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REPLY

Is Friedman a Monetarist?

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I alone am responsible for section 1 of our joint paper and for any misinterpretation of Milton Friedman's monetarism which it contains. If there is guilt, none of it falls on Willem Buiter.

On a previous occasion I wrote:

> Milton Friedman's work on money is important and influential: it commands the attention of economists, policy-makers, journalists, and men of affairs throughout the world. That is why it deserves and receives serious critical discussion. I am continually perplexed by Friedman's propensity in professional debate to evade by verbal quibbling the responsibility and the credit for the characteristic propositions of 'monetarism' associated with his name. [Tobin (1970a, p. 329)]

This time I have the following specific comments:

(1) Friedman is quite right that a horizontal *IS* locus, derived from infinite elasticity of investment or consumption with respect to the real interest rate, will sustain what I termed the "characteristic monetarist proposition". I should have recognized this alternative to the vertical *LM* locus. But I could not take it very seriously for short-run macro-economic analysis, even if I were to agree to Frank Knight's view that the demand for capital stock is infinitely elastic in the long run. Real interest rates, whether on fixed-nominal-value obligations or on equities, do vary in the short run.

(2) Our main differences may be empirical, not theoretical, as Friedman says. But the purpose of this discussion, as of the "Theoretical Framework" exchange, was to focus on theoretical differences. This focus also has an empirical purpose. Jerry Stein wanted to carry out my hope that we might "agree on which values

of which parameters in which behavior relations imply which policy conclusions, then ... concentrate on the evidence regarding the values of those parameters" [Tobin (1972, p. 852)]. This approach is a needed supplement to the empiricism of quasi-reduced-forms and of large macro-models, which have not been conclusive. It is regrettable that Friedman will not state his theory in a way which makes Stein's approach possible.

(3) Friedman chides me for implying that his words "certain to be temporary and likely to be minor" refer to *all* fiscal effects. He says that the words refer only to the two sources enumerated earlier in the same paragraph of his *Newsweek* column. But the full paragraph begins with a sentence that makes clear that these are the *only* sources of "any *net* effect on private spending". Of course the lower velocity is a fiscal effect, as he says. But it is not a new source; he had already listed it as the first of the sources of "temporary" and "minor" effects, additions to idle balances.

I must say that it did not occur to me that "temporary" could mean "once-for-all". No one has argued – except for unstable situations inviting "pump-priming" – that a one-time permanent reduction in government spending or increase in taxes causes velocity to decline continuously and indefinitely.

(4) In the same *Newsweek* (January 30, 1967) article, Friedman said:

> To have a significant impact on the economy, a tax increase must somehow affect monetary policy – the quantity of money and its rate of growth. It clearly need not have any such effect. The Federal Reserve can increase the quantity of money by precisely the same amount with or without a tax rise. However, a tax rise may embolden the Fed politically to hold down the quantity of money, because such a policy would then be more consistent with lower interest rates than if taxes were kept unchanged.
>
> The tax reduction of 1964 had this effect – in the opposite direction. It encouraged the Fed to follow a more expansionary policy. This monetary expansion explains the long-continued economic expansion. And it is the turnabout in monetary policy since April 1966 that explains the growing signs of recession.
>
> The level of taxes is important – because it affects how much of our resources we use through government and how much we use as individuals. It is not important as a sensitive and powerful device to control the short-run course of income and prices.

Indeed he quoted the first sentence of this passage in his J.P.E. comment [Friedman (1972, p. 915)].

In a previous exchange I quoted the first part of this passage in support of the following sentences:

> Milton Friedman asserts that changes in the supply of money M are the principal cause of changes in money income Y. In his less guarded and more popular expositions, he comes close to asserting that they are the unique cause. [Tobin (1970b, p. 301)]

Friedman objected strongly to the first sentence but said (1970, p. 319) that the second "does give the right flavor of my views, and I have no wish to quibble over wording." Speaking of the *Newsweek* passage cited above, he said also (1970, pp. 318–319), "The excerpt . . . says that a *tax increase* will not have a significant impact on normal income unless it somehow affects the quantity of money and its rate of growth. *This does say that taxes by themselves are unimportant for the course of nominal income* (my italics), it does not say that variables other than taxes and money may not have important effects on money income."

