

## THE CHANGE OF PARADIGM OF MILTON FRIEDMAN

Milton Friedman succeeded because Keynes had to be buried. It came out that the paradigm of the curve of Philips blew up, and the world was facing stagnation along with inflation. As Keynesianism couldn't come up with an answer to unemployment and inflation at the same time, monetarism was imposed as the only way to control the situation.

Instead of putting all the eyes on unemployment, inflation started to be the overall nightmare. Inflation started to be seen as a disease for the society. Indeed, it was able to destroy it. There were the examples of Germany, Austria, and Russia after World War I, when employers would pay their workers three times a day, after breakfast lunch and dinner so they could go out to spend it before it lost all its value.

So Milton Friedman came on and explained his theory of the causes of inflation. The first step to understand Friedman's theory, is to accept that inflation is always a monetary phenomenon. It's always a result of too much money, of more rapid increase in the quantity of money than in an output. Moreover, in the modern post gold era, his important intellectual basis was that governments control quantity of money. So, he would say that "inflation is made in Washington DC". In Milton Friedman's thought it's a printing press phenomenon. He spend his life trying to prove that there had never been in history a monetary supply growth without being followed by inflation. "Evidence is in the linkage between both" he would say.

The question is, why? Why does this happen?

He complained that Governments create a large quantity of money first of all, to pay for government expenses. Second of all, citizens that want governments to spend more on them, don't want to raise taxes. But, there is no way you can do the one without the other. If Government spends 450 million dollars and only raises 400 million dollars in taxes, who is going to pay that gap? If Government spends more than it takes in, it has to meet the difference either by printing money or borrowing. Friedman said that citizens end up paying it, and the way they pay it is a tax called inflation. Since Government creates inflation by printing money, collects more money proportionally. Inflation so, is an indirect way of taxation. So for Governments, printing money it's a marvellous way of raising taxes without voting for it.

Another reason that he gave is that inflation is a wonderful way of reducing debt weight. How can this happen? In the late 70s US Government had budget deficits, but the debt was going down every year. The reason was that they were not real deficits. They were deficits financed by inflation. I'll explain this: anybody that had bought long term Government bonds in ten years before (during the decade of the 70s) and redeemed it, had gotten back an amount of money which had less purchasing power, less ability to buy goods and services than when initially had paid for the bond. And on top of that, he had to pay taxes for interests. As a result, the debt goes down in meaningful terms because old money was easily paid per after-inflation new money. So Governments create more money because it is an historic way of financing.

Third factor to increase money is mistaken policies by central banks. Studying the Great Depression, Friedman observes that from 1929 to 1933, the Federal Reserve reduced quantity of money in the United States by a third and produced the catastrophe (the Great Depression). Later on, he tells that Governments learned the lesson, but made a different mistake in the opposite direction. In his point of view, they ended up confusing their function by thinking that they had something to do with interest rates instead of recognizing that their real function was to control the quantity of money. Nowadays,

Federal Reserve and European Central Bank do target interest rates policy and care pretty much about it.

So far, monetarism doesn't accept that external factors to money supply may be the cause of inflation. It is all about the quantity of money per unit of output that shapes the inflation rate, and all other factors are just excuses of politicians that do not believe his statements. For example, he maintained that the oil price increase in the middle 70s was not the cause of international inflation. Indeed, he said that the oil price increase was an excuse for governments that were producing inflation. Friedman argued that if the price increase was the cause of inflation, how could the very different impacts in different countries be explained? Germany and Japan imported almost all their oil and it should have hit them alike. But on the contrary, Germany went on a rate of inflation of 6 percent whereas Japan got up to 21 percent. He didn't recognize that the raw material price increase was a cause of inflation. Of course if he had accepted it, it would have refuted his own whole manufactured theory. So here comes the main point that I want to cover with this essay: in Friedman's point of view, an increase of wages, an increase of raw material prices or a drop in a currency's value are a consequence of inflation and not a cause of it.

As we said, Milton Friedman debunked international effects on domestic inflation. For Friedman, inflation was never a cost-push or exchange rate increase effect, but a national phenomenon produced by monetary policy. As a conclusion, Friedman said that inflation was always produced by high public spending and a growth in money supply. So, his recipe was having governments spend less and print less.

