THE ECONOMIC THINKING OF PROF. MILTON FRIEDMAN

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"Free Enterprise was born with man and shall survive as long as man survives."

—**A. D. Shroff**

1899-1965
Founder-President
Forum of Free Enterprise

ECONOMIC THINKING OF PROF. MILTON FRIEDMAN

INTRODUCTION

Prof. Milton Friedman was recently awarded the Nobel Prize for Economics. In the context of the Award, his writings and thinking have again attracted public attention. While on a visit to India in 1963, he had addressed meetings arranged by the Forum of Free Enterprise. We are reproducing in this publication one of Prof. Friedman's articles issued as a leaflet by the Forum in May, 1963. It is interesting to note that developments on India's foreign exchange front have moved in the direction indicated by Prof. Friedman in his article.

A critical appraisal of Prof. Friedman's economic thinking by India's eminent economist, Prof. P. R. Brahmananda, who is Professor of Monetary Economics, Department of Economics of Bombay University, is also given. We are grateful to the Editor of "Commerce" for granting us permission to reproduce this article from its issue dated 23rd October, 1976.

Those interested in studying Prof. Friedman's economic thinking may usefully read his books like "The Monetary History of U. S. A." (co - author, Anna Schwartz), "Capitalism and Freedom", "Essays in Positive Economics" and "A Programme for Monetary Stability".

India Needs A Free Market Exchange Rate

Prof. Milton Friedman

The Achilles heel of the Indian Economy at the moment is the artificial and unrealistic exchange rate. The official exchange rate is the same today as it was in 1955. In the interim, prices within India have risen some 30 to 40 per cent ; whereas prices in the US, UK, Germany have risen far less, at most by 10 per cent. If the Rupee was worth 21 cents in 1955, it clearly is not worth 21 cents today. And even in 1955, India was experiencing difficulty in balancing its payments. It was even then engaged in extensive foreign exchange control, import restrictions, and export subsidies.

The attempt to maintain an over-valued Rupee has had very far-reaching effects. The rise in internal prices without a change in the official price of foreign currency has made foreign goods seem cheap relative to domestic goods and so encouraged attempts to increase imports ; it has also made domestic goods seem expensive to foreign purchasers and so discouraged exports. This is the basic reason why India's exports have risen so much less than world trade. It is also the basic reason why India's foreign exchange reserves were so rapidly exhausted despite the very large amount of foreign exchange made available to India through aid from the US and other countries, loans by the International Bank, and the like.

The pressure on the balance of payments has been officially met in three ways : first, by using up foreign exchange reserves ; second, by getting additional assistance and loans from abroad ; third, by extending direct control over imports and subsidising exports. There has been a fourth unofficial way, namely, black market transactions in exchange and the smuggling of goods. Though no records exist on

this fourth way, there is little doubt that it has expanded greatly as the official exchange rate has become more and more unrealistic and that it increasingly renders official statistics unreliable as measures of India's foreign trade transactions.

The first of these resources is exhausted. The second may still be of some avail though it seems hardly likely that present assitance will be expanded very much. In any event, so long as the exchange rate is as far as it currently is from a realistic rate, foreign assistance will simply be poured down a bottomless well. The third recourse, direct controls, is the one on which most reliance will have to be placed, if the present official exchange rate is to be maintained. It is, therefore, worth examining in some detail what its effects have been and what the prospects are that it will be able to resolve the present difficulties.

Exchange control has not in fact been able to stimulate exports. They have stagnated or fallen. It has operated almost entirely by preventing individuals from importing as much as they would like at the controlled exchange rate. In doing so, it has done immense harm to the Indian economic and political structure. There is no satisfactory criterion available to the planning authorities to determine what items and how much of each should be permitted to be imported. There is much talk of restricting "unessential" imports and permitting only "essential' ones. But this is just talk unless there is some way of determining what is and what is not essential. In the absence of a market test, there is in fact no satisfactory way to do so. When a family must reduce its expenditure, it does not cut out whole categories of goods ; it cuts its expenditure a little here and a little there, balancing the loss from spending a Rupee less on toothpaste with that from spending a Rupee less on movies and so on in infinite variety. The same principle applies in restricting imports to available exchange. But how can planners at the Centre have the necessary information about each of the tens of thousands of items imported ? How can they know how much a little cut here will reduce exports of a hundred other items ? How costly will it be to provide domestic substitutes, directly and indirectly ? How much the consumers of the

ultimate products would be willing to sacrifice in other directions for a little more of a particular import item ?

