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Who Was Milton Friedman?

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1.

The history of economic thought in the twentieth century is a bit like the history of Christianity in the sixteenth century. Until John Maynard Keynes published *The General Theory of Employment, Interest, and Money* in 1936, economics—at least in the English-speaking world—was completely dominated by free-market orthodoxy. Heresies would occasionally pop up, but they were always suppressed. Classical economics, wrote Keynes in 1936, "conquered England as completely as the Holy Inquisition conquered Spain." And classical economics said that the answer to almost all problems was to let the forces of supply and demand do their job.

But classical economics offered neither explanations nor solutions for the Great Depression. By the middle of the 1930s, the challenges to orthodoxy could no longer be contained. Keynes played the role of Martin Luther, providing the intellectual rigor needed to make heresy respectable. Although Keynes was by no means a leftist—he came to save capitalism, not to bury it—his theory said that free markets could not be counted on to provide full employment, creating a new rationale for large-scale government intervention in the economy.

Keynesianism was a great reformation of economic thought. It was followed, inevitably, by a counter-reformation. A number of economists played important roles in the great revival of classical economics between 1950 and 2000, but none was as influential as Milton Friedman. If Keynes was Luther, Friedman was Ignatius of Loyola, founder of the Jesuits. And like the Jesuits, Friedman's followers have acted as a sort of disciplined army of the faithful, spearheading a broad, but incomplete, rollback of Keynesian heresy. By the century's end, classical economics had regained much though by no means all of its former dominion, and Friedman deserves much of the credit.

I don't want to push the religious analogy too far. Economic theory at least aspires to be science, not theology; it is concerned with earth, not heaven. Keynesian theory initially prevailed because it did a far better job than classical orthodoxy of making sense of the world around us, and Friedman's critique of Keynes became so influential largely because he correctly identified Keynesianism's weak points. And just to be clear: although this essay argues that Friedman was wrong on some issues, and sometimes seemed less than honest with his readers, I regard him as a great economist and a great man.

2.

Milton Friedman played three roles in the intellectual life of the twentieth century. There was Friedman the economist's economist, who wrote technical, more or less apolitical analyses of consumer behavior and inflation. There was Friedman the policy entrepreneur, who spent decades campaigning on behalf of the policy known as monetarism—finally seeing the Federal Reserve and the Bank of England adopt his doctrine at the end of the 1970s, only to abandon it as unworkable a few years later. Finally, there was Friedman the ideologue, the great popularizer of free-market doctrine.

Did the same man play all these roles? Yes and no. All three roles were informed by Friedman's faith in the classical verities of free-market economics. Moreover, Friedman's effectiveness as a popularizer and propagandist rested in part on his well-deserved reputation as a profound economic theorist. But there's an important difference between the rigor of his work as a professional economist and the looser, sometimes questionable logic of his pronouncements as a public intellectual. While Friedman's theoretical work is universally admired by professional economists, there's much more ambivalence about his policy

pronouncements and especially his popularizing. And it must be said that there were some serious questions about his intellectual honesty when he was speaking to the mass public.

But let's hold off on the questionable material for a moment, and talk about Friedman the economic theorist. For most of the past two centuries, economic thinking has been dominated by the concept of *Homo economicus*. The hypothetical Economic Man knows what he wants; his preferences can be expressed mathematically in terms of a "utility function." And his choices are driven by rational calculations about how to maximize that function: whether consumers are deciding between corn flakes or shredded wheat, or investors are deciding between stocks and bonds, those decisions are assumed to be based on comparisons of the "marginal utility," or the added benefit the buyer would get from acquiring a small amount of the alternatives available.

It's easy to make fun of this story. Nobody, not even Nobel-winning economists, really makes decisions that way. But most economists—myself included—nonetheless find Economic Man useful, with the understanding that he's an idealized representation of what we really think is going on. People do have preferences, even if those preferences can't really be expressed by a precise utility function; they usually make sensible decisions, even if they don't literally maximize utility. You might ask, why not represent people the way they really are? The answer is that abstraction, strategic simplification, is the only way we can impose some intellectual order on the complexity of economic life. And the assumption of rational behavior has been a particularly fruitful simplification.