What I found after my long study period for this essay is that Milton Friedman was not completely right. In his obsession to defeat Keynesian stimulus policies, he came up with this theory and denied any external factor's influence in domestic inflation. In order to prove what I'm saying I will make a separate exposition of i) the effect of raw material price increase on inflation, ii) the effect of the fall of the currencies on inflation and iii) the change of paradigm regarding the relation between monetary supply and public expenditure and inflation.

On the first hand, Milton Friedman maintained the lack of effect of the oil price increase in domestic inflation. Inflation couldn't be produced primarily by pressures on cost (an inflation in supply). Regarding the oil crisis of 1973, Friedman argued that the same oil price increase hit unlikely several economies. By this means, he tried to prove the lack of relation between the price increase and inflation.

In my opinion, this is not correct and can be proved by looking at the inflation indicators in several economies during the oil crisis. Thus, I found that during the oil crisis, the United States' inflation grew from 3.4% in 1972 (before crisis) to 12.3% in 1974 (after oil price increase), and dropped down to 4.8% later in 1976 when the crisis remitted. In the case of Japan, the inflation skyrocketed from 5.6% in 1972 up until 21% in 1974, dropping to 8% in 1975. It is true that money supply increased in both countries during that period (1972-1976). But when inflation slumped in 1976, money supply was still growing even more than before.

Here we can see the graphic of both US inflation rate and money supply during the period above-mentioned:



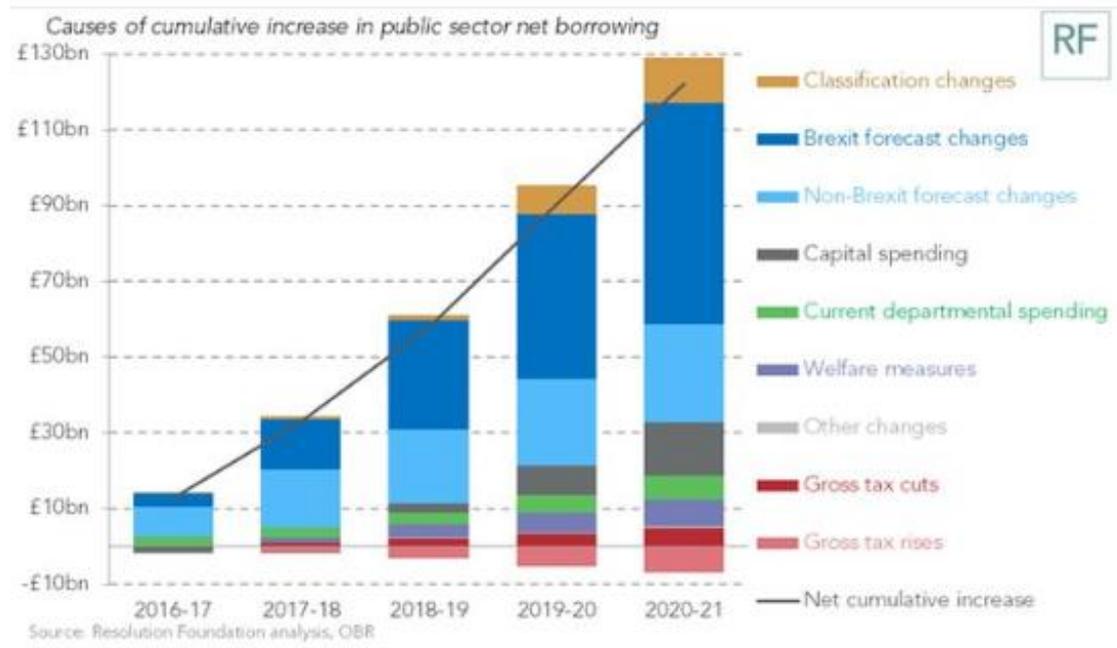
And here we can contrast same data of Japan:



