# Friedman at 100

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**Professor Niall Ferguson**

# The Speakers

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John Redwood MP - Conservative MP for Wokingham and head of Margaret Thatcher's Policy Unit in the early to mid-1980s.

Professor Niall Ferguson – the Laurence A. Tisch Professor of History at Harvard University, who examined Friedman's historical significance for free-market thinking.

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# TRIBUTE

Professor Richard Epstein

**Professor Emeritus of Law and Senior Lecturer at the University of Chicago Law School**

Milton had this wonderful image which I repeat all the time and this is what he said:

"You've got a boat, and it has a hole in the front and it's starting to sink and somebody says 'what are we going to do to level the boat?'"

Milton says, if you're a socialist you'll bash a hole in the back of the boat.

What Milton was always in favour of was patching the hole rather than creating another hole and the difference is if you patch the first hole the boat will float, if you create the second one it will sink all the more rapidly.

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There is a strong theme in Milton which I think has to be honoured which is Milton said:

"Fine tuning is for violins"

And to make it quite precise, if we go and actually look at a violin you'll see on the E string, for example, there are two ways to tune it: there is something back at the handle and you twist that little knob, but with the E string the frequencies are very high and you have to get it exact.

So there is another little piece at the front and you twist that one to fine tune the violin.

Now what Milton said is that economies are not violins, it's not a single guy trying to produce a single tone and so you don't want anybody sitting out there trying to act as though there is an E string which if you pull upon somehow he could fix things right.

So Milton was smart enough to understand the limits of his own knowledge and to advocate policies that reduce discretion in order to create an additional level of certainty which would work itself through the system.

And what was so great about Milton is that he knew himself quite well and he always went to the areas of his strength.

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Milton and I have interacted at both ends of my career.

I arrived at Chicago from four years at the University of Southern California in 1972 and by that time Milton was a giant who walked across the University of Chicago stage.

I can recall meeting him several times over various workshops and listening to him badger people, he was a very deceptive man, he had a small body but a huge voice and one of his greatest intellectual powers was the incredible speed by which he could cut to the heart of a problem.

My moment of fame with him at the University of Chicago came when I had written this claim on medical malpractice: *The Case for Contract*, and Milton took out a paragraph and gave it as a final examination question to his students and announced why the error was in the particular paper. And anybody whose errors were thought worthy of Milton became some kind of a stage figure in the eyes of students.

They said:

‘You made a mistake that he thought worth correcting!’

And this was greeted as a kind of a source of genuine approbation, so I was permanently thrilled with all of that.

I then had the great privilege to speak on a ceremony in his honour at the Hoover institution shortly after he died. But the one story I told which got the most attention from everybody had nothing to do with his giant intellectual achievements.

I reported the following incident:

My wife and I were driving up Palm drive one day, which is the main thoroughfare on the campus, and we see this vehicle in front of us which seems to be driving without a driver, going very slowly.

We look around and there’s no driver and nobody in the passenger seat so what we do is we speed up in order to see who this non

person is who's driving the car. There sits Milton in the driver's seat and his wife, Rose, sitting next to him in the passenger seat.

And the reason why this story had such impact, I was told later, is that 90% of the people in the audience had no idea that Milton was very short and that what I did was manage to get some kind of human element onto this guy because people always thought of him in terms of his voice, which was very big.

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Indeed at Chicago one of the great all-time pictures is on University Avenue where Milton was with his close friend George Stigler. George was about 6' 4", very thin and came from Washington and you see a picture of Milton and George walking down, almost arm in arm.

George is about 14 inches taller than Milton and so everybody said they're obviously opposites in one regard but they're certainly kindred spirits in another.

So there's a lot of personal law about Milton and I think that many people forget that with all great people there's a human side and Milton's was rather interesting.

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I think most people do not understand how nice and kind and caring a man Milton turned out to be when he was working with real people.

In order to be a good economist, in order to be a good lawyer, what you have to do is dehumanise people. But it is one thing to know how you set rules to govern the lives of other people and it's another thing to work out how you run your own life.

Now the first guy who understood that was Aristotle who started to talk about all the ethical virtues of moderation.

There is no legal duty to be moderate in any sense of the word and Milton did not want to say that because there is self-interest out there in the world this means that somehow or other when I deal with my graduate students and my family and my friends I’m going to be selfish just for the sheer fun of it.

He was, in fact, a generous guy.

Certainly in his prime Milton always had so much energy and so much vitality that he was a kind of helping party and it is very important to break this stereotype which says that if you believe in conservative market institutions you’re a louse.

There is no correlation and you don’t want to draw it and Milton, in fact, scored very well as a human being.

# 1. Friedman’s influence on academic economics

I am delighted to be here to celebrate this hundredth anniversary of Milton Friedman’s birth.

I have been asked to talk about his academic contributions which have changed not just public policy but also much of academic thinking.

Therefore I will emphasise his main contributions, before I briefly discuss the relevance of his ideas to current macro policy debates both here and in the US.

His first great book was the *Consumption Function* and, in some ways, I think this was his greatest work.

Keynes had argued in his General Theory that households increase their consumption in a smaller proportion than their increase in current income.

This became the cornerstone of what used to be called the multiplier in Keynesian theory, whereby if you have an autonomous increase in expenditure this will lead to an even larger increase in aggregate demand and hence economic expansion.

Now this argument has, if you follow Krugman and various other people, been resurrected in the current Great Recession.

