Chapter 3—The Control of Money

Friedman covers a lot of ground here. He summarizes the findings of his masterful *A Monetary History of the United States 1867-1960* in more accessible terms. To understand it, you need to know the quantity theory of money. You should recall this from ECO 231. (Yes, you should.) If not, here is a one-page summary:

Recall that in a given economy, total spending must equal total income over any given time period, because if I spend a dollar, someone else must receive it as a dollar of income. So

\[
\text{TOTAL SPENDING} = \text{TOTAL INCOME} \quad (1)
\]

And since GDP can be calculated as either total spending or total income, both equal GDP:

\[
\text{TOTAL SPENDING} = \text{TOTAL INCOME} = \text{GDP} \quad (2)
\]

Now, let’s say that Country X’s GDP last year was $10 billion. If the money supply (M) was equal to $1 billion, then, on average, each of those billion dollars must have been spent 10 times. Thus, the velocity of money, (V), which is the average number of times a dollar is spent to purchase goods that count toward GDP, is

\[
V = \text{GDP} ÷ M \quad (3)
\]

and so total spending is

\[
\text{TOTAL SPENDING} = M \times V \quad \text{or} \quad MV \quad (4)
\]

No doubt you will recall that real GDP (Y) is found by dividing GDP by the price level (P):

\[
Y = \text{GDP} ÷ P \quad (5)
\]

rearranging to solve for GDP,

\[
\text{GDP} = P \times Y \quad \text{or} \quad PY \quad (6)
\]

and since total income equals GDP, we can use this as a definition of total income.

Now, substituting (4) and (6) into (1) gives us the Equation of Exchange

\[
MV = PY \quad (7)
\]

which is the basis of quantity theory. The idea is that we have M and P on opposite sides of the equation, and so we can see the effect of a change in the money supply (M) on prices (P).

Next, what Friedman refers to as rigid quantity theory—more commonly called crude quantity theory—holds that changes in M do not affect V or Y, that is,

\[
\overline{MV} = \overline{PY} \quad (8)
\]

The reasoning is like this: If the government creates some new money and places it in circulation, the public will spend this new money at the same rate as it has been spending the “old” money. So, the velocity of the new money will be the same as for the old money, and the overall velocity will not change. (On the other hand, if the public saves a lot of the new money, on the other hand, its velocity will be lower, and so overall velocity will fall.) Regarding Y, the idea is that the creation of new money will not affect firms’ profit margins and so there will be no increase in output.

So, for example, if M rises by 3%, that means that we multiply M by 1.03:

\[
(1.03)\overline{MV} = (x)\overline{PY} \quad (9)
\]

Since V is held constant, the left side of the equation rises by 3%, i.e., it’s multiplied by 1.03. Obviously, x has to be 1.03, too. But since we’re holding Y constant, the full effect has to fall on P, so prices rise by 3% as well. Changes in the money supply drives prices the same direction and in the same proportion. This gives rise to Friedman’s famous dictum “Inflation is always and everywhere a monetary phenomenon,” i.e., if you see inflation, then it was caused by an increase in the supply of money.
Likewise, a fall in the money supply will cause prices to fall. This is important for following Friedman’s discussion of the Great Depression.

Friedman doesn’t discuss this by name, but modern quantity theory, which eventually became known as monetarism, is what he has in mind in this chapter. (Friedman was one of the founders of monetarism.) This adds some sophistication to crude quantity theory, but essentially holds that changes in the money supply lead to more or less proportionate changes in prices in the long run, though not necessarily in the short run.

Now on to Chapter 3.

pp. 37-38: This is really depressing.

A private free-enterprise economy, it is said, is inherently unstable. Left to itself, it will produce recurrent cycles of boom and bust. The government must therefore step in to keep things on an even keel. These arguments were particularly potent during and after the Great Depression of the 1930’s, and were a major element giving rise to the New Deal in this country and comparable extensions of governmental intervention in others. (p.37)

As a result, in the 1930’s, the New Deal created a system of government regulation to cure the ills of supposedly unbridled capitalism. Friedman goes on to describe the effects of this expansion of government:

Similarly today, governmental measures constitute the major impediments to economic growth in the United States. Tariffs and other restrictions on international trade, high tax burdens and a complex and inequitable tax structure, regulatory commissions, government price and wage fixing, and a host of other measures give individuals an incentive to misuse and misdirect resources, and distort the investment of new savings. What we urgently need, for both economic stability and growth, is a reduction of government intervention not an increase.

But in the decades following the publication of Capitalism and Freedom, and to an extent because of the book and its influence, many of these obstacles to “economic stability and growth” were removed. Tariffs are far lower today, and international trade has expanded, creating jobs in the US, and raising incomes, and making goods cheaper. Income tax rates have been reduced, from a top marginal rate of 91% in 1962 to 35% (in January, 2009). These, and many of the other changes Friedman advocated, have contributed to an increase in real GDP per capita from $14,555 in 1962 to $38,195 in 2007—an increase of 162%. And now, in the midst of a financial collapse, we have a government that proposes to reduce international trade and increase the national debt to a level that will make higher taxes in the future the least bad of a set of awful choices.