The fact is that the planners cannot possibly know what they would have to know to ration exchange intelligently. Instead, they resort to the blunt axe of cutting out whole categories of imports ; to the dead hand of the past, in allocating certain percentage of imports in some base years ; and to submission to influence, political and economic, which is brought to bear on them. And they have no alternative, since there is no sensible way they can do what they set out to do.

On the economic front, the result has been waste, inefficiency, and misdirection of resources. India has become a protected economy in which items are produced domestically at a multiple of the cost at which they could be obtained from abroad. And at the same time, foreign exchange is wasted in purchasing goods abroad for which it would be more economical to use domestic substitutes. Once an import licence is granted, the recipient gets foreign exchange at the official rate ; he gets a dollar for 4.7 Rupees. Hence he uses this rate in judging whether to use the imported goods rather than domestic products. But this is a false basis for calculation from the national point of view since the official rate is so far below the rate that would prevail in a free market. A dollar should be spent abroad only if domestic substitutes for the item purchased would cost something like 7 or 8 Rupees ; but the recipient of an import licence figures that it is worth spending it abroad if one can save thereby more than 4.7 Rupees. Hence the very large demand for import licences and the waste of foreign exchange by the lucky recipients.

To some extent this deficiency is offset by the black market that has sprung up in import licences. The original recipient of the import licence may never use it but resell it to someone else for a premium. The effect is to raise the cost of foreign exchange to the ultimate user and force him to use a more appropriate rate in making his calculations. But this gain is purchased at a high social and political cost. It promotes

corruption and the exercise of influence, in obtaining import licences, produces windfall profits to persons lucky enough or influential enough to get the licences, widens the inequality of income and wealth, and undermines public trust in Government.

It is one of the great vices of centralised control that, as in this instance, it both stimulates conduct that on a private level is reprehensible and unethical and makes such conduct useful. The black-marketeer, the purchaser and seller of import licences, and so on are flouting the law and behaving in a way that most of us find highly objectionable. Yet they are also reducing the harm that is done by direct controls over exchange transactions.

Despite the extensive network of direct controls, it will be impossible to maintain the present exchange rate indefinitely. The only thing that has made it possible to do so up to now has been the large sums of foreign exchange that the Government has acquired from foreign aid and loans. Unless these are stepped up drastically, the pressure on the present rate will become unbearable. Experience of many other countries, such as the United Kingdom, France, Israel and so on has shown that an artificial exchange rate can be maintained by direct controls only if the deviation from the market exchange rate is minor. Once it gets as wide as one-third to one-half of the official rate—which is probably roughly the present discrepancy in India—a change in the rate becomes inevitable.

What is probable is that sometime within the next year or so India will devalue, moving to an exchange rate of something like 7 Rupees to the dollar or 20 Rupees to the pound. This will be preceded by a very sudden and rapid worsening of the exchange situation as people inside and outside the country come to expect devaluation and try to convert Rupee assets into foreign exchange assets.

While this is the probable course of events, it is not the most desirable. The new fixed rate of exchange may be satisfactory for a while but sooner or later similar difficulties are likely to arise.

A much better resolution would be for the Government of India to cease trying to peg the foreign exchange value of the Rupee. Let the exchange rate float and be determined from day to day in the market by private transactions. A floating rate would provide an automatic adjustment mechanism. It would render impossible exchange crises.

It would be best of all if a floating rate were accompanied by the complete elimination of import quotas, export subsidies, and other interference with international trade. But even if this is not feasible, it would be far better to discriminate among imports by tariffs than by quotas, and to do so in the presence of a floating rate to provide an automatic adjustment mechanism to balance payments.

