
DECISION MAKING IN DEAL OR NO DEAL • WHY MARRIED MEN ARE WORKING SO MUCH
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GREAT MINDS IN ECONOMICS: MILTON FRIEDMAN
5 Hot Minds in Economics
Keith Chen headlines a crop of rising stars bringing a fresh perspective to the dismal science
PLUS ARTHUR LAFFER AND ROBERT SHILLER

YER SPECIAL FEATURE:

The Legacy of Milton Friedman

Building off of on one of the last interviews of Friedman's life, Senior Editor Mark Schneider profiles the life, work, and passions of the iconoclastic Nobel Laureate.

The late Robert Heilbroner, author of the 1953 classic *The Worldly Philosophers*, wrote about a "handful of men with a curious claim to fame." These men wield no political or military authority, and yet, by no more than the force of their arguments, "shaped and swayed the world". These men "left in their train shattered empires and exploded continents; they set class against class and even nation against nation—not because they plotted mischief, but because of the extraordinary power of their ideas." Heilbroner chronicled the development of economic philosophy spanning the lives and ideas of Adam Smith, Karl Marx, and others, concluding with John Maynard Keynes, whose *General Theory of Employment, Interest and Money*, published in 1936, became the standard of macroeconomic analysis and the platform for Nobel Prize-winning research. Only shortly thereafter did another worldly philosopher named Milton Friedman emerge on to the scene to become a leading critic of Keynesian ideology.

Editor's Note:
On November 16, 2006, the field of economics lost one of its giants. Milton Friedman, the indomitable flag-bearer of free markets and individual responsibility, passed away in a San Francisco hospital. He was 94. Back in August, The Yale Economic Review had the privilege of interviewing Mr. Friedman for our recurring Great Minds in Economics feature. Even at his advanced age, Mr. Friedman was as astute and articulate as ever. Great Minds is a commemoration of the life's work of an irreplaceable genius, and even as we mourn his passing, we consider ourselves honored to carry his words. News of Friedman's death reached our editorial team the afternoon before our scheduled time to send the issue to print. We choose to leave the article untouched as a fitting tribute to one of our heroes. Consequently, the article below is in its original form. For this issue we choose to feature five talented young economists. Although we will never have another Milton Freidman, with any luck, one these promising newcomers will pick up his flag and, with the same stalwart dedication to truth, carry our field into the future.

Milton Friedman's creeds reads like an advertisement for the American dream: free choice, capitalism, and limited government. Born in New York City to a working class family of Jewish-Hungarian immigrants, Friedman has benefited from the system of individual liberties he has so vocally championed, springing from his humble upbringings to become one of the world's greatest economists. His ideas have inspired an entire generation of conservative economic thinking, from the Federal Reserve to the White House, and propelled his public persona to a level virtually unmatched in all of academia. Still carrying the vibrancy and dedication of his youth, and always eager to discuss his sometimes controversial proposals, Dr. Friedman spoke with YER about his life, his work, and his political and economic philosophy.

The Gospel of Adam Smith

After the 1952 publication of his classic book *Capitalism and Freedom*, a work that expounded economic and political liberties as part-and-parcel co-requisites, Friedman and freedom became virtually inseparable. Over the next half century, Friedman carried the flag of laissez-faire into various positions of public prominence. In politics he advised Barry Goldwater, Richard Nixon, and Ronald Reagan; in academia he taught at the University of Chicago and won the Nobel Prize; and in the media, he produced an award winning television series and wrote a nationally syndicated column. Through his varied endeavors, Milton Friedman has espoused ideas and principles that have illuminated the inner workings of the economy to persistently remind individuals across the world of the myriad options and freedoms that free markets make available to them. To this day, Friedman's proposals for improving society maintain the same themes: "Dismantle the IMF, eliminate the Federal Reserve, legalize marijuana, abolish Medicare, get rid of the estate tax...." While the list of goals stretches on, the overarching theme—individual liberty—remains the same.