But the evidence, which even many Keynesians have to accept, from contemporaneous cross section data, households at a particular point in time, and historical household behaviour based on time series data, are both inconsistent with the Keynesian consumption function.

Friedman showed that this Keynesian concept of household behaviour was fatally flawed.

People based their consumption on variations in their long-term expected, or what he called permanent, income and not on these transitory variations which can go up and down depending upon shocks and various other things.

Thus in his Permanent Income Hypothesis, the relatively low propensities to consume which people found from the cross section data were consistent with the higher propensities to consume which you found in the time series data.

The importance of this permanent income theory is, I think, accepted very widely and is incorporated in almost every aspect of applied economics that I can think of.

The second major contribution that I would emphasise is that Milton was one of the earliest people to make a case for floating exchange rates.

This is another issue with considerable contemporary relevance given the on-going crisis in the fixed exchange rate Eurozone.

Milton’s case for flexible exchange rates was largely based on his view that a country needed the freedom to choose its own monetary policy without being concerned about the balance of payments.

Now more recent theories about the adjustment mechanism base them, not just on this, but on recognising the importance of the real exchange rate, that is the price of traded to non-traded goods, and the real exchange rate, which changes all the time.

Under a fixed exchange rate system, to get the necessary adjustment in the real exchange rate, it requires that all domestic prices and wages must change to get the necessary equilibrium.

Whereas if you have a floating exchange rate you just change one price, the nominal exchange rate, and all these relative prices will be immediately fixed.

So, as we see in the current Eurozone crisis, the club-Med countries are facing an internal devaluation of about 30-40% through deflation and this would have been unnecessary if their own independently floating currencies were available to deal with their payments imbalances with various surplus countries in the Eurozone.

The third major contribution of Milton was his critique of the Phillips curve.

Those of you old enough will remember that there was a huge argument in the 60s and 70s about the trade-off between inflation and employment.

In his presidential address to the American Economic Association in 1968 Friedman questioned this view, and in a sense, though he doesn't mention it in that paper, he was taking off from work by earlier economists which, in my view, is central to all the various macroeconomic perspectives which have been offered since.

By the late nineteenth century the gold reserves, which were the base for the pound, had declined to a very small share of the value of the pound.

The question which began to be asked was:

How could the price level be anchored in a pure credit economy?

And the answer was that if the bank rate could be set at the natural rate of interest, which balances productivity and thrift, the price level could be kept constant.

Friedman used this, he argued that with the real natural rate being determined by productivity and thrift, monetary and fiscal expansion will only raise nominal interest rates through inflationary expectations.

Given this natural rate there will also be a natural rate of unemployment, which is now called NAIRU; the 'non-accelerating rate of unemployment'.

Expansionary monetary policy can then only lead to transitory deviations from these natural rates if, assuming of course capital and labour markets work relatively well, there is no long run Phillips curve. I think most people now accept this, the most famous example being Peter Jay and then his father-in-law, James Callaghan, being convinced of this in the 1970s.

Milton's fourth great contribution, and what people most remember him for, was his monumental study with Anna Schwartz called *A Monetary History of the United States*.

In this he showed that the variations in the rate of growth of the money supply had short run effects on real output, as in the Great Depression, and on prices, but in the long run the only substantial effect was on prices.

This confirmed one of the assumptions of the Quantity Theory of Money; that the long run demand for money was stable.

Following from this he recommended his policy of maintaining a fixed rate of increase in the broad money supply.

There has been a constant and probably justified complaint that Friedman's view of the transmission mechanism, that rises in money leads to rises in spending, was never theoretically tied down - so people thought that Friedman's monetarism was a black box.

Later papers by Karl Brunner and Alan Melser in the 60s and 70s, and above all Alan Melser's recent, magisterial, three-volume history of the US Fed, should put these doubts to rest.

I now want to finish by asking the question:

How have Milton's prescriptions for monetary policy fared in this Great Recession?

At his 90th birthday party, Ben Bernanke, the current chairman of the Fed, promised Milton that, having read his and Schwartz's great book, he would never let a Great Depression occur again.

Now, by and large, the Fed in 2008-09, the Bank of England and the ECB, in 2009, through their policies of QE, have increased the

broad money supply in their respective regions and, through the real balance effect, this has led to a stalling of the deflationary impulse generated by the global financial crisis.

This has led to some economic expansion.

But, recently, all these economies have stalled, with the UK in a double dip recession.

Why?

Tim Congdon, the last remaining British monetarist, has put together data which I think provides an explanation. Unfortunately, I think both the US and the UK stopped publishing broad money figures some years ago so he has to construct these himself.

If you look at his figures the growth of broad money, M3 and M4, for the US, UK and Eurozone, shows that after their periods of QE, instead of following the Friedmanite prescription of maintaining a fixed rate of increase of broad money in all three regions, there have been sharp changes in the trend of broad money, and there has been a crash to negative rates of growth since 2010.

Given the lags involved in the effects of monetary policy outcomes, the current deflationary trends in these economies can be readily explained.

But then, finally, why, despite seemingly accepting the monetarist case, which these various periods of QE suggest, have the monetary authorities failed to keep broad money growing at a constant rate?

This, unfortunately, is due to the rise of an economic theory of the monetary transmission mechanism which has been christened by Ben Bernanke, who has written some papers on it, as ‘creditism’.

Although, it is probably better called the bank lending theory, as Alan Melser calls it, to contrast it with traditional monetarism.

This theory argues that the relevant channel for monetary policy transmission is the credit channel, or bank lending to the private sector.