The question, however, is how far to push it. Keynes didn't make an all-out assault on Economic Man, but he often resorted to plausible psychological theorizing rather than careful analysis of what a rational decision-maker would do. Business decisions were driven by "animal spirits," consumer decisions by a psychological tendency to spend some but not all of any increase in income, wage settlements by a sense of fairness, and so on.

But was it really a good idea to diminish the role of Economic Man that much? No, said Friedman, who argued in his 1953 essay "The Methodology of Positive Economics" that economic theories should be judged not by their psychological realism but by their ability to predict behavior. And Friedman's two greatest triumphs as an economic theorist came from applying the hypothesis of rational behavior to questions other economists had thought beyond its reach.

In his 1957 book *A Theory of the Consumption Function*—not exactly a crowd-

pleasing title, but an important topic—Friedman argued that the best way to make sense of saving and spending was not, as Keynes had done, to resort to loose psychological theorizing, but rather to think of individuals as making rational plans about how to spend their wealth over their lifetimes. This wasn't necessarily an anti-Keynesian idea—in fact, the great Keynesian economist Franco Modigliani simultaneously and independently made a similar case, with even more care in thinking about rational behavior, in work with Albert Ando. But it did mark a return to classical ways of thinking—and it worked. The details are a bit technical, but Friedman's "permanent income hypothesis" and the Ando-Modigliani "life cycle model" resolved several apparent paradoxes about the relationship between income and spending, and remain the foundations of how economists think about spending and saving to this day.

Friedman's work on consumption behavior would, in itself, have made his academic reputation. An even bigger triumph, however, came from his application of Economic Man theorizing to inflation. In 1958 the New Zealand–born economist A.W. Phillips pointed out that there was a historical correlation between unemployment and inflation, with high inflation associated with low unemployment and vice versa. For a time, economists treated this correlation as if it were a reliable and stable relationship. This led to serious discussion about which point on the "Phillips curve" the government should choose. For example, should the United States accept a higher inflation rate in order to achieve a lower unemployment rate?

In 1967, however, Friedman gave a presidential address to the American Economic Association in which he argued that the correlation between inflation and unemployment, even though it was visible in the data, did not represent a true trade-off, at least not in the long run. "There is," he said, "always a temporary trade-off between inflation and unemployment; there is no permanent trade-off." In other words, if policymakers were to try to keep unemployment low through a policy of generating higher inflation, they would achieve only temporary success. According to Friedman, unemployment would eventually rise again, even as inflation remained high. The economy would, in other words, suffer the condition Paul Samuelson would later dub "stagflation."

How did Friedman reach this conclusion? (Edmund S. Phelps, who was awarded the Nobel Memorial Prize in economics this year, simultaneously and independently arrived at the same result.) As in the case of his work on consumer behavior, Friedman applied the idea of rational behavior. He argued that after a

sustained period of inflation, people would build expectations of future inflation into their decisions, nullifying any positive effects of inflation on employment. For example, one reason inflation may lead to higher employment is that hiring more workers becomes profitable when prices rise faster than wages. But once workers understand that the purchasing power of their wages will be eroded by inflation, they will demand higher wage settlements in advance, so that wages keep up with prices. As a result, after inflation has gone on for a while, it will no longer deliver the original boost to employment. In fact, there will be a rise in unemployment if inflation falls short of expectations.

At the time Friedman and Phelps propounded their ideas, the United States had little experience with sustained inflation. So this was truly a prediction rather than an attempt to explain the past. In the 1970s, however, persistent inflation provided a test of the Friedman-Phelps hypothesis. Sure enough, the historical correlation between inflation and unemployment broke down in just the way Friedman and Phelps had predicted: in the 1970s, as the inflation rate rose into double digits, the unemployment rate was as high or higher than in the stable-price years of the 1950s and 1960s. Inflation was eventually brought under control in the 1980s, but only after a painful period of extremely high unemployment, the worst since the Great Depression.

By predicting the phenomenon of stagflation in advance, Friedman and Phelps achieved one of the great triumphs of postwar economics. This triumph, more than anything else, confirmed Milton Friedman's status as a great economist's economist, whatever one may think of his other roles.