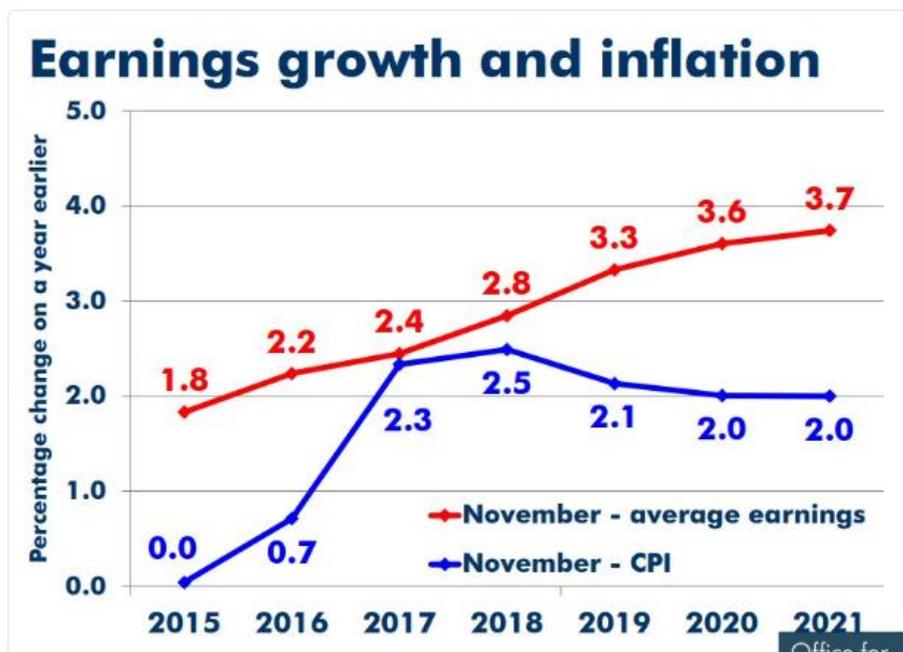
In both cases, we can see that whereas money supply is in a constant increase during the whole period, inflation slumps over 1975 drastically after measures taken by Governments to fight oil price increase. If as Friedman said pressures in costs barely affect inflation, inflation should had followed the same path of the money supply. When oil consumer countries affected by the crisis adopted new attitudes and habits of energy thrift, inflation dropped despite of the simultaneous increase of money supply. It's an evidence that increase in the costs affected to the heart of domestic inflation.

On the second hand, and regarding the influence of an exchange rate drop, inflation can also be affected by an increase of costs due to a loss of purchasing power. The most recent and close example is United Kingdom after Brexit. The pound has fallen to its lowest level in more than 30 years against the dollar, following the UK's vote to leave the European Union and companies like Apple or Unilever have already raised their prices reflecting the lower value of the pound. As a result, inflation has grown more than a 100% since January 2016 regardless austerity measures and tory Governments commitment to a balanced budget. So there is a direct effect of the increase in supply costs even if cabinet applies Milton Friedman theories of reducing fiscal expansion, debt and deficit.

As we can see in this graphic, the biggest cause of increase in public sector net borrowing are Brexit forecast changes and not capital spending:



On top of that, as Exchequer Phillip Hammond's said at autumn statement of this week, inflation has grown wildly and is forecasted to skyrocket more than 300%.



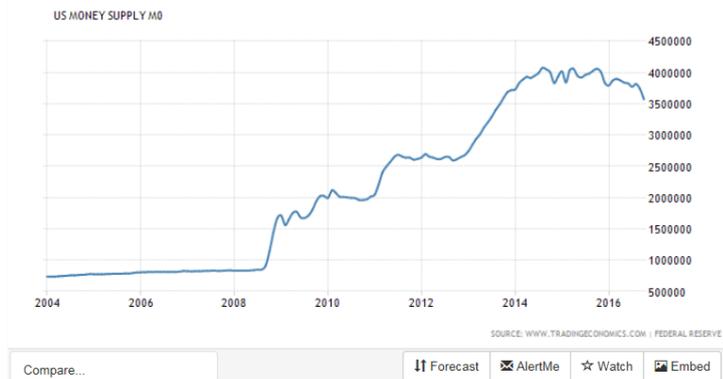
As a conclusion of an overall assessment of inflation causes in United Kingdom after Brexit, Milton Friedman's endeavour to prove that inflation is only led by monetary supply proves quite inaccurate. In this particular case, cost-push has made the whole point.