But if you go back and look at Friedman and Schwartz and, more recently, Alan Melser's work, they show that clearly, firstly, money and credit are different, and it is money that matters for the economy.

I think the simplest way to bring this out is a question I used to set for my Oxford undergraduate tutees in the mid-1960s, and I think it is a question which Milton once posed to someone, I remember him asking this:

What would be the effects of a large helicopter drop of money in the UK?

The answer is that this increase in the cash holdings of all private economic agents in the economy would lead to a deviation of the composition of their asset portfolios from their previously desired ratios, so you would have more cash relative to goods and other assets.

Now, looking at the economy as closed, the domestic economy, this excess money could only be spent on goods and assets.

And the cash ratio, the preferred cash ratio, which we assumed was an equilibrium one initially, would only be restored in their portfolio balance once all the prices of all other goods and prices had changed, and that of course would also impact spending and, if you were not at full employment, would cause national income to rise.

This would happen irrespective of what was happening to bank lending, or the creditist view of monetary easing.

So spending depends on money balances and not bank spending.

The Fed chairman described his QE policy in 2008 not as quantitative easing, which is increasing the quantity of money, but as credit easing to lower credit spreads.

Mervyn King, in the UK's brief reversion to monetarism in 2009, used traditional open market operations to buy gilts from the non-bank public to increase bank deposits to boost the broad money supply.

This increase in deposits at banks, which is their liabilities, is entirely different from increases in bank lending, which are banks assets - the former, the increase in liabilities with deposits rising, requires no increase in their capital as these liabilities can be readily offset by increasing their riskless assets at the central bank, or purchases of government debt.

By contrast, loans to the private sector, this is their assets, these are always risky and will require extra capital to cover any defaults.

So this continuing theoretical confusion between money and credit, I would argue (the intellectual imbalance which you see in newspapers, with lots of commentators making the same mistake) is really why the old Friedmanite rule, that spending depends on money, and hence what you need to do is increase broad money, has not been followed.

But there are two other dangerous consequences of thinking in terms of credit rather than money.

The first is clearly evident in the US. To ease credit in the troubled housing market, the Fed, unlike the Bank of England, which conducted traditional open market operations to increase broad money, instead, has purchased mortgage based securities to reduce their interest rate. This is equivalent to the monetary authorities undertaking credit allocation which would not be permissible in a market economy.

The second danger is that by embracing what is called financial repression, by keeping interest rates artificially low, most recently in the so called operation twist, there is a bubble in treasuries which, when it bursts, will lead to the euthanasia of the bond holders, much as happened in the decades after the Second World War.

Perhaps the undisclosed intention of Bernanke is to mitigate the US's large, and growing, debt burden through this euthanasia.

Thus the failure of the world's pivotal central bank to accept that broad money, and following the Friedmanite rule, matters, is likely to continue the title of Friedman's last book, *Money Mischief*.

Deepak Lal

## 2. **The relevance of Friedman's ideas to the current economic & financial crisis**

In the 1980s the Thatcher economic policy really divides into three periods. They’re useful to remind ourselves, in a little sketch, because we can remind ourselves what worked and what didn’t work.

In 1979 to ’81 the Thatcher government presided over a very large increase in public spending.

They put through extremely large increases in public sector wages, they continued very high levels of public borrowing which had been undertaken by the predecessor government and they kept interest rates high and money tight because they were trying to control the very high and worrying inflation which they had inherited.

This triggered a recession, a modest one by modern standards, but it was still painful at the time.

So you could call that the Keynesian period and the large fiscal stimulus of course did not offset the contractionary forces of tight money and the difficulties in the economy on the supply side.

From 1981 until they decided to join the Exchange Rate Mechanism they followed a policy which, broadly, had the support of Milton Friedman.

As we've heard, he made a very distinctive and important contribution to world economics and it was due to him, in no small measure, that punk Keynesianism, poor Keynesianism, was exposed for the fraud that it is and an alternative was provided that was more likely to increase the prosperity of nations.

We had to fight a political battle here in the United Kingdom to establish that in polite society you could draw on the words of wisdom of Milton Friedman in conducting a successful economic policy and you could reject some of the words of wisdom of Keynes's followers, who I think were not nearly as subtle and great thinkers as Keynes himself had been, by saying that you didn't always get growth by putting the fiscal deficit up and you didn't always get contraction by cutting the fiscal deficit.

Everybody now remembers the legendary battle of the budget of 1981. The neo-Keynesian economists, often economists who weren't a patch on Keynes and didn't fully understand his work, denounced the 1981 budget for daring to cut the budget deficit and to cut public spending during a period of recession and they said that it would trigger a depression.

Of course it led directly to a very strong and long recovery in the United Kingdom economy.

What we haven't explained quite as often as maybe we should is this didn't happen because we cut spending and the deficit as much as because we expanded the money supply.

The other part of the policy, well advised by Alan Walters, who knew his Friedman and agreed with a lot of Friedman, realised that

whilst cutting the budget deficit to control the excesses in the public sector and the public borrowing, which would otherwise keep interest rates too high for private sector recovery, you needed to relax monetary policy to allow the private sector to respond. It worked extremely well.

Unfortunately the Thatcher era ended with a catastrophic policy error when the government was persuaded to drop an independent monetary policy based on targeting M3 and to go over to a proxy monetary policy from Germany through the exchange rate mechanism.