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The Power of Money

Friedman once quipped, "There's only two types of money in this world: your money and my money." All joking aside, however, money on a grand scale is no laughing matter. Professor Friedman was instrumental in teaching the world that changes in a nation's money supply determine misery and prosperity through ripples spreading as far through the economy as inflation, unemployment, and political change. Friedman was one of the first to realize that the little crumpled pieces of green paper and loose change that, on an everyday basis, many of us unthinkingly sacrifice to the parking meter or the local barista prove to be, in aggregate, key in determining the workings of the macro economy.

Atop Friedman's most earth-shattering insights was his recognition in the 1930s of the Federal Reserve as a powerful institution capable of checking inflation through its regulation of the money supply. That this notion seems so blatantly obvious today speaks to the revolutionary nature of his observation. As Friedman told the *San Francisco Chronicle* in his characteristically composed and reflective tone, "When I began saying that inflation was a monetary phenomenon I was pretty much alone. Today it is conventional wisdom."

In *A Monetary History of the United States*, coauthored with Anna Jacobson Schwartz, Friedman explores how changes in the supply of money have affected leading economic indicators such as GDP growth. In a chapter entitled "The Great Contraction," Friedman asserts that the Federal Reserve was largely inept during its early years, particularly throughout the Great Depression, and did not recognize how best to regulate the economy. He argues that, resorting to guesswork, the Fed played around with the economy much like a weekend-warrior with a broken lawnmower: tinkering, often with less-than-desirable caution, until finally understanding how it works. William Nordhaus, once a member of President Carter's council of Economic Advisers, notes that the Fed did not learn it could affect short term interest rates through open market operations until it more or less accidentally observed the effects in practice.

The early blunders of the Federal Reserve were ultimately addressed as the Fed came to recognize the truth of Friedman's observations on the importance of money, which, in turn, led to Friedman's development of the quantity theory of money—the impetus of the monetarist movement in economic thought. The foundation of monetarism is the belief that fiscal policy decisions have no long-term effect on the economy. Instead, the monetarists' view that the Federal Reserve retains sole power in regulating the economy is often summarized by the statement "only money matters for the determination of real output." Despite recognizing its massive influence over the economy, Friedman's vitriolic opinion of the Fed has not tempered with time. In 1992, when the Min-

Monetarism

At the heart of Monetarism is the debate over the effectiveness of fiscal and monetary policy. Fiscal policy is primarily exercised by the government through changing the tax system in order to stimulate the economy. Monetary policy can be exercised by a nation's central bank, such as the US Federal Reserve, in three ways.

1) Open market operations, in which the Fed modifies the supply of money through buying and selling US treasury bonds.

2) Changing the federal funds rate, which is the rate at which banks lend money to other banks overnight.

3) Changing the discount rate, which is the rate at which the Federal Reserve loans money to banks.

The strategy most frequently used by the Federal Reserve today is engaging in open market operations.

The general consensus prior to 1956 in mainstream economics was that monetary policy was not a major factor in determining an economy's long-run output. In 1956, Milton Friedman expressed his version of nesota Federal Reserve asked him about the most important dilemmas in economics, Friedman replied, "One unsolved economic problem...is how to get rid of the Federal Reserve." Friedman told YER that "if you abolished the Fed and had a more automatic system of stable prices, I think the economy would be a lot better."

Terms of Exchange

Friedman has always been sharply critical of fixed exchange rates, the likes of which dominated the world economy until shortly after the Great Depression. He explains in his autobiography that he developed this view after spending a month in Paris following World War II, where he was a consultant for the Marshall Plan. He has since witnessed the demise of many institutions founded on fixed exchange rates, including the failure and elimination of the Gold Standard, the passing of the Bretton Woods System, and the fall of the Soviet Bloc. Much to his delight, these systems have been largely replaced by the emergence of efficient international free markets.

There is, however, one related experiment today which troubles Friedman—the European Monetary Union. In 1992, when asked by the Minnesota Fed about his thoughts on Europe's plan for a unified currency, Friedman replied, "I do not believe it will happen in my lifetime. It may in yours, but I'm not sure that's true either...I do not believe, at the moment, that a single European currency is either feasible or desirable.