Third of all and lastly, in my opinion, there has been a change of paradigm of Friedman's money supply and inflation relation. All this Friedman's monetarism goes about debunking Keynesian theory of the demand problem. Friedman's main point relied upon convincing the world that public spending would never fight unemployment and boost economic growth in a long run. He hated the idea of having the

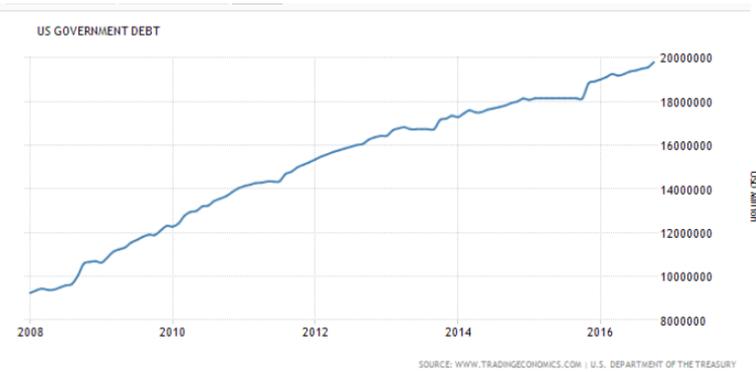
State stimulating the aggregate demand when unemployment was growing and private demand slumping. The Keynesian recipes of adjusting tax policies, monetary supply and interest rates in order to boost the demand horrified him, and so he spent his whole live trying to prove that an expansionist monetary policy was the direct cause of inflation. So as one of the biggest concerns of policy makers was keeping inflation under controlled, he tried to bring them closer to his position debunking the effects of expansionary fiscal policies, boosting deregulation and denying any effect of cost-push on inflation.

After the financial crisis of XXI century, while the European Union and the European Central bank started handling it taking the inflation warnings of monetarists to the letter, Ben Bernanke and Barack Obama's Quantitative Easing monetary policy overthrew austerity approaches. In this way, and this is the most important point I made after this research, we have that Milton Friedman's theory paradigm has totally changed. Monetary and fiscal expansion economic policies have not increased inflation in United States and they have reduced unemployment and all this not having the interest rates skyrocketing. All Friedman's economic formula has been disproved as follows:

First of all, we can observe how the money supply increased constantly due to expansionist policies to boost the economy between 2008 and 2016:

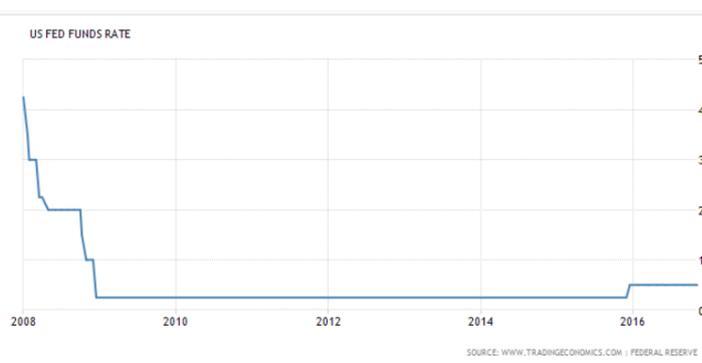


Being constant and lower during the years before the crisis, at the beginning of 2009 money supply started to grow rapid and largely. Indeed, it wasn't only that money supply was multiplied 4 times since the crisis started, but also debt and deficit grew:

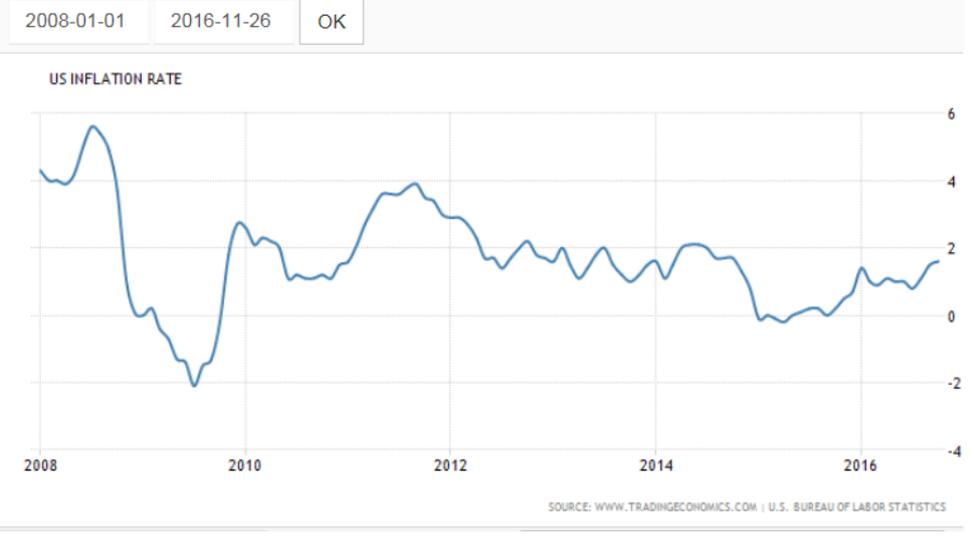


As we can see, the American Government raised debt up until spilling over the 100% of US GDP and had a deficit in 2009 that almost surpassed -10% of the budget.

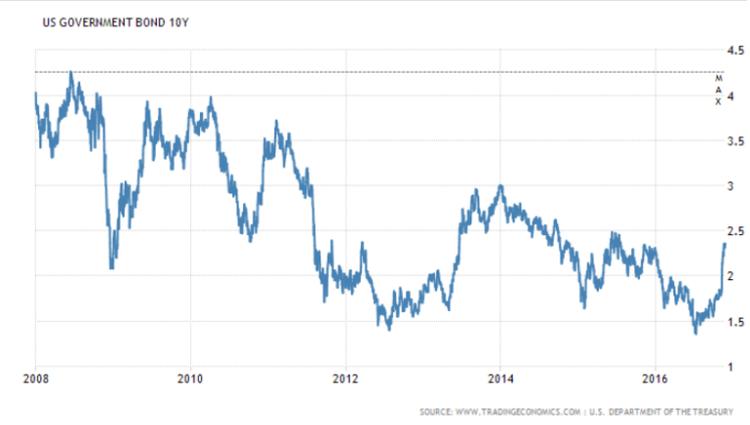
On top of that, and in order to foster the movement of the money that had been supplied, interest rates were cut down to almost zero, boosting vast amounts of cheap money:



All told, the effects of this equation have not matched monetarist predictions. All the factors in the formula were appropriate to follow the monetarist result: inflation. On the contrary, we can see that unemployment has been decreased, and what is more important for this essay, inflation has in a long term gone down and stabilize.



Last but not least, we can observe that overdebt and deficit, have neither repel investors' confidence, which is always one of the mantras of the austerity and detractors of public spend. American 10 years bond yield has been reduced from its maximum at the peak of the crisis down to less than 2.5 points.



As we can see, American Quantitative Easing policy exactly proved the opposite of what Milton Friedman supported. From a monetarist point of view, the paradigm has oppositely changed due to

the fact that a huge increase of monetary supply has not lead to inflation. On the contrary, we've got money supply inflation without price inflation. Its an evidence that inflation has reduced from its peak of almost 6% down to 1.6 percent last October 2016 despite of the 400% increase of the money supply and the interest rates under 0.5%. On top of that, American debt has increased up to 102.7% of its GDP in order to fight recession and unemployment without dismaying the confidence of the markets. Indeed, American 10 years bond yield have fallen from more than 4% down to 2.36 percent last Friday, November 25.

We can perfectly tell Milton Friedman that *Inflation is "not" always and everywhere a monetary phenomenon*. Besides, there is evidence of the strength that public spending has when aggregate demand is slumping. Austerity measures are proving counter-stimulating in Europe due to a simple axioma: if you are flying and the plane's got too much weight, last thing you would drop would be the engines.

#### Bibliography:

Alesina A, Cohen G, Roubini N. 1991. Macroeconomic policies and elections in OECD democracies.

Friedman M. 1968. The role of monetary policy. Am. Econ. Rev.

Grilli V, Masciandaro D, Tabellini G. 1991. Political and monetary institutions and public financial policies in the industrial countries.

Hall PA. 1986. Governing the Economy. The Politics of State Intervention in Britain and France.

Iversen T. 1998. Wage bargaining, central bank independence and the real effects of money.

Iversen T, Wren A. 1998. Equality, employment, and budgetary restraint: the trilemma of the service economy.

Leube K. 1987 The Essence of Friedman.

Soskice D, Iversen T. 2000. The non-neutrality of monetary policy with large price or wage setters.

Svensson LEO. 1997. Inflation forecast targeting: implementing and monitoring inflation targets.

<https://www.federalreserve.gov/econresdata/>