As Friedman shows in this chapter, the real cause of the Great Depression was the sheer incompetence of the Federal Reserve System—the US government agency charged with controlling the supply of money. Friedman’s work in A Monetary History of the United States was so compelling, and so irrefutable, as to make heavy-handed government intervention impossible to justify. But for true believers, no amount of evidence, however clear, can dissuade them from their cherished myths. And so, the same arguments that Friedman summarized are being heard on all sides today. Members of Congress, the news media, academics, and others trumpet the notion that the ongoing financial panic is a symptom of unregulated capitalism, of the free market run amok, and that only a big, beneficent government can save us. And to judge from the results of the past election, a majority of voters have bought this.

pp. 38-39: Scylla and Charybdis were sea monsters in Greek mythology, located on either side of the Strait of Messina. In order to avoid one of them, a ship passing between would have to pass too close to the other. This metaphor is used to describe a dilemma involving two opposite errors, avoiding one of which means falling into the other. At present, the Fed is in such a position. Eager to avoid repeating the disastrous monetary policy of the early 1930’s which Friedman discusses in this chapter, it has been creating bank reserves and new money at an unprecedented rate. Right now, banks aren’t lending the money, because few want to borrow and the banks are scared of defaults. But sooner or later, lending will take off again, with the banks stuffed full of cash. As a result, we may avoid a severe economic contraction only to find ourselves battling hyperinflation in the future.

pp. 39 ¶ 3: Vladimir Lenin was the leader of the Bolshevik faction which took control of Russia in 1917 and established the world’s largest penal colony, known as the Soviet Union. The actual quote (translated, of course) is “The best way to destroy the capitalist system is to debauch the currency.” A money economy depends on a stable money. Take that away, and the economy will fail. Of course, it wasn’t necessary to meddle with the money supply to destroy the Soviet Union. A quote from your instructor: “The best way to destroy the socialist system is . . . just leave it alone and wait.” Lenin’s preserved corpse, having outlasted his creation, is still on display in his tomb in Red Square. R.I.P.

Same ¶: “. . . monarchs clipped coins. . .” Once upon a time, when coins were made of real gold, silver, and copper, rulers would take in coins for payment of taxes, and then clip, or shave, off a bit of metal from each coin, and then spend the clipped coins to pay their bills. They would then melt down the clips and make new coins out of them, which they also spent. Needless to say, this diminished the value of the coins and made trade more difficult to carry out. The Romans did a lot of this, which didn’t help the survival of their empire.

pp. 40-42: Friedman explains why a gold standard is not a cure-all for economic ills. You’ll recall from ECO 231 that when banks loan money in a fractional-deposit system, they create money. The only way to have a 100% gold standard is for banks to keep full deposit backing of all loans. That is, if I borrow $1,000 from a bank, then the bank will have to reduce depositors’ access to their funds by $1,000. It’s hard to see how such a system would work in a modern capitalist economy.
A “discretionary monetary authority” one that has the power to create money at its own discretion, without using any commodity to back it, i.e., it can create money at will. Modern central banks worldwide do this, and the Fed is no exception. The Fed and other central banks have been creating discretionary money at a record pace the past few months.

Friedman here summarizes the results he published in A Monetary History. For all its flaws, the sort-of gold standard we used prior to 1914 kept the supply of money much more stable than anything the Fed has ever been able to manage. And if you’ll recall quantity theory of money on the previous page, you’ll see that an unstable money supply leads to unstable prices and unstable GDP and unemployment. Put simply, the Fed has not done a good job of managing the supply of money. Unnecessary economic instability has been the result. And a political response to all this has been to create more regulation. The pattern looks something like this:

Step 1: All is well.
Step 2: The Fed keeps interest rates too low, which makes politicians and voters happy.
Step 3: The low interest rates lead to excessive borrowing and money creation. The money supply grow too fast.
Step 4: Seeing inflation beginning to creep up, the Fed reverses course and raises interest rates.
Step 5: Oops, too much. Rising interest rates cause a recession. Maybe a really bad one, such as in the 1930’s.
Step 6: Voters are swayed by politicians who claim that it’s all the free market’s fault, that capitalism is to blame, and so they vote for socialist-inclined politicians who regulate, tax, and spend, increasing the role of government in the economy and reducing the role of the free market.

As Friedman makes clear, up ‘til late 1930, the recession was not much different from ordinary ones. But bank failures, caused by the Fed keeping interest rates too high, led to a collapse of the financial system. Since banks create money, if banks go out of existence, there’s no money. The Fed’s policy turned an ordinary recession into an economy-destroying monster. The social cost and political consequences (New Deal socialism in the US; Hitler in Germany; the rise of Communist parties across much of Europe) of this are staggering.

A note to all of this: When Friedman wrote this, almost everyone, economists and everyone else, believed that the Depression was caused by the stock market crash and a fall in business confidence, and hence a clear sign of the instability of the capitalist system. It’s not surprising that Friedman was attacked by these people when he published A Monetary History, which showed clearly, using hard, painstakingly gathered and analyzed quantitative data, that this was nonsense. The economics profession, at least, has long been convinced by Friedman’s evidence. But socialists the world over haven’t forgotten, and Friedman remains on their enemies’ list. (Or in the case of the Huntsville Library, off their bookshelves.)

In these pages Friedman lays out his alternative to both the gold standard and the discretionary central bank monetary systems. It’s known as the monetary rule, or instrument rule, and is really pretty simple. Congress passes a law that requires the Fed to carry out its monetary policy so that the money supply grows at some specific rate, year in, year out, regardless of recession, boom, or whatever. Friedman suggested that the Fed be required to keep the money growth rate in the 3 - 5% range, rather than a single number, since it’s impossible for the Fed to target more precisely than that. Under such a system, the Fed would decide to raise or cut interest rates based solely on what is necessary to control the growth of the money supply—not what is politically acceptable, not what the Fed’s (fallible) economists think is best to maintain economic growth or to reduce unemployment.