(5) I am at fault for some misunderstandings because I took for granted but did not explicitly state that there are, in addition to the systematic effects on velocity attributable to changes in the exogenous – policy or non-policy – variables of a macro-model, unsystematic or random variations in velocity. Friedman says that "about 50% of the variance of nominal income. . . can be attributed to fluctuations of velocity", although he notes that this exaggerates the fraction attributable to non-monetary forces. He includes fiscal policies in the same category as relative price changes, technological developments, and other events which are from a macro-economic vantage point the sources of unsystematic noise in the time series of velocity.

For me this is enough to justify the amazing claim of section 1 of our paper: Friedman is a monetarist. The Pope is a Catholic.

(6) Whether fiscal policy has a significant systematic effect on monetary velocity or is a source of minor noise is important in evaluating fiscal policy. But it is important for the conduct of monetary policy too. If fluctuations in velocity – other than those related to current and past money stock – are unsystematic and unpredictable, the Federal Reserve might as well follow a fixed monetary rule. But if there are important systematic effects attributable to fiscal policies, export surpluses, or other causes, the "Fed" should try to measure them, predict them, and to modify its policies accordingly.

(7) I believe that my language made clear my uncertainty about Friedman's views on the longer-run demand effects of accumulation of stocks of money or government debt. His J.P.E. comment does claim that growth of monetary debt is

much more expansionary than growth of non-monetary debt, but beyond that it is not explicit.

I pointed out a possible rationalization of the assertion that fiscal impacts are temporary. The absorption of non-monetary debt into portfolios might raise interest rates, enough eventually to cancel out the one-time fiscal impact. This sequence of events would also be consistent with Friedman's statement that growth of government debt occurs "largely" at the expense of growth of private debt. Otherwise, it is hard to understand such "crowding out" in an economy *not* fully employed. At any rate the possibility that debt accumulation shifts *LM* to the left seemed worth investigating, as a route by which the monetarist conclusion could be reached without a vertical *LM* curve.

(8) I recognize that an even more fundamental question is the effect of growth of government debt on saving. I discussed this briefly in my J.P.E. comment, but it is not the subject of our paper. Is the public satisfying any part of its desire for wealth when it purchases Treasry bonds? If not, its consumption spending will be the same whether a given budget of government expenditure is financed by taxes or by non-monetary borrowing. This is a central argument in a very recent *Newsweek* article (January 27, 1975), where Friedman is once again a monetarist, opposing proposals to stimulate recovery by tax reduction without equivalent expenditure cuts. Note that the argument that government debt issues, like taxes, crowd out consumption, is not consistent with the claim that it crowds private borrowers and investors out of the capital markets.

(9) While strong monetarism survives in *Newsweek* and in the pronouncements of the Shadow Open Market Committee, the monetarism of professional conferences is pretty tame. Monetarists certainly give different policy recommendations from other economists, but they have a hard time grounding those recommendations in their theories or even differentiating their theories from other models. I see nothing particularly monetarist, as I used to understand the word, in the Brunner–Meltzer paper. I certainly cannot accept their imperialist claim that concern for long-run equilibrium and for stock and balance sheet equilibrium is an invention and exclusive possession of "monetarists".

Friedman's own litmus paper test, "What is the price of money?" is fun at cocktail parties. But some of my friends are good enough capital theorists to question the question. They can recognize *both* the purchasing power value of a dollar bill and the per annum opportunity cost of holding a dollar bill rather than some other asset. Others are good enough Marshallians or Walrasians to reject Friedman's favorite money–credit dichotomy. They suspect that "monetary policy and monetary change" operate *both* through credit markets and through "actual and desired cash balances".

(10) Distinctively monetarist policy recommendations stem less from theoretical or even empirical findings than from distinctive value judgments. The preferences revealed consistently in those recommendations are for minimizing the public sector and for paying a high cost in unemployment to stabilize prices. Maybe at the next conference we should discuss those basic issues.

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