The effect of setting the exchange rate free would be to increase the foreign trade of India. Exports would be stimulated and the funds available to spend on imports increased. Attempted imports would be reduced, but actual imports increased. To illustrate by hypothetical figures : At the official rate, people would like to import, say 200 units, but foreign aid and export provide foreign exchange for only 100, the difference being eliminated by direct controls. At a free market rate, people would seek to import less, say 130, and would be able to import this much because the stimulus to exports would make 130 units available.

A free market rate would make everyone throughout the country aware of the true cost of foreign exchange and of the true gain from selling abroad. It would thus enlist the interests of tens of millions of people in their everyday lives in economising on imports and in promoting exports to precisely the extent that is in the social interests. The activities of these tens of millions of people each drawing on his little store of specialised knowledge, would provide a far more subtle and efficient adjustment than blunt measures of a few central planners, who, however knowledgeable individually, do not begin to match collectively the aggregate of knowledge of the population as a whole. — (*Reproduced from "Swarajya" of March* 30, 1963, *with kind permission of the Editor.*)

Milton Friedman — Leader of Monetarist Revolution

By

Dr. P. R. Brahmananda

Dr. Milton Friedman, who has been awarded the Nobel prize in economics this year, is known in professional economic circles for a variety of contributions to a diverse number of areas in economics. He has interpreted Marshall's consumer demand theory as based on the strict assumption of actual constancy of the marginal utility of real income, thus eschewing scope for any income effects. He has upheld a methodological position in social sciences that the validity of any theory should be tested primarily by reference to the empirical credibility of its conclusions ; no need to test the validity of the assumptions. He is a believer in perfect flexibility in exchange rates. He is also well known as the champion of an extreme form of *laissez-faire.* Consumers should have complete freedom in regard to the pattern of resource allocation that they indirectly direct. The State must confine itself to maintaining the market, legal and moentary framework and enforce competitive conditions rigorously. He would abolish most of the functions of a modern government. Dr. Friedman believes in the dictum that men are governed by enlightened self-interest and know best what is best for them.

"Friedmannism" *in general* though apparently a consistent logical system of political economy does not have many adherents ; it is a lost cause. The real world is characterised by conflicts, between private and social interests, between the interests of the present and of the future ; neither the consumer nor the firm operates under conditions of full information ; competition is not the rule in industry, since economies of scale and gains through collusion are conspicuous.

But then everyone knows, and the Nobel Prize committee has also said as much , that the award for Friedman is for his contributions to moentary and business cycle theory.

This Friedman, the leader of the Monetarist Revolution, the outstanding champion of the Quantity Theory of Money, has a legion of adherents all over the globe. In this area he has carved out a path on which he continues to be a leader of scholars. Prof. Paul Samuelson, Friedman's equally distinguished contemporary, has termed him as the ninth (or is it the tenth) wonder of the world. Wonders of the world belong to bygone ages. But this wonder is very much of the current and for the current. Sraffa is said to have placed classical economics at the centre of modern economics ; and Friedman may justly claim the achievement of having placed the Quantity Theory of Money almost at the centre of modern macro economics. The fox, it is said, is very clever and knows many things, but the hedgehog knows *one* thing. Milton Friedman is certainly a hedgehog.

Modern Quantity Theory

What exactly are the components of the "modern" Quantity Theory of Money ? Unfortunately, no precise account is available. I have tried to outline below the essence of this theory in the form of ten propositions.

I. The quantity of money in an economy is determined by (a) the volume of high powered money consisting of (i) currency with the public and (ii) foreign exchange reserves of the commercial banks ; (b) the value of the multiplier linking high-powered money to total money supply. The value of the multiplier varies inversely with the proportion of currency with the public to total money supply and with the desired, and statutorily required, ratio of cash reserves of banks to demand deposits. Money supply is augmented when given (a) the cash base of the banking system gets augmented, and when the volume of high-powered money gets expanded for example by government deficits and/or by accretion of foreign exchange reserves.

