How Milton Friedman Changed Economics, Policy and Markets

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A half century ago, Milton Friedman's advocacy of free markets over government intervention and his prescription for inflation-fighting by central banks were treated as fringe notions by many economists. By the time the Nobel Prize-winning economist died yesterday at the age of 94, his views had helped to reshape modern capitalism.

A diminutive man known for his strong-willed and combative style, Mr. Friedman provided the intellectual foundations for the anti-inflation, tax-cutting and antigovernment policies of President Ronald Reagan and British Prime Minister Margaret Thatcher and an era of more-disciplined central banking. His ideas helped to end the military draft in the 1970s, gave birth to staple conservative causes such as school vouchers and created the groundwork for new economic views about the Great Depression, unemployment, inflation and exchange rates.

Many of his ideas remain controversial to this day, or carry less weight. Central bankers don’t follow his prescriptions for how to implement monetary policy, considering them impractical. And despite his strong advocacy, publicly funded vouchers for students to attend private schools are still rare and researchers struggle to prove their effectiveness. His advocacy of the decriminalization of drugs hasn’t been heeded.

But few would argue against the notion that Mr. Friedman -- with highly technical academic papers, popular books and columns, and the ear of powerful politicians -- helped to shift the center of debate in the U.S. and abroad about the proper role of government in managing a nation's economy. His influence spread far afield, from Hong Kong to Chile to Russia and Eastern Europe, and his ideas took root with reformers pushing for privatization and open markets.

"Among economic scholars, Milton Friedman had no peer," Federal Reserve Chairman Ben Bernanke said yesterday. "The direct and indirect influences of his thinking on contemporary monetary economics would be difficult to overstate. Just as important, in his humane and engaging way, Milton conveyed to millions an understanding of the economic benefits of free, competitive markets, as well as the close connection that economic freedom bear to other types of liberty."

President Bush said, "His work demonstrated that free markets are the great engines of economic development."

Critics said he inspired policies that put millions of people out of work in pursuit of low inflation and demonized almost everything the government did, no matter how beneficial or democratically chosen. "Milton Friedman didn’t make a distinction between the big government of the People’s Republic of China and the big government of the United States," said James Galbraith, professor of government at the University of Texas and son
Mr. Friedman, who died of heart failure at home, is survived by his wife, Rose -- whom he met in graduate school and who co-authored many of his books -- his son and daughter.

Mr. Friedman exercised extraordinary influence through his academic work, which is viewed as among the most authoritative in the economics field in the 20th century. He went beyond the role of academic by advising politicians such as Mr. Reagan and Ms. Thatcher and by writing popular books, such as 'Capitalism and Freedom' in 1962 and, with his wife, 'Free to Choose' in 1979. The latter book was adapted as a television series.

Mr. Friedman was awarded the Nobel Prize for Economic Science in 1976. He was best known for explaining the role of money supply in economic and inflation fluctuations. By managing the amount of money sloshing through a financial system, Mr. Friedman theorized, central banks could control inflation without making costly mistakes.

As with many of his ideas, his prescriptions weren't immediately accepted by central bankers when he advanced them in the 1950s and 1960s. Many economists believed inflation could arise from other factors, such as the influence of unions, corporations or oil-producing countries.

These views were advanced by Mr. Friedman's early mentor and friend, Arthur Burns, Federal Reserve chairman from 1970 to 1978. Mr. Friedman was harshly critical of Mr. Burns's monetary policy, and as inflation rose and unemployment took hold, his own views grew in prominence. By the time he won his Nobel, the unemployment rate had climbed to more than 7% and was on its way to surpassing 10%. The inflation rate, too, had flirted with double-digit levels.

Along with economist Edmund Phelps, this year's Nobel Prize winner, Mr. Friedman in the 1960s also developed the theory that policy makers couldn't maintain low unemployment by permitting higher inflation. The view holds sway at major central banks today, including the Fed, and helped to defeat the inflation of the 1970s and set the stage for the low inflation and low unemployment of the 1990s and today.

It took Paul Volcker, who became Fed chairman in 1979, to put the monetarist theory into practice, adopting money-supply targets that drove interest rates to double digit levels, sent the economy into a deep recession, and ultimately brought inflation down drastically. But unemployment eventually fell as well, proving that Mr. Friedman and Mr. Phelps were right about the absence of a rigid tradeoff between unemployment and inflation.

"That was a victory among many victories," Mr. Phelps said.

While central bankers still accept that inflation is largely a result of money-supply growth, few target the money supply in practice because it is difficult to measure and its relationship to overall spending often shifts.

The Fed stopped setting target ranges for monetary-supply growth in 2000 and has stopped publishing some long-followed data series on money growth. Still, Mr. Bernanke noted in 2003 at a conference on the legacy of Milton and Rose Friedman that the professor's ideas held enormous sway in the field.