This led both to boom and bust. The first consequence was money was too loose and we had a big inflation, the second consequence was then money became too tight and we had a nasty recession and that, of course, is the origin of the Conservative troubles and since the full consequences of that were worked through in the British economy we haven't had a Conservative majority government again.

The reason the Conservatives lost their hard won reputation for economic skill based on the good Thatcher period was the membership of the Exchange Rate Mechanism.

We also learnt, from Friedman and others and through some inspiration of our own, that setting lower tax rates would stimulate economic recovery and would yield more tax revenue rather than less.

The decision to cut the higher rate of tax from an almost unbelievable 98% on savings income and an 83% figure on so called 'earned income' to 60% and then to 40% was, I think, perhaps one of the most important decisions that government took.

And the money just poured in.

More rich people arrived, more rich people worked harder and put their investments to work in better ways, more income was declared, fewer tax devices, legal or otherwise, were adopted and so the rich paid much more tax.

They didn't merely pay much more tax in cash terms, they paid a much higher proportion of the total income tax paid in the country because lower tax rates worked, and Milton Friedman I'm sure approved, and it was good to see that practical demonstration of two crucial elements in the Friedman approach.

Lower taxes bring prosperity. When did you ever see a country tax itself into prosperity?

And the second very important point was that if you tightened fiscal policy, and loosened monetary policy at the same time, you could have a very important private sector led recovery.

Milton Friedman as a great thinker is a hundred years young and I think today we need to draw again upon the wisdom of his thoughts for tackling the necessary task of turning round the United Kingdom economy.

The Chancellor of the Exchequer and the government set out at the beginning of the government's challenge what sounded like a very sensible Friedmanite approach.

They said that they would tighten fiscal policy. They set out tough but achievable targets to reduce the deficit, as we thought, and they said that they would loosen monetary policy so that they could have that private sector led recovery.

But if Friedman were alive and taking an interest today I think he would be the person who would point out that in the first two years

of the coalition government public spending has risen quite substantially in cash terms and has risen in real terms as well.

He would point out that although the rate of increase in public borrowing has come down a bit, to set out to borrow £550 billion extra over the lifetime of this parliament is ‘quite heroic, minister’.

That is more that the total United Kingdom state debt in 2004.

And he would doubtless point out, along with Tim Congdon, that money has been very tight. So instead of having the private sector led recovery based on lower taxes and looser money, we’ve had a phenomenal squeeze on the private sector thanks to persistently high inflation, thanks to tax rises, particularly operating through the price of fuel and energy, and, at the same time, the public sector ‘looseness’, surprise, surprise, has not delivered the growth that everybody said it would.

If you look at the GDP figures, and I seem to be the only politician who reads them, every quarter they show the same thing,: that the public sector offers a real increase to the economy, makes a positive contribution, but so often the private sector disappoints. Overall we have ended up with negative quarters over the last two quarters.

So what should we deduce for the future (because we wish this government well and we want our countries economy to return to flourishing good health)?

I think we should say that we fully support the strategy that they set out at the beginning but we need to give them help in delivering it.

The first thing we need to do is to get that looser money transmitted to the private sector.

Quantitative easing has been an excellent way of keeping the cost of excess public spending down because it has benefited the public sectors borrowing rate. But there is no evidence that it is doing much to promote realistically costed and wanted private sector lending to fuel the recovery.

I don't think we are going to go very far or very fast unless we mend the broken banks and I would begin by breaking up RBS. It is an obstacle in the way of our recovery. We need to create some working banks out of the assets, liabilities, staff and branches within that very large conglomerate and float them off into the private sector as quickly as possible so that we have competing domestic banks on the high street capable of delivering sensible monetary growth to fuel our domestic recovery.

I think we need to revisit our tax rates on savings, enterprise and achievement. I'm glad they're beginning to move them down - the world is a far more competitive place in that respect than it was in the 1980s and our rates are still above the level we set in the 1980s to achieve that growth.

I think we also need to revisit the whole supply side revolution that we started in the 80s but were not able to finish as a great deal needs to be loosened up, freed up in a way that Milton Friedman recommended so that the private sector is less impeded by high cost regulation, clumsy regulation, interventionist regulation of the kind we've gotten very used to.

So Milton Friedman, Chairman, is much needed, fortunately he is still there in his great works and his words of wisdom, which remains with us.

We need more to carry his torch, to remember that when we last did it worked very well and we need to do it again on a bigger scale.

His monetary history of the United States of America has indeed protected us from a worse recession, but we have still have not found the policies and the people in our central banks and in our banking parlours to solve the banking crisis and to get our banks into a position where they can help us deliver the economic recovery we desperately need.

# 3. Friedman's significance for free-market thinking

Milton Friedman would have been a hundred later this month and I wish he were here so that we could celebrate that hundredth birthday with him.

When Lord Saatchi invited me to speak to you this evening I assumed it was because I had one or two things in common with Milton Friedman.

Not his intellect.

But we were both fellows of the Hoover Institution and when I was invited to become a fellow, for me the great attraction was that Milton Friedman was a fellow already.

I've also made a small contribution to writing on inflation but that's not, in fact, why Lord Saatchi invited me to be here.

He invited me to be here I suspect because I also have in common with Milton Friedman an enthusiasm for the low pursuit of journalism.

In addition to being, as Deepak Lal has pointed out, one of the great economists, if not the greatest economist of the twentieth century, Milton Friedman was also a regular presenter on PBS, the American equivalent of the BBC.