"Consider the process you have to go through to reach a unified currency. In order to have a truly unified currency, not a collection of separate national currencies joined by temporarily fixed exchange rates like the European Monetary System...you either need to have no central bank, as with a commodity currency like a gold standard, for example, or you need to have at most one true central bank: one authority that can issue money. In the United States that authority is the Federal Open Market Committee of the Federal Reserve System. In order to have a comparable situation in Europe, you have to eliminate the Bank of France, the Bank of Italy, the Deutsche Bundesbank, the Bank of England and so forth. You have to have one true central bank with full authority."

Friedman's concerns about the Euro remain 14 years later. He told YER that the Euro represents an "unstable situation and that sometime in the next 5, 10, or 15 years it will break down...because of the fact that changes that come along in the world affect different countries in different ways." He notes the difficulty in tailoring a one-size-fits-all monetary policy to diverse economies. While countries like Ireland stand to benefit from a more restrictive monetary policy, others, like Germany and to some extent France, would enjoy a looser policy. Rather than addressing the needs of each economy, general European monetary policy attempts to straddle the divide, spelling inflation on one side for Ireland and deflation or depression on the other for Germany and France. "The monetary policy that was appropriate for one was not appropriate for the other," explains Friedman. "Now historically, this type of difference has been allowed for through a change in the exchange rate. Then one country could have an expansionary monetary policy and the other a contractionary one. That's not possible when there is a single monetary policy for all of Europe. That brings about a difference in interest rates among the countries, and sooner or later that will lead to a break down of the Euro. I should note that there is no historical precedent for the Euro. To the best of my knowledge there has never been an occasion in which a number of countries have used the same fiat money for monetary exchange."

> The problem with the Euro is that it is used in different political states with different political authorities.

Friedman implies the imprudence of tying artificial economic bonds where no political ones exist. The difference between the 12 countries of the European Monetary Union and the 50 states of the United States, says Friedman, is that only the latter con-

quantity theory of money and used it to argue not only that monetary policy does matter, but also that fiscal policy is inconsequential.

The quantity theory of money, originally developed by Yale economist Irving Fisher in 1911, states:

$$MV = PQ$$

Where:

- M is the supply of money in the economy. There are several ways to measure M. Progressing from more narrow to more expansive measurements:
- M0 is the amount of cash in the economy plus accounts at the Federal Reserve which can be exchanged for cash.
- M1 includes M0 and also checking accounts.
- M2 includes M1 along with saving accounts, stocks and most financial market accounts, and certificate of deposit accounts under $100,000.
- M3 includes M2 as well as all other certificate of deposit accounts, deposits of Euros and repurchase agreements. On March 23, 2006, the Fed announced that it would no longer calculate M3, primarily due to difficulty in determining how it should be defined and measured.

stitutes a single political union. "The problem with the Euro is that it is used in different political states with different political authorities."

The Draft

Friedman points to a distinctly political accomplishment—working to abolish the military draft—as his proudest public achievement. Hoover Institution research fellow David Henderson recounts a particularly evocative exchange between Milton Friedman and General William Westmoreland, then commander of all U.S. troops in Vietnam. "In his testimony before the commission, Mr. Westmoreland said he did not want to command an army of mercenaries. Mr. Friedman interrupted, 'General, would you rather command an army of slaves?' Mr. Westmoreland replied, 'I don't like to hear our patriotic draftees referred to as slaves.' Mr. Friedman then retorted, 'I don't like to hear our patriotic volunteers referred to as mercenaries. If they are mercenaries, then I, sir, am a mercenary professor, and you, sir, are a mercenary general; we are served by mercenary physicians, we use a mercenary lawyer, and we get our meat from a mercenary butcher.'"

But even the draft's political hue cannot prevent the economist in Friedman from wrapping it in an economic light. As he recounted to YER, "The draft made no sense. It was costly to the government and it did not yield a quality military. But the consequences of its abolition have been remarkable. You do not hear from the soldiers in Iraq the same type of complaints that you heard from the soldiers in Vietnam. And the difference is that the soldiers in Vietnam got forced. They were drafted. They were forced to be there. Every single soldier in the army in Iraq is there by choice. He chose to be a member of the armed forces. And the result is a very different morale in the armed forces, a very different efficiency."

photo: www.u-chicago.edu

A Public Message

Over his long career, Friedman let his instinct guide him as he drifted in and out of the public debate. "I cannot say I had a policy of any kind," he told YER, "I just did what seemed appropriate as the time went by. But fortunately, and here Paul Samuelson and I were both involved, our public influence got a boost when we were asked to write tri-weekly columns for *Newsweek* … Paul called me and urged me to accept the request of *Newsweek* and join as a regular columnist."