One interesting footnote: although Friedman made great strides in macroeconomics by applying the concept of individual rationality, he also knew where to stop. In the 1970s, some economists pushed Friedman's analysis of inflation even further, arguing that there is no usable trade-off between inflation and unemployment even in the short run, because people will anticipate government actions and build that anticipation, as well as past experience, into their price-setting and wage-bargaining. This doctrine, known as "rational expectations," swept through much of academic economics. But Friedman never went there. His reality sense warned that this was taking the idea of *Homo economicus* too far. And so it proved: Friedman's 1967 address has stood the test of time, while the more extreme views propounded by rational expectations theorists in the Seventies and Eighties have not.

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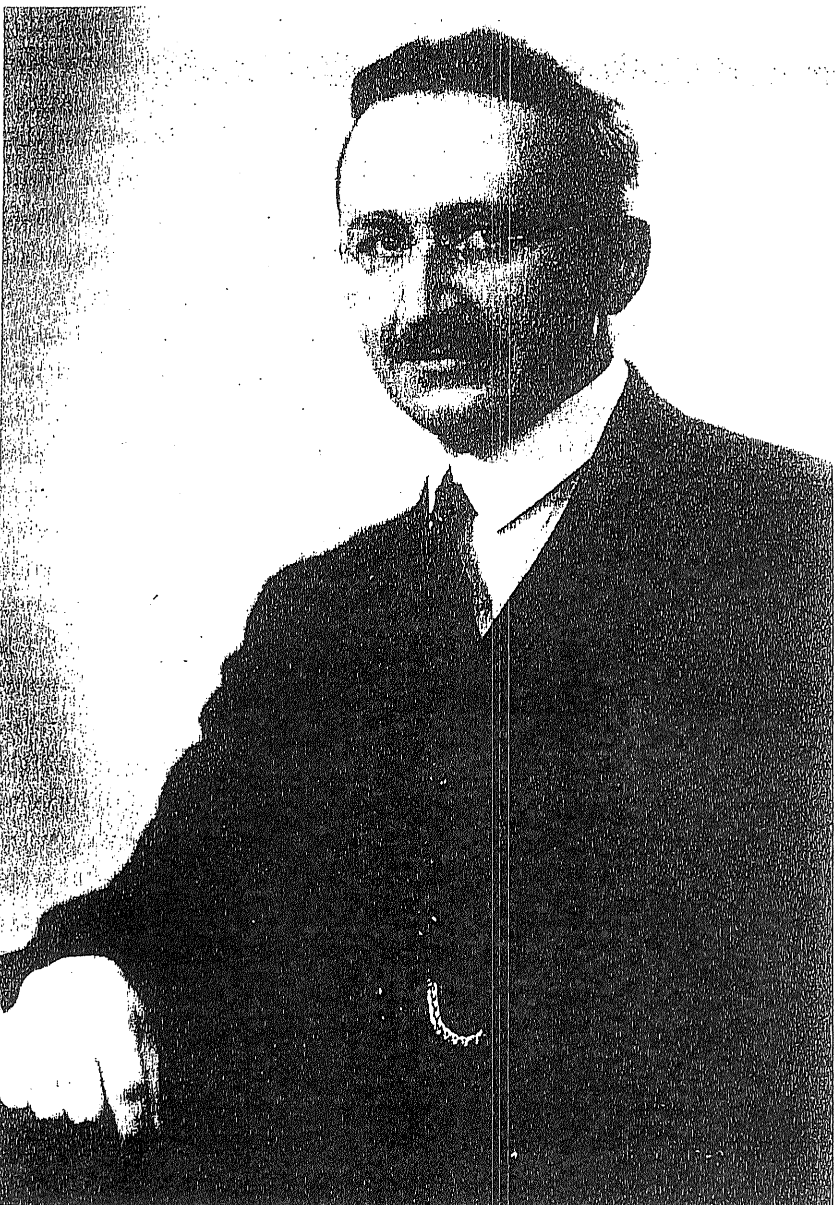
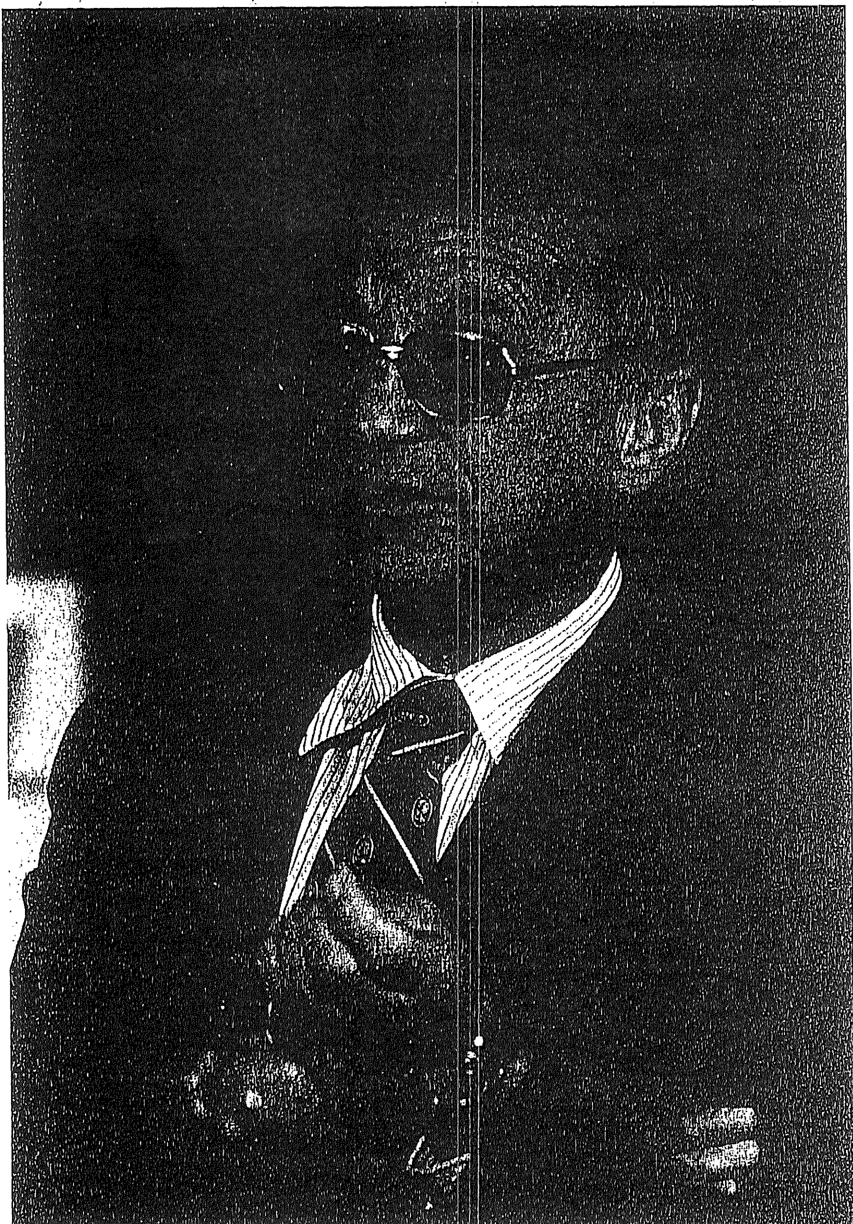