*Free to Choose* was a ten part series that aired in the late 70s and he also wrote a column for Newsweek for an astonishing 18 years.

I have lapsed into writing for Newsweek myself of late.

So I guess the idea is that I now say some words about Milton Friedman the public intellectual, as Americans say, or the hack, as we like to say here in Britain.

In the world of hackery it is extremely fashionable today to say that the financial crisis has proved Milton Friedman wrong. You can read that on almost a weekly basis in the New York Times or the Guardian or, if anybody still reads it, The Independent.

It is extremely hazardous to say in public that anything has proved Milton Friedman wrong.

An illustration of this point was made even before the financial crisis by none other than Paul Krugman, who wrote a long, double-edged piece in the New York Review of Books in which he argued that monetarism had been comprehensibly disproved by the fact that the Federal Reserve and other central banks had moved from targeting automatically, so to speak, the growth of broad money, to discretionary monetary policy of the sort Milton Friedman had been against.

And Krugman remarked with considerable satisfaction the huge success that the Federal Reserve had enjoyed with this discretionary monetary policy under Alan Greenspan, suggesting it clearly falsified Milton Friedman's theory.

It should be said that subsequent events did not treat this article kindly, since if one wanted to point to a single cause of the great real estate bubble that ultimately triggered the financial crisis one would point to the monetary policy of the Federal Reserve under Alan Greenspan, when discretionary policy replaced a monetary target.

So it's very risky to say that Milton was wrong and I'm here to remind you of how many things he was right about, which haven't yet been mentioned.

His very earliest work, published work I think, was against rent control at a time when rent control was universally believed to be a good and wonderful thing.

I had the great privilege of lunching with the Burmese opposition leader Aung San Suu Kyi, and in addition to being a most charming and charismatic person, she turned out to agree entirely with Milton Friedman on the subject of rent control having for a time, through her in-laws, been a modest landlord in the Oxford area. That is just one of many examples I could cite.

When I was trying to explain to my students at Harvard what the Fed was likely to do when the financial crisis got going in late 2008, I said the simplest thing to do is to read Freidman and Schwartz's chapter 'The Great Contraction' in *The Monetary History of the United States* and assume that the Fed will do the exact opposite.

And so it proved.

Indeed there has been almost no better guide to Fed policy than that great work. Deepak Lal has brilliantly elucidated the profound distinction between Friedman's thought on money and the erroneous theory of credit expansion which has come to dominate

the Fed and other economic theorists in our time, so I won't revisit that.

But I will revisit perhaps the single most important sentence that Milton Friedman ever published:

'Inflation is always and everywhere a monetary phenomenon'

I still remember vividly, as if it were yesterday, the shiver that ran down my spine when I read those words for the first time, I was a graduate student sitting in the library in Hamburg trying to write a PhD about the German hyperinflation and Milton proved an invaluable guide in those days.

But you see he wasn't just an economist and it's not just his insights at that high level that should influence us today.

He generated an idea a week and in almost every case those ideas turn out to have been right.

He was a consistent opponent of farm subsidies and tariffs, a passionate believer in free trade, he was against state intervention in the form of conscription, one forgets, too easily, the part he played in the creation of the All-Volunteer Force out of the wreck of the draft army that had lost the Vietnam War.

Milton Friedman was an early and passionate advocate of voucher schemes to create choice, to create freedom in education, he was a forceful and justified critic of American public schools long before it was fashionable to point out that they no longer were very good and, indeed, failed the poorest families in American society.

Confronted with the problem of pollution, long before anybody had heard of Al Gore or the phrase 'climate change,' it was Friedman who argued in his columns and elsewhere that a system of

emissions permits was preferable to crude, state control of industry.

When one looks at the list of positions that Friedman adopted as a public intellectual or hack the striking thing is that he was nearly always right.

Initially reviled, seen as a crank, ultimately vindicated because his policies were adopted.

Only, perhaps, in his campaign for a legalisation of drugs has he so far been unsuccessful, but I want to emphasise *so far,* because if one thing is clear to me it is that ultimately the United States will have to admit defeat in its misnamed war on drugs, as surely as it abandoned prohibition in the 1930s.

But we must not, as we celebrate Milton Friedman's one hundredth birthday, overlook what will seem to many on the left as the slam dunk proposition, that Milton Friedman was wrong about deregulation and wrong about allowing businessman to pursue profit and only profit as the sole form of social responsibility they should take.

I'm sure Milton would approve of me quoting from an iPhone because there is no better illustration of what the free market can produce than this handy gadget.

I want to read to you a quotation that you may well see in print when somebody tries to prove Milton Friedman wrong this week:

'The question is: Do corporate executives,…,have responsibilities in their business activities other than to make as much money for their stock holders as possible? My answer to that is no, they do not.'

This was from an article published in 1970 from, of all places, the New York Times magazine and presumably there will be somebody, perhaps writing in the New York Times, perhaps even named Paul Krugman, who will seize the opportunity presented to him by the calamities of the financial sector on both sides of the Atlantic to say:

'Aha! Here, truly, Friedman was wrong.'

But I didn't read you the full quotation. I deliberately abridged it in the way, I suspect, it often is abridged. Here is what he in fact wrote:

'The question is: Do corporate executives, provided they stay within the law, have responsibilities in their business activities other than to make as much money for their stock holders as possible?'

That is, I think you will agree at this, a time of crisis, a rather important qualification.

Milton Friedman understood, not only the benefits of free markets but, like Adam Smith, he understood the failings of businessmen, the shortcomings of capitalists as a class.