II. The (nominal) money national income, given the quantity of money, is governed by the income velocity of money.

III. The income-velocity of money tends to be higher when (a) interest rates are higher, (b) the rate of return on equities is higher, and (c) the price level is expected to go up. Since a rate of money supply expansion in excess of output growth tends to generate expectations of rising prices, velocity movements go *pari passu* with money supply movements.

IV. The velocity function, or its inverse, the demand for money function, is stable. It is more stable than the consumption function. Other conditions being equal, if interest rates and rates of return are unchanged and the price level is expected to be stable, the income velocity of money can be deemed to be constant in the short period.

V. Under institutional conditions in which prices (and wages) are rigid and remain so in the face of excess capacity and unemployment, an increase in the quantity of money will lead to an increase both in nominal and in real national income.

VI. The transmission mechanism between an increase in the quantity of money and in the volume of effective demand consists of a number of channels : (1) Purchase of shares, bonds, non-monetary assets, real property, etc.; (2) Purchase of real capital assets and new investment goods ; and (3) purchases of consumption goods. Under conditions of initial excess capacity and unemployment, real output expands.

VII. Since there is a lag of uncertain length between variation in the quantity of money and real output, and between real output and prices, contra-cyclical money supply and/or interest rate policy defeats its purpose and proves anti-damping in its effects. Hence a predetermined *fixed* growth rate, period by period, is preferable to discretionary money supply-variation policy.

VIII. Real balances as a ratio of household real incomes arise as a result of saving by households who forego consumption utility by this process. Since money costs little to society, it is preferable to minimise the sacrifice involved in

saving for real cash balances. A policy of falling price level enables households to increase their holdings of real cash balances and obtain a premium on such holdings.

IX. Monetarists would distinguish between the real component in the rate of interest and the compensating component for the expected rate of change in the price level. Thus, under long-run inflation, the nominal rate would be higher than the real rate. The real rate would not be capable of being permanently altered by changes in money supply.

X. In the long period, the quantity of real output and its rate of growth cannot be manipulated by monetary factors.

The Quantity Theory of Money is an ancient cat in economics. And like the proverbial cat, is has several lives. Three decades ago many economists had thought that the cat had been finally and decisively killed by Keynes. The quantity of money as a regulator of demand had disappeared. Autonomous expenditure and interest rate manipulation had ascended the throne of macropolicy. The revival of interest in money supply is an extraordinary event in the history of economic ideas. Of course, not all the ten propositions given above can be attributed to Dr. Friedman. In fact, Dr. Friedman himself has not claimed any originality for all the ideas concerning the Quantity Theory of Money. His main contribution is the effort of synthesising these ideas together and of having conducted and stimulated empirical tests in order to verify the new Quantity Theory of Money.

We may now briefly comment on each of the above propositions.

Money multiplier : Proposition I, which focusses attention on the mechanism of the money supply process, has been developed in the famous book, THE MONETARY HISTORY OF THE USA by Milton Friedman and Anna Schwartz. In earlier days, even in Keynes' GENERAL THEORY itself, the supply of money was somehow taken to be given from outside of the production and prices system. There was very little of an analytical account of how exactly

the supply of money could be varied. It was noted that extension of credit by the banking system to the government would be a contributory factor for an expansion in money supply. There were discussions concerning the process of the multiple creation of credit. Keynes talked of open market operations and bank rate change as having some effect upon the cash base of banks and money supply. Friedman switched the attention from credit to money and developed a precise account of the money supply expansion process.

Proposition I has the limitation that it assumes that under all conditions, the money multiplier would have reached a maximum value. The point made by Tobin that the capacity to lend is not necessarily reflected in actual borrowings has to be kept in mind. However, largely due to Dr. Friedman's impact, economists are now concentrating on the effect on money supply of various types of monetary and fiscal policies. For example, government borrowing under unchanged money supply conditions has a different effect on demand than when such borrowing occurs through the expansion of high-powered money. Dr. Friedman has now given to the monetary authorities a new tool for controlling demand through variation in the value of the money multiplier.