Seizing the opportunity to be a voice for freedom, Friedman began churning out columns advocating laissez-faire policies on a wide range of issues. In his column of May 1, 1972, Freidman drew from historical precedent to advocate the legalization of drugs. He quoted evangelist Billy Sunday, who rejoiced in the early days of Prohibition, saying "The reign of tears is over. The slums will soon be only a memory. We will turn our prisons into factories and our jails into storehouses…. Hell will be forever for rent." But Friedman pointed out that the ban brought forth the opposite of what it intended. "Prohibition," Friedman wrote, "undermined respect for the law, corrupted the minions of the law, created a decadent moral climate—but did not stop the consumption of alcohol. Despite this tragic object lesson, we seem bent on repeating precisely the same mistake in the handling of drugs."

Friedman's third major work, *Free to Choose* was published after the airing of a television series he made for PBS. The book, inspired by the 10-part television series, was endorsed by Ronald Reagan and became an instant success. In his PBS series, Friedman traveled the nation filming at schools, factories, and bureaucratic institutions.

While each of Friedman's episodes promoted a distinct message, there was one central theme that he did not cease to emphasize. When discussing an array of choices about where to work, where to live, how to educate children, or what to buy, he emphasizes that there are many options available. Government regulation and bureaucratic institutions, though, tend to limit this freedom of choice. One of Friedman's chief concerns is that the government will force equal resource allocation. Echoing F.A. von Hayek's *Road to Serfdom,* Friedman writes, in *Free to Choose,* "A society that puts…equality of outcome ahead of freedom will end up with neither equality nor freedom. The use of force to achieve equality will destroy freedom, and the force, introduced for good purposes, will end up in the hands of people who use it to promote their own interests. On the other hand, a society that puts freedom first will, as a happy by-product, end up with both greater freedom and greater equality." In this manner, Friedman perceives "Laissez-Faire" economics as the desirable solution.

Friedman's support of Adam Smith's free market system and invisible hand ideology arise from his view of government intervention as ultimately harmful and dangerous, even if done with altruistic intentions. His 1993 essay Why Government is the Problem dissects virtually every facet of American life from the workplace to family values and argues that society has been worsened through government involvement in nearly every instance. In another essay advocating congressional term limits, Friedman notes that America is now a society "of the people, by the bureaucrats, and for the bureaucrats."

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A Mark on History

Friedman's contributions have certainly not fallen on deaf ears. On top of his Nobel Prize, Friedman has earned the Gold Medal from the National Institute of Social Sciences in 1978, the Presidential Medal of Freedom in 1988, and honorary degrees from 19 institutions of higher education.

Robert Formaini, a senior economist at the Federal Reserve Bank of Dallas, recounts, "On May 9, 2002, Friedman was honored for lifetime achievements by President George W. Bush, who said during the ceremony, 'He has used a brilliant mind to advance a moral vision—the vision of a society where men and women are free, free to choose, but where government is not as free to override their decisions. That vision has changed America, and it is changing the world.'" Federal Reserve Chairman Alan Greenspan added, "There are many Nobel Prize winners in economics, but few have achieved the mythical status of Milton Friedman."

There can now be little doubt that Professor Milton Friedman has earned his place alongside Heilbroner's greats. In helping to institute the volunteer army, in understanding the power and role of a nation's central bank, and in advising some of the most important politicians of the last half-century, Milton Friedman's actions have certainly been more decisive for history than the rhetoric of many a better known statesman. His insights and ideas have been often more profoundly disturbing than soldiers maneuvering through battlefields. In the wake of his ideas, we have witnessed the shattering of the Gold Standard and the tumbling of the Berlin Wall. He has pitted fiscal conservatives against both parties seeking government infringement. He has done all he has not because he plotted mischief, but because he engaged and influenced the world with a unwavering—albeit sometimes unpopular—commitment to his economic ideals. As Adam Smith, Karl Marx, and John Maynard Keynes would likely acknowledge, they are in good company.