I want to quote another, wonderful, Friedman observation that one doesn't hear often enough from an article, or rather a lecture, from 1983 entitled *The Suicidal Impulse of the Business Community*:

'The broader and more influential organisations of businessmen have acted to undermine the basic foundation of the free market system they purport to represent and defend.'

It is reminiscent of that great passage in *The Wealth of Nations* where Smith points out that the natural business is, in fact, to collude against the public.

It is not the teaching of Milton Friedman any more than it was the teaching of Adam Smith that one should just leave the bankers to it and give them a free reign.

On the contrary the real wisdom of Friedman's work lay in his capacity to see the perils as well as the opportunities of a lightly regulated free market.

One last thought, which seems to me highly apposite, as the world rushes to create regulation upon regulation upon regulation in the belief that it was a lack of regulation that caused the financial crisis.

'One of the great mistakes' Milton Friedman wrote 'is to judge policies and programmes by their intentions rather than their results.'

In my experience the left nearly always can claim to have good intentions, but it nearly always has disastrous results.

Milton Friedman spent his entire career, as an economist and as a public intellectual, pointing out how disastrous those results could be.

# 5. Q & A Session

**Q:** In terms of regulation what would you say to the German Chancellor who takes the view that as corporations are global entities they can't be controlled by local regulators? Therefore there have to be at least regional and then ultimately global regulators who will be able to control global corporations. What would you say to that?

**Niall Ferguson:** Well, channelling my inner Milton as best I can, I would argue that the key insight of the financial crisis is that very complex regulation, whether at the national or the regional level, whether at the level of the United States or say at the level of the Basel accords on bank capital adequacy, is the disease of which it purports to be the cure and the more complex the regulations become the more the insiders are tempted, incentivised, to game the system, since only they can really navigate around its complexity.

I'm in favour of simple regulation. I recently went back to Walter Bagehot's great work, *Lombard Street*, and reading it I felt as excited as Milton Friedman's work used to make me feel because what Bagehot says there is you need a powerful Bank of England,

you need a powerful central regulatory authority but its powers should not be too precisely delineated.

It should have considerable discretion not in terms of its monetary policy, that Bagehot's steered clear of, but in terms of its supervisory role.

Now whether we regulate the City of London at the national level or at the European level is ultimately a political decision.

My sense is that, as regulation becomes Eurozone wide, and as the Eurozone becomes ever more likely federal republic, the United Kingdom will withdraw from it and John Redwood will ultimately be a happy man, and he's been an unhappy man I think since we started shadowing the Deutschemark in the late 1980s.

Ultimately we will not be part of this federal project and we will have to regulate ourselves. I hope we do it with a strong Bank of England and very straightforward, transparent regulation and a very straightforward monetary rule of the sort Deepak Lal described.

**Q:** Just thinking from the events of today with Bob Diamond stepping down I think one of the key underpinnings of capitalism and freedom and *Free to Choose* was of the superiority of the market to self-regulate because of the instability of private collusion. Does this episode with Libor act as a counterexample to that in that it seems, at least on a first viewing, that this comes from the SEC who have busted this cartel that has been going on for a few years? I'd be very interested in all the panel's thoughts on this. Thank you.

**Deepak Lal:** Well let's go back to this whole mess in banking.

Now it starts, if you really want to go back in time, it really starts with deposit insurance, so you have to go back to FDR and I've forgotten the name of his first federal bank governor we appointed who agreed to a deposit insurance because it's just popular.

Once you've got democracy it's very unlikely that you'll get old ladies monitoring their bankers to make sure they're not fiddling their accounts and lending money to all sorts of strange people.

So you have to have deposit insurance. If you have deposit insurance then you must have what is now called the Glass-Steagall act that means you must separate investment from commercial banking. That served the US very well until this was given up in the 1970s and 1980s and I think that is exactly what you see happening here.

A big bank did effectively the same thing in Britain.

Now there are two ways out, either you restore this, that's the only regulation you need as it means they can't raid commercial bank deposits and so beyond that they gamble with whatever money they can borrow or lend etc.

It's not my business, it's not your business, they can gamble in the stock exchange.

It's their money and they're responsible for it and I think that has to come.

Now all these other things, trying to achieve that in round about ways I think is completely counterproductive.

Basel I, II, III was gamed by the system; it just led to SIB's.

Now they're trying to shrink this capital, I mean that is completely ridiculous trying to lay capital ratios, what that means is that on one

hand they want to say ‘raise your capital’ and on the other hand they say you should lend.

So what are banks doing?

They’re setting they’re balance sheet back which means deposits are shrinking and the money supply is declining.

It’s completely incoherent and the simplest, easiest way is get to the heart of the matter which is one of the most simple and sound economic principles, which Milton would also agree with, and to get to the heart of the matter of the problem you cannot get rid of deposit insurance, you have to have commercial banks with deposit insurance.

In which case you must separate investment from commercial banking.

Not firewalls, no Chinese walls, just say that Barclays Capital is a separate entity it has nothing to do with Barclays the commercial banks.

**Q:** Both sides of the Libor problem sat within the investment bank. It’s all the investment banks together agreeing on what the discount rate is because they’re trading arm has asked them. It’s not really to do with the commercial bank side is it?

**Deepak Lal:** It’s just criminal activity - they shouldn’t be sitting around trying to fiddle the Libor rate and I’m sure, I don’t know about Britain, but in America they would get a jail sentence.

