

Summary Sheet

Famous Economist: Milton Friedman

Biography:

- Born July 31, 1912, Brooklyn, NY to Jewish immigrant parents
- Education: BA Rutgers (1932), MA Chicago (1933), PhD Columbia (1946)
- Professor at University of Chicago (1946-1977), leader of Chicago School of Economics
- Nobel Prize (1976) for consumption analysis, monetary history & theory
- Presidential Medal of Freedom & National Medal of Science (1988)
- Published A Monetary History of the United States (1963)

What is Monetarism?

- Monetarism is an economic school of thought, formulated by Milton Friedman, which states that the supply of money in an economy is the primary driver of economic growth.
- Instead of using government spending or taxes to fix the economy, he thought the focus should be on managing the money supply.
- The monetarist viewpoint is also a strong advocate for the free market.

Monetarism Core Ideas:

- **Quantity Theory of Money**
 - QTM is based on the Fisher equation ($MV = PQ$), developed by Irving Fisher in 1911
 - M = money supply, V = velocity of money, P = price level, and Q = output of goods and services.
 - If money supply (M) grows faster than output (Q), the economy will experience inflation.
 - "Inflation is always and everywhere a monetary phenomenon."
- **K-Percent Rule**
 - Friedman proposed that the money supply should grow at a fixed percentage annually (around 3-5%), matching long-term real GDP growth
 - He believed in the effectiveness of a rules-based system as it removed the risk of mistakes and excessive response in discretionary policy.
- **Natural Rate of Unemployment**
 - Milton Friedman proposed that there is a "natural rate of unemployment" at which the economy would settle, and this rate is independent of monetary policy.
 - It is referred to as the Non-Accelerating Inflation Rate of Unemployment (NAIRU)
 - He also argued that there is **no long-run trade-off between inflation and unemployment**, meaning attempts to reduce unemployment below this natural rate would only lead to higher inflation without any lasting decrease in joblessness.
- **Long-Run Neutrality of Money**
 - Friedman believed in the long-run neutrality of money, meaning that printing more money might boost spending for a short time, but in the long run, it only raises prices, not actual output.
 - To maintain stable economies, monetary policy should focus on controlling inflation rather than micromanaging unemployment.

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Monetarism vs Keynesianism

- Monetarists emphasize the control of money supply, using monetary policy; Keynesians emphasize the control of consumer spending (Aggregate Demand), using fiscal policy
- Keynesians use the Keynesian model while monetarists use the Neoclassical model.

Historical Significance

- **1970s Stagflation**
 - Friedman's NAIRU and QTM helped explain stagflation:
 - There was too much money chasing too few goods, causing inflation.
 - The Keynesian model struggled to explain the phenomenon of high unemployment and high inflation.
 - Paul Volcker (U.S. Federal Reserve, 1979–1982) used strict Monetarist policies, sharply reducing money supply growth and raising interest rates above 15%.
 - It was one of the first high-profile implementations of monetarist theory
 - Short-term: painful recession, high unemployment.
 - Long-term: inflation brought under control → restored stability and confidence in monetary policy.
- **2008 Financial Crisis**
 - The credit freeze caused greatly decreased transactions (V); consumers and businesses started hoarding cash, and banks completely stopped lending to each other.
 - Much of Friedman's research blamed the severity of the Depression squarely on the Federal Reserve.
 - Claimed the Fed's fundamental failure was allowing the money supply to collapse, which led to a deflationary spiral.
 - **Quantitative Easing (QE)** was used to increase the money supply, buying assets and long-term bonds to inject money into the economy.

Summary/Modern Influences

- Friedman brought forward the role of monetary policy, emphasizing the responsibility of the central bank, in a time when fiscal policy was the prevalent option.
- Many of his ideas laid the groundwork for anti-inflationary policies and free-market reforms used by governments globally.
- QE and discretionary policy are used by most central banks (i.e. cutting/increasing interest rates)
- He refined the understanding of the nuances of the Phillips curve, and the relationship between inflation and unemployment.