

## The Achilles' Heel of Prof. Friedman's Counter-Revolution

1. - During a lecture given at the University of London in September 1970,<sup>1</sup> Prof. Milton Friedman, the protagonist of the « Chicago School », summarized with great clarity what is meant by the « counter-revolution in monetary theory », which he himself had outlined 12 years earlier precisely with the title *The Counter-Revolution in Monetary Theory*.<sup>2</sup>

In effect, this counter-revolution starts with a reaffirmation, supported by an up-to-date re-elaboration, of the ultra-secular quantity theory as far as this theory gives outstanding prominence to the changes in the quantity of money as being decisive elements in the changes of prices and income levels (income being considered also at its real value). By means of this reaffirmation of the quantity theory, strong emphasis has been laid on the importance of money, as an element that does matter in economic developments. For this very reason the followers of the Chicago School have been termed « monetarists ». Hence, while monetary policy, after the so-called « Keynesian revolution » that followed the publication of the *General Theory*, had been relegated almost to second place, to be integrated if not substituted outright by fiscal policy, it came to be replaced on its former high pedestal by the reaffirmation of the quantity theory.

This reaffirmation certainly represents one of the important features of the counter-revolution promoted or at least advocated by Friedman.<sup>3</sup> Actually, this is not its most characteristic feature, which

<sup>1</sup> Published by the Institute of Economic Affairs, « Occasional Papers », No. 33, 1970, and reproduced in *Bancaria*, April 1971.

<sup>2</sup> In a speech given at the London School of Economics.

<sup>3</sup> Evidence for this can be found in the debate between Friedman and Heller at the « Graduate School » of the University of New York in November 1968, published under the title *Monetary vs. Fiscal Policy* (New York, Norton & Co., 1969).

must rather be found in the fact that he ignored the fundamental assumption of the Keynesian revolution, according to which the basic instrument of monetary policy should be recognized in the changes of interest rates and in their twist, and not merely in the changes in the quantity of money issued by the central bank, as monetary base. It is precisely with Friedman's counter-revolution that the changes of interest rates and their twists are once again regarded, against a more appropriate background, as elements that can help to lead to but not to determine by themselves the turning points of and, generally speaking, the trends in economic activity.<sup>4</sup>

2. - What undoubtedly stands greatly to the credit of Friedman is to have thus brought to the fore again the importance of changes in the quantity of money, after they had been deliberately relegated to the loft of the armoury of monetary policy weapons.<sup>5</sup>

From this point of view, one can agree with the decided position taken up by Sir John Hicks when he said that the statement « If God didn't exist, He would have to be invented » might well be applied to Milton Friedman.<sup>6</sup> Friedman's merit in having brought up to date and rehabilitated the quantity theory is certainly widely recognized also in Italy, where the validity of this theory has been repeatedly affirmed, and not only from the academic standpoint, by no less an authority than Prof. Costantino Bresciani Turrone.<sup>7</sup>

<sup>4</sup> In the report of Friedman's lecture (see page 456 of *Bancaria*) one reads that the « monetarists insist in maintaining that interest rates are a very misleading guide for monetary policy » and that « this is one of the points where the line taken by the monetarists has already had a notable impact on United States policy ». So much so that « in January 1970 the Federal Reserve, which up to then had relied on the 'state of the monetary market' [that is, on interest rates] as the basic criterion of monetary policy, instead assumed as its criterion mainly the 'monetary aggregates' [that is, the quantity of money] ».

<sup>5</sup> Thus, in the Radcliffe Report, as I pointed out in my *Economia Creditizia*, § 114, pp. 179-180 (UTET, 1962), the conclusion was reached that the quantity of money, while being important, was not the decisive factor in the case of monetary policy.

<sup>6</sup> At the close of the lecture given at the Bank of Italy on April 2, 1970, published in the *Banca Nazionale del Lavoro Quarterly Review* of September 1970 and by *Bancaria* in June 1970.