**Niall Ferguson**: I think that this is such a tremendously complex subject that most members of the public are entirely baffled by what Libor is, what the different Libor rates are, how they are set and what exactly was going on.

Now it's clear that there was wrong doing and it's highly likely that it didn't involve only Barclays.

Why does this matter?

I think there are two reasons that it matters that traders were seeking to get an edge as Libor was set.

One is that Libor rates, there are many of them, are the basis for a vast pile of transactions around the world and so the integrity of London as a financial market is profoundly undermined by this story, it's really, in that sense, of a much wider significance than the fate of the chairman and chief executive of Barclays.

Second, from a political standpoint, this is the culmination of story after story the net effect of which is to persuade us that the major banks, the giant entities, the too big to fail entities that Maurice [Lord Saatchi] alluded to earlier have been grotesquely mismanaged.

I wish this were the last straw, I suspect there are bales of hay yet to come.

What does this tell us from a Friedmanite perspective?

I think it has to do, and here I want to come back to a point that Maurice made right at the beginning, with the dangers of monopoly or oligopoly within the capitalist system.

This is something which anyone who thinks seriously about the free market has to be concerned about.

It's now been two years, or more, since I wrote a pamphlet for you, Maurice, on the problem of 'too big to fail' and we seem no nearer to really solving that problem.

Regulations are being passed in the US, discussed and turned into statute here, but I remain to be convinced that there will be, as a result of these regulations, a significant reduction in concentration in the banking sector.

So this is an issue from, it seems to me, from a Conservative or Friedmanite point of view that is deeply, deeply troubling.

**John Redwood MP:** I think it is too early to say.

I've read a lot of very hasty comment, spoken or written by people who do not know the facts.

Let's take some of the issues; people are now saying why did the banks set this rate. Well, they set this rate because it was an interbank rate, it was the rate they were prepared to lend and borrow from each other so of course they had to set it.

Was there a system to set it?

Yes of course, the fifteen banks, I think it was, put in an expression of what they thought the rate should be and the outrider ones were discounted so that if a single bank were trying to move it too high or too low their bid on that day would not have counted.

So if you wanted to concert to get a 'false' rate, a rate higher than they would freely have chosen then there would have to be collusion.

Now we need to see if there is proof of collusion, at the moment we now that there was some emails that were extremely worrying from one bank and we know that there is action being taken against that bank. But if the market was truly rigged and damaged we will discover that there are offences committed in other banks and there would presumably be collusion between the banks.

But we then need to ask ‘what was the regulators view of this’?

Was any of this approved by the regulator in any way?

Was it approved but the regulator didn’t fully understand it?

Or was it never put through the regulator?

These are highly regulated bodies where there is a huge increase in the amount of regulation over the last decade designed to stop these sorts of things so we have to ask what was happening.

We then hear today through the FT and other reputable newspapers that the Bank of England was very interested in the rates that were being fixed because when the crisis really got underway if they allowed Libor to be too high it sent out a signal that maybe the banks were damaged and when they were fighting to get liquidity back into this interbank market who knows what was said and what was done.

We need to have a proper investigation.

Things may have been said and done which were perfectly sensible at the height of the crisis but might now seem inappropriate when the question is being changed.

The question today is not how do you stop the banks going bust?

The question is did everybody behave entirely properly about fixing the price or a rate.

So I just want to say tonight that I don’t in any way condone wrong doing, I hate the rigging of markets and if people have committed fraud or market manipulation there is a law against it and the evidence can be collected and they should be prosecuted.

But we need to understand the very tense and strange times these banks have been through and we need to work out what that rather close relationship between regulators and bankers was and whether any signals were sent which are in retrospect unfortunate.

**Niall Ferguson:** It should be said that Barclays have been fined for attempting to rig the rate, not succeeding, and anyone who followed the financial crisis closely knows that the Libor rate exploded during the worst of the financial crisis to entirely unprecedented heights, indeed it became one of the regular measures by which we sought to see how serious the crisis was, so if there was rigging it had an extremely small impact, if any at all.

**Q:** I was wondering about the panel's view on Milton Friedman's intellectual relationship, specifically with that other titan of free market economics, F. A. Hayek, and perhaps more generally the Austrian school.

**Deepak Lal:** Well it's a tricky question because having known both the principals… let's put it like this, let me give you the answer which Hayek would have given; this is going back a long long time.

I was having lunch with Hayek at the IEA and we started talking about Milton and he said:

'Milton and I agree on most things' - politics and all this sort of stuff - 'but I don't think we agree on macroeconomic policy.'

Milton was very keen on all these numbers, these regressions etc. but Hayek had a very dim view of this stuff.

I also think that Milton always thought that Austrian economics or certainly the extreme forms, Von Mises etc., was too subjective.

They just started from some subjective theory, facts didn't really matter and theory was sufficient.

So there was not really a meeting of minds between the two on this.

I personally believe that Hayek was right, the Austrian theory, the Trade cycle theory, is probably the best explanation of what we see happening in this GFC.

Milton is right in how we get out of it, increase broad money. Keynes is right, up to a point, forget about all his liquidity trap, he is right that once you get to a depression you have to raise aggregate demand, the only thing he got wrong was you have to have the multiplier and all this other theory.

So you have to have a combination of all three, Hayek plus having Fisher explain what caused this global financial crisis, Friedman tells you how to get out of it so you don't have deflation and Keynes is right that you have to do something about raising aggregate demand.