4. Friedrich August von Hayek (1899–1992)

Libertarianism

Often associated with the economic doctrines of Friedrich von Hayek and Milton Friedman, libertarianism is a political creed hostile to government intervention. While sharing general agreement with mainstream liberalism on the primacy of individual liberty, most libertarians are strictly opposed to other liberal values such as equality, solidarity, and social responsibility. Rejecting modern governments as illegitimate for their use of 'coercive' policies, many libertarians subscribe to the utopian ideal of a loose 'society' of autonomous individuals engaged in strictly voluntary forms of exchange. Indeed, some libertarians go even so far as to demand the wholesale abolition of the state.

The neoliberal principles advocated by Hayek's Mont Pelerin Society greatly influenced the American economist Milton Friedman, winner of the 1976 Nobel Prize. The charismatic leader of the Chicago School of Economics (based at the University of Chicago), Friedman had an influential hand in guiding neoliberalism from constituting a mere minority view in the 1950s to becoming the ruling economic orthodoxy in the 1990s. Focusing on inflation as the most dangerous economic outcome of state interference – such as price controls imposed by Keynesian governments to guarantee low-income earners access to basic commodities – Friedman developed his theory of monetarism. It posited that only the self-regulating free market allowed for the right number of goods at correct prices produced by workers paid at wage levels determined by the free market. By the early 1980s, monetarists like Friedman insisted that slaying the dragon of inflation required that central banks like the US Federal Reserve pursue anti-inflationary policies that kept the supply and demand for money at equilibrium. In short, monetary policies should take precedence over fiscal policy (taxation and redistribution policies) devised by 'big government'.