"Friedman's monetary framework has been so influential that, in its broad outlines at least, it has nearly become identical with modern monetary theory and practice," Mr. Bernanke said.
Mr. Friedman was born in Brooklyn, N.Y., in 1912, the fourth child of European immigrants. His mother ran a small retail store and his father 'engaged in a succession of mostly unsuccessful 'jobbing' ventures,' he wrote in an autobiography on the Web site for the Nobel Prize. 'The family income was small and highly uncertain, financial crisis was a constant companion.'

Early in his life, he planned to become an actuary. But he emerged after World War II as a strong-minded young professor at the University of Chicago. At the time, economic thought was dominated by the theories of John Maynard Keynes, who advocated activist government spending to stimulate demand and fix the economy during troubled times, such as the Great Depression of the 1930s. (When asked in 2004 by The Wall Street Journal to name the most important economist of the 20th century besides himself, Mr. Friedman named Mr. Keynes. Read the full Q&A.)

Mr. Friedman, who had started his studies at Chicago during the Depression, challenged the Keynesian approach, espousing the idea that the government should stay out of individuals' affairs whenever possible, and that markets can solve economic problems much more efficiently than government officials can. His ideas formed the basis for what became known as the "Chicago School" of economics, a concept of free-market capitalism.

Influenced by such earlier free-market thinkers as Friedrich von Hayek, Mr. Friedman -- some of whose relatives died during the Nazi occupation of Eastern Europe -- saw economic and political freedom as inextricably linked. As he wrote in the 1962 text "Capitalism and Freedom," "a society which is socialist cannot be democratic, in the sense of guaranteeing individual freedom."

"No one in the 20th century has had the ideological influence that Milton Friedman has had in moving the economic profession from Great Depression-era do-goodism towards a friendliness toward, and appreciation of, the free market," said Paul Samuelson, a fellow Nobel laureate and frequent ideological opponent of Mr. Friedman. "We've lost a giant in economics."

Mr. Friedman's ideas weren't all laissez-faire. His concept of a "negative income tax" to eliminate poverty, for example, laid the foundation for today's Earned Income Tax Credit.

Mr. Friedman considered his best purely scientific contribution to economics to be his work on how people make spending decisions -- which was based on data he collected while working with future Nobel laureate Simon Kuznets at the National Bureau of Economic Research. Under his "permanent income" theory, people smooth their spending based on what they expect their incomes to be in the long term -- meaning that things such as unexpected tax breaks or other windfalls will have only a limited effect on spending.

He also attacked the system of fixed currency-exchange rates that emerged after World War II with a announcement from Mr. Keynes. "George Smiley," a character created by Mr.
War II with encouragement from Mr. Keynes. George Schultz, a longtime friend of Mr. Friedman who served in both the Nixon and Reagan administrations, says that after Mr. Nixon was elected in 1968 but before he took office, Mr. Friedman wrote to him saying that "pressures on the tie of the dollar to gold are relentless" and that Mr. Nixon would be wise to sever the link immediately as an affirmative action, rather than be forced to. Mr. Friedman "turned out to be right," but Nixon didn't listen "until he was forced to," Mr. Schultz says.

Mr. Nixon abandoned the gold standard in 1971.

By the 1970s, his influence had become substantial. He was a member of the Commission on an All-Volunteer Armed Force, appointed by Mr. Nixon in 1969. Former Fed Chairman Alan Greenspan, who was also a member, says that at the outset, panel Chairman Thomas Gates "was very clearly unconvinced that a volunteer army would work. At the end of the commission hearings he was strongly in favor of it, and the main reason was Friedman kept dissuading him on all the concerns he had." Mr. Nixon ended the draft in 1973.

In the 1970s, Mr. Friedman courted controversy for his association with Chile's military government which, after toppling a civilian government in 1973, implemented many free-market and monetarist ideas learned by its advisers who had studied at the University of Chicago. He was widely criticized for meeting with Chilean dictator Augusto Pinochet, whose government was eventually blamed for murdering and torturing thousands. Mr. Friedman's Nobel Prize ceremony was disrupted by demonstrators.

That same year Mr. Reagan, who had just made an unsuccessful bid for the presidency, noted the demonstrations in a radio address and said, "It seems when Milton Friedman talked, someone in Chile listened. Wouldn't it be nice if just once someone in Washington would ask: What did he say?" In another address, he quoted Mr. Friedman, saying, "When you start paying people to be poor, you wind up with an awful lot of poor people."

One of the paradoxes of Mr. Friedman's immense influence on policy was his low regard for policy making. He often advocated abolition of the Fed for its failures during the Great Depression and the 1970s, though he later relented and admitted Mr. Greenspan had done a remarkable job from 1987-2006. After two years in the Treasury Department during World War II, he never served in government, aside from advisory roles.

Lawrence Lindsey, who served in both Bush presidencies and on the Fed board, recalls telling Mr. Friedman in the early 1990s, "Why don't you come to Washington, we could use you here." Mr. Friedman replied, "I detest that town."

Mr. Friedman once described his refusal to leave academia as necessary to his larger mission: "For society to be at once humane and to give opportunity for great human achievements, it is necessary that a small minority of people who do not have materialistic objectives have the greatest degree of freedom."

--Jon E. Hilsenrath contributed to this article.