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Milton Friedman on Inflation

The death of Milton Friedman on November 16, 2006, led Federal Reserve Chairman Ben Bernanke to remark that the "direct and indirect influences of his thinking on contemporary monetary economics would be difficult to overstate" and President Bush to note that "his writings laid the groundwork that transformed many of the world's central banks." Undoubtedly a major factor underpinning these assessments is the overwhelming influence that Friedman's work has had on the way that economists and policymakers look at inflation.

As Friedman emphasized, "Inflation is an old, old disease. We've had thousands of years of experience of it. There is nothing simpler than stopping an inflation—from the technical point of view."[1]

That remedy took a specific form: "The only cure for inflation is to reduce the rate at which total spending is growing." This cure involved a temporary side effect, as Friedman noted: "There is no way of slowing down inflation that will not involve a transitory increase in unemployment, and a transitory reduction in the rate of growth of output. But these costs will be far less than the costs that will be incurred by permitting the disease of inflation to rage unchecked."

On the issue of how economic policy should manage total spending, Friedman led the profession away from the weight it gave to fiscal policy. His work was important in forming the consensus that monetary actions have more sizable and reliable effects on aggregate spending than fiscal actions. In fact, Friedman offered the judgment, "I don't think monetary policy has to be backed up by fiscal policy at all. I think monetary policy can curb inflation." His reasoning behind this was straightforward: "A budget deficit is inflationary if, and only if, it is financed in considerable part by printing money"—that is, only if fiscal actions are accommodated by the monetary authorities. In light of the importance of monetary policy for aggregate spending behavior, and of total spending for inflation, Friedman stated the policy implication: "[M]onetary policy is an appropriate and proper tool [when] directed at achieving price stability or a desired rate of price change." This principle underlies the monetary policy framework of major economies today.

Friedman was particularly scathing about "cost-push" theories, prevalent in the 1960s and 1970s, that attributed high inflation to autonomous increases in costs rather than to excess demand. As he observed, "To each businessman separately it looks as if he has to raise prices because costs have gone up. But then, we must ask, 'Why did his costs go up? Why is it that [for example] from 1960 to 1964 he didn't find that he had to pay so much more for labor he had to raise prices, but that suddenly from 1964 to 1969 he did?' The answer is, because, in the second period, total demand all over was increasing." Friedman's monetary view of the inflation process led him to dismiss "incomes policy"—i.e., direct controls on wages and prices—as an alternative or supplement to monetary policy in fighting inflation. Asked in 1974, "Do you think an incomes policy is an essential adjunct of a strict monetary policy?" Friedman replied simply, "Not at all." Consistent with this judgment, many countries that once assigned an important role to incomes policy now rely on monetary policy to control inflation.

Policymakers in the 1970s saw that inflation was costly, but failed to grasp that to get inflation under control, they needed to use monetary policy, and *only* needed to use monetary policy. The fact that today's policymakers do understand this reflects the profound impact of Milton Friedman on monetary economics.

—Edward Nelson

[1] A list of sources for the quotations from Friedman used here is available at http://research.stlouisfed.org/publications/mt/Jan2007MT_Milton_Friedman_on_inflation-SourcesWeb.pdf.