5. **Milton Friedman (1912–2006)**

As we shall see in ensuing chapters, neoliberalism soon spread to other parts of the world – often by means of so-called 'shock therapies' devised by prominent neoliberal economists. Examples include Chile after General Augusto Pinochet's 1973 CIA-supported coup, the economic transformation of formerly communist Eastern Europe, and post-Apartheid South Africa. In some cases, domestic elites, educated in elite universities abroad, embraced neoliberalism enthusiastically. Others adopted it only grudgingly because they felt that they had no choice but to swallow the bitter pill of structural adjustment demands that inevitably accompanied much-needed IMF or World Bank loan offers. Although Chicago School economists like Friedman disliked the 1940s Keynesian regulatory framework under which the IMF

The Washington Consensus

The 'Washington Consensus' is often viewed as synonymous with 'neoliberalism'. Coined in the 1980s by the free-market economist John Williamson, the term refers to the 'lowest common denominator of policy advice' directed at mostly Latin American countries by the IMF, the World Bank, and other Washington-based international economic institutions and think tanks. In the 1990s, it became the global framework for 'proper' economic development. In exchange for much-needed loans and debt-restructuring schemes, governments in the global South were required to adhere to the Washington Consensus by following its ten-point programme:

1. A guarantee of fiscal discipline, and a curb to budget deficit
2. A reduction of public expenditure, particularly in the military and public administration
3. Tax reform, aiming at the creation of a system with a broad base and with effective enforcement
4. Financial liberalization, with interest rates determined by the market

5. Competitive exchange rates, to assist export-led growth
6. Trade liberalization, coupled with the abolition of import licensing and a reduction of tariffs
7. Promotion of foreign direct investment
8. Privatization of state enterprises, leading to efficient management and improved performance
9. Deregulation of the economy
10. Protection of property rights

and World Bank had originally been devised, their neoliberal ideological descendants in the 1990s managed to capture the upper echelons of power in these international economic institutions. With the support of the world's sole remaining superpower, they eagerly exported the 'Washington Consensus' to the rest of the world.

Let us now examine in more detail the concrete ideological and policy manifestations of neoliberalism across countries, regions, and regimes. Its various strands sometimes diverge on issues such as the precise role and appropriate size of government or take different positions on policy priorities and prescriptions. But most neoliberals share broadly similar ideological positions regarding the superiority of self-regulating market mechanisms over state intervention in producing sustained economic growth. They also agree on policies promoting individual entrepreneurial growth and productivity. Finally, they are united in their view that maintaining low levels of inflation is more important than achieving full employment. We begin our journey through the landscapes of neoliberalism by exploring two of its earliest and most spectacular strands: Reaganomics and Thatcherism.

STOP!

Chapter 2
First-wave neoliberalism in the 1980s: Reaganomics and Thatcherism

The rise of neoliberalism in the English-speaking world is most notably associated with US President Ronald Reagan (1981–8) and British Prime Minister Margaret Thatcher (1979–90). Their fervent campaign to put an end to Keynesian-style 'big government' was shared by the Australian Prime Minister Malcolm Fraser (1975–83) and the Canadian Prime Minister Brian Mulroney (1984–93). These political leaders not only articulated the core ideological claims of neoliberalism but also sought to convert them into public policies and programmes. What distinguished Reagan and Thatcher from many other neoliberals, however, was their remarkable resolve to stand by their principles even when it was politically risky or inconvenient to do so. President Reagan, for example, seriously considered not running for a second term in office if doing so meant he would have to reverse his deep tax cuts. Similarly, when some conservative members within Thatcher's own Tory Party stated that they could no longer tolerate her tough anti-inflation policies, she boldly declared, 'You turn if you want to – this Lady is not for turning'. Indeed, the 'Iron Lady' was famous for coining other ideological slogans such as 'There Is No Alternative' (to her neoliberal agenda). Although the political Left in Britain lost no time in assailing such economic determinism, it nonetheless failed to assemble an alternative political vision that would prove the Prime Minister wrong.