<sup>7</sup> « The very marked importance always attributed by Bresciani Turrone to the quantity theory as an instrument for interpreting concrete facts, and even more, as an instrument for regulating the conduct of monetary and credit policy » was emphasized by me (p. XIV) in the « Introduction » to the volume published by the Banco di Roma, as a « Special Issue » of the *Review of the Economic Conditions in Italy* (December 1964), in which were collected Bresciani Turrone's principal articles published in the same *Review* from 1947 to 1962.

But the subject must be carried farther than this. It is necessary to recall that the fame which Friedman's name has acquired, rather than being attributed to his reaffirmation of the quantity theory, must also, and indeed primarily, be attributed to his having taken up again the ideas and precepts of Henry Simons, which aimed at establishing "a simple mechanical rule of monetary policy" in the management of the quantity of money.<sup>8</sup> Thus Friedman has emerged as a propagator of "automatism" as opposed to "discretion" in monetary policy.<sup>9-10</sup> The Governors of the central banks, he holds, should relinquish the claim to regulate monetary base at their discretion, according to the trend of certain cyclical indicators, such as the level of prices, the state of employment at home and the external position of the balance of payments, the state of the money and capital markets, with their corresponding trends of interest rates, and so on. This may be taken to imply, among other things, that it would prove illusory to attempt to manage monetary base by resort to highly complicated econometric models, such as the "Federal Reserve - M.I.T." model already introduced in the United States, or else the one that, following the American example, has been proposed for Italy, viz. the "M1 BI" model. According to Friedman and the followers of the Chicago School more promising results would be achieved by endeavouring to put changes in income into direct relationship with changes in the quantity of money.

Friedman has gone even farther: he maintains that the discretionary interventions of the monetary authorities would defeat their own ends as far as monetary stability is concerned. He has attempted to prove this by ample documentation, the fruit of wide empirical research and culminating in the monumental work *Monetary History of the United States, 1867-1960* (which appeared in 1963, a joint work of Milton Friedman and Anna Schwartz: Princeton University Press), the conclusions of which had already been for-

<sup>8</sup> During his lecture on "The Monetary Theory and Policy of Henry Simons" given at the Chicago University in 1967 and reproduced in the collection on *The Optimum Quantity of Money* (Macmillan & Co., 1969), Friedman recognized that Simons had been "above all, a shaper of my ideas" (p. 81).

<sup>9</sup> This opposite stance has been underlined in masterly fashion by SCHNEIDER in one of his most recent articles, "Automatism or Discretion in Monetary Policy?", published in the *Banca Nazionale del Lavoro Quarterly Review* of June 1970 (and reproduced in *Moneta e Credito* of the same date).

<sup>10</sup> Automatism, or at least "a minimum resort to discretionary policy by the central bank" would represent, according to HAYES (in the *Monthly Review* of the Federal Reserve Bank of New York, June 1970, p. 121), one of the principal features of monetarism.

mulated in Friedman's *A Program for Monetary Stability* of 1959.<sup>11</sup> And during the lecture that we mentioned at the start, he explained how the discretionary interventions would inevitably defeat their own ends: the monetary authorities, and first among them the Federal Reserve Board, would have "acted, almost invariably, too late and too strongly" (*Bancaria*, p. 453).<sup>12</sup>

From this comes Friedman's golden rule, presented more recently in the already cited collection of essays in *The Optimum Quantity of Money*: in the last analysis, he asserts, automatism could be regulated at a rate of increase of monetary base of 2 per cent, bearing in mind, above all, long term considerations, or else at a rate of 5 per cent, bearing in mind short term considerations. In any case, Friedman holds that "a steady and known rate of increase in the quantity of money is more important than the precise numerical value of the rate of increase: either a 5 per cent rule or a 2 per cent rule would be far superior to the monetary policy we have actually followed" (p. 48).

3. - There is no need to recall here the "great number of critical voices" that the position assumed by Friedman provoked.<sup>13</sup> This has naturally reopened the old debates on the range to be given to the conception of money:<sup>14</sup> that is to say, whether money is to be understood as monetary base alone, namely, money issued by the central bank (indeed, precisely that part of it actually held by the public) or whether also other means of payment or even other stores of value in liquid form are to be regarded as forming part of it. However, this question is of no interest as regards the validity of the quantity theory, in the formulation implicitly accepted by Friedman, since the alternative always remains open of considering

<sup>11</sup> Friedman then wrote: "Governmental intervention in monetary matters, far from providing the stable monetary framework for a free market that is its ultimate justification, has proved a potent source of instability" (Fordham University Press, p. 23).