Credit deadlock : Proposition II had been formalised earlier in the writings of Irving Fisher and the late Ralph Hawtrey. In fact, prior to Milton Friedman, the most outstanding monetarist was certainly Hawtrey. There is considerable similarity between the theories of Hawtrey and of Friedman. It was Hawtrey who substituted "income" in place of the "volume of trade" in the Quantity Theory analysis. The chief difference between Hawtrey and Friedman is is that the former has made provision for "credit deadlock"— a state of affairs wherein the banks may be willing to lend but there may be insufficient borrowers. There is close affinity between Hawtrey's "credit deadlock" and Keynes's "liquidity trap". The account of the business cycle given by Friedman is very similar to that given by Hawtray. Keynes almost silenced Hawtrey. But through the medium of Friedman, Hawtrey's ideas have come back !

Robertson and Friedman : Proposition III owes a greal deal, in terms of elaboration, to Friedman ; but the originat idea is that of D. H. Robertson who stubbornly argued with Keynes that the holder of money balances has a number of alternatives open to him. Keynes had argued that the alternative to lending money was to hoard it, whereas it was Robertson who pointed out that the more proper alternative to hoarding money was to spend it. Friedman himself would consider the chief difference between Keynes and himself to be that whereas Keynes considered only a narrow range of alternatives, his own analysis has a wider range. One of the chief criticisms against the Quantity Theory has been that the velocity of money and the quantity of money may move in opposite directions. Friedman has shown that empirically this does not generally happen. Velocity movements and money supply movements tend to proceed in a similar direction.

Demand for money : Proposition IV, according to many, is the central contribution of Friedman. He has demonstrated by means of the empirical examination of the US evidence, over a long historical period, that the demand for money function is stable, and more so than the consumption function. The stability of the demand for money function, not the same thing as constancy, has been empirically attested for a number of countries, including the UK. There is, of course, the unresolved dispute as to whether the monetarist hypothesis based on the stability of the demand for money function is a more powerful predictive tool than say the Keynesian hypothesis, which places emphasis upon autonomous public expenditure. The tide of evidence, however, has turned a great deal in favour of the monetarist hypothesis.

Proposition V is very important. Under Keynesian background conditions, the monetarists are able to demonstrate that an expansion in the quantity of money will lead to an increase in real as well as nominal income. The credit for this proposition must strictly go to Vera Lutz who, in a not so well-known article in ECONOMICA of February 1955, had demonstrated that the velocity analysis can be

used as an alternative to the multiplier approach. The chief criticism against the velocity approach to the determination of the real income is that there are many slips between money and output.

In Friedman's analysis, the stock of money is with the households (and firms) ; variations in the stock are ultimately reflected in variations in the amounts with the above units. In the transition we have to provide for credit variation and expenditure decisions by the government or by firms. Hawtrey's "credit deadlock" can stand between money-creating power and output. In a sense when Keynes emphasised the liquidity preference trapping, he was emphasising the gap between money and expenditure.

The transmission mechanism : Proposition VI, related to Proposition III, highlighting the numerous channels in the transmission mechanism has to be attributed to Robertson though it is Friedman who has elaborated the various channels and asserted their cumulative importance. Patinkin's Real Balance Effect also can be taken in the model of transmission mechanism.

Proposition VII is not specifically Friedman's contribution. The idea of a predetermined fixed growth rate of money supply is due to Friedman's teacher Henry Simons ; this notion was further elaborated, prior to Friedman taking it up, by Shaw of Gurley and Shaw fame.

Proposition VIII has been recently emphasised by Dr. Friedman, but the original credit for this proposition must go to Professor Hayek and the Austrians who brought up the doctrine of neutral money.

Indexation : Proposition IX was an important discovery of Irving Fisher and forms a major component of any full version of the Quantity Theory of Money under conditions in which there is freedom to contract and absence of rigidities. In fact, the theory of 100 per cent indexation, which has been most recently emphasised by Dr. Friedman, has its origin in

the above proposition. Hundred per cent indexation would not be a panacea for inflation ; it is just a pain-killer preserving the *status-quo ante*. Full-indexation, if it comes about, would imply that the essential properties of money would have evaporated.

Proposition X is an age-old proposition emphasised in the writings of Ricardo and Hume. It is part of the doctrine of dichotomy between money and goods.

