of bundle of certainty bouncing through the world, without doubt, without personal growth, without much in his life besides economics. We get little insight from Burns's book into Friedman's conversation; his intellectual interests outside of economics; his passions or his humour. Despite apparently having access to Friedman's correspondence, we learn little that is personal, affecting, or surprising. The chief personal insight I got was that Friedman's desk was very untidy. Facts like these tell us much about a person and I should have liked to learn a few more from the book. *Milton Friedman: The Last Conservative* is not a portrait of Friedman as a person, it is an account of his professional career. This is valuable and well done. But upon reaching the end one cannot help wondering – was there more to Friedman or was he only ever a talented hedgehog?