<sup>12</sup> Similar reasons and conclusions were presented by HARRY G. JOHNSON during the lesson he gave in Buenos Ayres in the summer of 1963 (reproduced under the title "Recent Developments in Monetary Theory" in *Essays in Monetary Economics*, London, 1969, 2nd ed.), based on research carried out for the Royal Commission on Banking and Finance in Canada. He says he "obtained the result that monetary theory was doing more good than harm for about one month in twelve".

<sup>13</sup> In large part recalled by SCHNEIDER in footnote 3 of the paper "Automatism or Discretion in Monetary Policy?" already cited.

<sup>14</sup> MARZANO has recently dealt with this, in the article on "La variabile monetaria nelle analisi storiche" (*Rivista Bancaria*, Milan, January-February 1971, pp. 46-51).

every other kind of money (except monetary base) as a "substitute" to be aggregated to the base money or as an accelerator (in the "virtual" sense) of the velocity of money itself.<sup>15</sup>

It follows that whatever range may be given to the conception of money, the quantity theory, on which Friedman's construction is based, still remains valid. In fact, it is just the developments of the "equation of exchange", as the expression of that theory (with the velocity of circulation being explicitly considered), which lead to it being established — in the words of Schneider — "that the price level remains constant through time, if the growth rate of the money supply is equal to that of real income", thus making it "possible to devise a simple rule for a policy aiming at price stabilization... It is this rule for the regulation of money supply which Milton Friedman and his collaborators have been vigorously propagating for some ten years".<sup>16</sup>

4. - The fact is, however, that while the condition concerning the parallelism between the growths of real income and those of the quantity of money certainly represents a necessary condition, it is not one that is sufficient for price stabilization.<sup>17</sup> For this purpose, account must also be taken of the "fundamental equations" given by Keynes in his *Treatise on Money* (in chapter 10), in order to establish the necessity of the equilibrium, in the sense of adjustment, between savings and investments.<sup>18</sup>

<sup>15</sup> The two different ways of interpreting the conception of money date back, respectively, to J. Law and to R. Cantillon, while "virtual" velocity is expressly taken into consideration by Wicksell, as I mentioned in the already cited *Economia Creditizia* (§ 171, pp. 286-289).

<sup>16</sup> On page 121 of the article cited.

<sup>17</sup> For Friedman, the condition of parallelism is not only necessary but also sufficient. An explicit confirmation of this is found also in the text of the lecture referred to, in which one reads, among other things, "inflation is, and can be, determined only by a more rapid increase in the quantity of money than in production" (in *Bancaria*, p. 455, § 8; my italics).

<sup>18</sup> Hicks has dwelt upon these "fundamental equations" in a special "Note on the Treatise", on pp. 189-202 of his *Critical Essays in Monetary Theory* (Oxford, 1967). The equation to which we are referring now can be written, disregarding the problems inherent in the measurement of the changes in price levels and following the usual notations (P=price level, I=investments, S=savings, E=equilibrium income):

$$P = \frac{I + I - S}{E}$$

Thus the price level would rise each time there was an excess of investments over savings and would fall in the opposite case.

Not to have taken into account these conditions constitutes the "Achilles' heel" of Friedman's counter-revolution, since in this way the validity of the rule he upholds is vitiated. If the equilibrium between savings and investments is to be maintained, and consequently the price stability, it cannot be sufficient to maintain the parallelism between growths of real income and growths of money, considering these latter growths solely from their quantity aspects. We must rather consider as well what the "nature" is of money to be used to finance real investments.