One should not get the impression that there are no challenges to the Monetarist School and that Keynesianism has been completely routed. Friedman's victory is for Monetarism against Fiscalism. Friedman has already partly surrendered himself to Keynesianism when he holds that, under Keynesian conditions, in the short period, monetary expansion can take the economy to full employment, of course, with provision for a modicum of natural unemployment. *He has admitted here that effective demand at the macro-level is a necessary condition for the flow of real national income.* This was the point which Keynes was struggling to establish against the classicists. Keynes had attacked Say's Law which stated that the supply of balanced real capital creates its own demand. The classical school has taken its stand on the proposition that balanced productions create their own demand. Effective macro-demand, either through the velocity-multiplier form or through the investment-multiplier form, is *not* a necessary condition to obtain full-capacity balanced output. Milton Friedman has argued that the Great Depression of the thirties should be properly called as the "Great Contraction", his point here being that considerable contraction in money supply had occurred prior to the depression.

It is not enough to show that empirical tests bear out a particular theory, for there could be different theories which can alternatively explain the same phenomenon. Secondly, the theory itself must be logically consistent and the assumptions — or the premises — must be deemed to be realistic. Friedman's general methodological position may not be acceptable to all. But, I would like to point out that until

very recently Friedman has not tried to present a *whole* system of economic ideas pertaining to the macro-economic behaviour of an economy. The most recent efforts which he has made in this direction are admittedly incomplete. The great merit either of classical economics or Keynesian economics is that these are *systems* of thought containing *structures* of inter-connected ideas. Obviously, Friedman must abandon Say's Law if he has to be satisfied with the positions which he has taken. This puts him outside of not merely the classical school but also of neo-classicals like Pigou and others.

The success of monetarism is, therefore, not a success of monetarist theory against the *General Theory*. Its success at the policy level is partly due to the climate of revulsion against inflation, and of frustration due to the inability of modern governments to control it. But unlike the Austrians— and may I add the classical economists—in essence, Friedman cannot be deemed to be an enemy of inflation. His espousal of 100 per cent indexation has come as a shock to many, and to those who have admired Friedman's economic ideas. Does this not mean that Friedman has at least shaken hands with inflation ?

Mark the difference between the positions taken by Hayek and Friedman. Hayek continues to be an opponent of inflation; he cannot enter into any compromise, through indexation or otherwise, with the phenomenon of inflation. I am sure that would have been the position taken by the classical economists like Ricardo, Hume, J. S. Mill or even Alfred Marshall, and, may I say, also Robertson.

The case against inflation has been that it adversely affects the conditions of the working class and of the poor. A country like China is reported to have adopted a policy of allowing money supply to grow at a lower rate than the growth rate of output. Economists like Gurley, Lloyd Reynolds, Galbraith and others have attested to the beneficial effects of such a policy in a country like China. The same policy was suggested in India several years ago by this writer. The

criticism then was that it was not "progressive". A rising rate of inflation was deemed, by some economists, to be a "progressive" measure under Indian conditions. In fact, before, our Government took the measures against inflation in July 1974, a case was being made out for 100 per cent indexation in India ! I have drawn attention to this in order to point out that the case against inflation also implies a case against 100 per cent indexation. Economists like Alfred Marshall and Robretson favoured a falling-price-level path primarily to improve the economic status of workers and the savers. Such a path was conducive to greater social justice.

The Quantity Theory of Money has been the economists' banner against inflation. One would have admited Dr. Friedman's achievements to a greater extent if only he had not become an espouser of the case for indexation. One hopes that Friedman will return to the old Quantity Theory tradition and take up afresh the battle against the sources of inflation.

The root of the trouble, I think, is that Friedman has rejected Say's Law. Thanks to Piero Sraffa, and some others, classical economic theory has come back. The climate is conducive for rejecting completely the doctrine of effective demand, *a la* Keynes or *a la* Friedman. (*Courtesy : "COMMERCE", Bombay, October* 23, 1976)

The views expressed in this booklet are not necessarily the views of the Forum of Free Enterprise

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

—**Eugene Black**

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