In this connection, for that matter, the customary distinctions regarding money from the technical-formal point of view do not hold good: no purpose is served, for example, by taking account of the features that distinguish banknotes from deposits registered in special bank-books (such as the so-called savings books) or held as bonds or certificates, however they may be called, always bearing in mind their technical-formal features. It is preferable to clarify what is — to repeat — the "nature", i.e. the background of the money and other financial assets that are to be used to finance real investments.<sup>19</sup> This means clarifying whether against such investments there is either the transfer of a corresponding amount of actual — or at least future — savings, or else a more or less varied offsetting of credits given and credits received, such as to render possible the creation of money or other financial assets through "self-generation", that is to say, without any transfer of savings whatsoever.<sup>20</sup>

5. - In point of fact, assessments of this kind are anything but easy and, indeed, are almost unattainable in numerical terms. On the other hand, the progress already achieved and which continues to be achieved in analysing the processes of creating credit money and other financial assets, as well as in elaborating the relative statistics enables an essential point regarding the validity of Friedman's rules to be established, viz. that the share of money and

<sup>19</sup> The need for such an investigation was stressed by me in § 2 of the paper on "The Coverage of Financial Requirements of the Public and Private Sectors" (in *Bancaria*, August 1970).

<sup>20</sup> As regards offsetting, as a process that can give rise to the creation of financial assets through self-generation, I dwelt on this in a special paragraph (4.1) of my *Introduzione alla Economia Creditizia* (Boringhieri, 1969).

other financial assets created by self-generation has become, and is becoming as time goes on, ever more important in relation to the share created by savings transfers.

It is just this which is happening under our very eyes today, not only in international relations as they result (through savings transfers) from the balances of payments, but also within the individual countries. In the latter case, the growing importance of the self-generation process results not only from "inter-sectoral" transfers, as these are now revealed in financial statistics, but also from "intra-sectoral" transfers. As regards the latter, only conjectures, more or less reliable, can be made, in the absence of exact verifications.<sup>21</sup>

In any case, quite apart from numerical assessments, what might be called a macroscopic proof of the changes that can occur and are occurring in the "nature" of money that we use to finance investments (also within the individual countries) is provided by the almost dizzy crescendo of the proportion of financial assets in the form of Euro-currencies and, first among them, Euro-dollars. This crescendo has by now brought home to us how that proportion forms — to quote Governor Carli's<sup>22</sup> apt expression — "a paper pyramid".<sup>23</sup>

The result of such changes that take place in the "nature" of money is that variations of the same amount in the quantity of money, regarded only from the point of view of its size, though they may meet the conditions of parallelism, as is inferred from the equation of exchange, cannot meet the condition of equilibrium between savings and investments, as is inferred from the "fundamental equations" of the *Treatise*. This means that the validity of the Chicago School's rule based exclusively on the condition of parallelism remains — to repeat — vitiated.

<sup>21</sup> I have quoted some figures in this connection both in the aforementioned *Introduzione* (pp. 75-76) and in the paper cited in footnote 19 (in paragraphs 4 and 5).

<sup>22</sup> During the lecture given at the Istituto di Studi per lo Sviluppo Economico in Naples on March 24, 1971 and reproduced in the *Banca Nazionale del Lavoro Quarterly Review*, June 1971.

<sup>23</sup> During the lecture just mentioned, the crescendo of the volume of Euro-dollars was rightly attributed to the "multiplier effects" of credit, ascertained for some time past within the individual countries. In point of fact, such "multiplier effects" must be attributed, from the economic point of view, to the offsetting between credits given and credits received, without transfers of savings, as is more clearly evidenced in international relations in the case of "reciprocal credit facilities" and "swaps".

6. - Thus, when all is said and done, this consideration of only one of the conditions necessary for the price stability constitutes — as was said — the Achilles' heel of Friedman's counter-revolution, with which he advocates automatism in the management of monetary policy.

The significance of that presumed counter-revolution must therefore be reduced to its proper proportions, and an appropriate integration be made of the purely dimensional aspects of the changes in the quantity of money, so as to take into account also the aspects inherent in the "nature" of money as money is adopted also in the financing of real investments. And this means that also in the field of monetary policy one cannot rely upon a rule of automatic behaviour.

While certain rules, such as that formulated by Friedman, can serve to give guidance, like the North Star, adequate margins for discretion must nevertheless always be left to those who are responsible for managing monetary policy according to the alternate patterns of the incessant fluctuations in the economy's developments, also in their international aspects.

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