**Q:** I'm a sixth form student from the Robert Clack School in Dagenham and my question is directed to Niall. Much of what government intervention has done is break the relationship between young people and the intergenerational contract. Why do you think young people are so against Friedman?

**Niall Ferguson:** Well this is a great question and I think the best answer I can give you is this:

First of all very few young people in this country go to schools as good as yours and the Robert Clack school is an absolute exemplar of what can be achieved in not very propitious

neighbourhoods with serious discipline and excellent teaching and I'm delighted to see you hear tonight.

I'm looking forward to welcoming you one day to Harvard.

The second part of the answer is that it is uncool to be conservative.

Young people are not only quite poorly informed in economic questions, they're also strongly swayed by a sense that if ones young one ought to be on the left.

There is this awful iconography from 1968 that lingers on in the imagination long after the 1968ers have taken an early retirement and gone off to live at the expense of the young.

I don't know quite how one combats this sense that if one is young one ought to be on the left.

Probably harsh economic reality will do the work.

The other thing that makes young people slow to grasp Friedman is that young people exist more often than not in an economic parallel universe where the bank of dad pays for everything, or perhaps the bank of mum, or the bank of the state and it's extremely hard to understand how the free market works until you're in the free market.

Unfortunately policies around the world currently seem designed to keep young people out of the free market and render them dependent on unemployment benefit.

So these three things together make it quite hard for a young audience to understand the power of Friedman's thought if they're ever exposed to it, which I'm afraid in most cases they simply aren't.

**Q:** I would like to ask this question to the historian, professor Ferguson. This is a dark episode from the history of Friedmanism, the 1973 coup in Chile where you had the brutal dictatorship of Pinochet and Friedman sent some of his enlightened men to Chile to conduct the experiment of monetarism against a repressed population and I find it very paradoxical that on one hand he spoke about freedom and on the other hand this brutal monetarist experiment was carried out in Chile where thousands of people were murdered by the Pinochet dictatorship. As a historian can you answer this?

**Professor Ferguson:** Well it's not quite true what you say in several respects.

What is certainly true is that after Pinochet came to power in Chile, violence was used and political opponents of the new regime were murdered and nobody here would condone that. Milton Friedman certainly did not.

Here are the things that need to be straightened out.

First of all, the Allende regime had run the Chilean economy into a state of such chaos that the Chilean National Assembly, in fact, had mandated his removal from power. That's an extremely important point that is often omitted from ideologically charged accounts of the crisis.

Secondly, they weren't his people who went to Santiago; they were Chileans who had had the good fortune to study in the United States.

Not all of them had studied with Friedman, José Piñera for example, who played a really important role in the 1980s, had studied at Harvard, notoriously a hotbed of salt water liberal economics rather than fresh water Chicago economics.

Thirdly, after the initial period of recession the generals, including Pinochet, realised that the most important thing that they had to do was to get out of managing the economy and turn Chile around and in order to do that they invited the best economist in the world at that time to advise them.

Friedman paid a visit, wrote a letter and left the rest to the young Chilean economists who, as I said, had not all studied with him.

And the results were, of course, hugely successful.

The Chilean economy today is, in many ways, the most advanced, and the closest to being an OECD economy, in the entirety of Latin America including much overpraised Brazil.

So I think when one's talking about what happened in Chile it is very important to get the facts right and recognise that it was the right thing to do, a responsible thing to do, to advise that government how best to pull its people out of the poverty they'd been plunged into by a completely misconceived socialist experiment.

By the way, Milton Friedman advised a far more blood-thirsty regime than Pinochet's - the People's Republic of China, which he advised for a rather longer period than he advised for in Santiago. That is a regime that killed people not in their hundreds but in their millions.

**Q:** I was thinking about the quote that you said about the left having good intentions and I do think that it is bad that people vote thinking purely about how they will be affected, with better policies, and obviously the average person in Britain won't have that much economic knowledge. John Redwood you were saying even many politicians don't look at the current GDP figures. So I was wondering that, although it threatens democracy, what steps do

you think could or should be taken to stop economic decisions being made by politicians and more by economists?

**John Redwood MP:** I think we have just heard a very good demonstration of the damage that experts can perpetrate when left in charge of central banks.

In my lifetime I think the British economic establishment has made a series of catastrophic errors, it was certainly the strongly held view of most professional opinions that we had to join the Exchange Rate Mechanism and link ourselves to a fixed exchange rate system when all that writing and literature and history told you that it couldn't conceivably work and it did enormous damage to the living standards and the opportunities of many people.

And more recently we've seen a so called independent Bank of England lurch from boom and bust and preside over runs on banks and bankruptcies of major banks in a way that we thought had been left behind in the nineteenth century. This was all done by the technicians not the politicians.

Of course it is true that the Labour government presided over all this and set up a system that didn't work, whilst it is true that any point Mr Brown or Mr Darling could have reigned in the excesses in 06/07 or could have loosened the ridiculously tight conditions in 07 and 08.

Those who favour independence have to admit that the bank was given a lot of independence over those calls in that period and that it resulted in a boom and bust and whilst I have no wish to exonerate Mr Brown and Mr Darling from the ultimate responsibility, because I do believe that the elected officials rightly have the ultimate power and the ultimate responsibility, I would point out that when they started to relax the ridiculously tight

squeeze to prevent the whole of the banking system going down it was the elected officials, Mr Darling and the other finance ministers, who overruled the wishes of the independent central banks and made them cut interest rates.

Even in Britain with this so called independent bank, the Bank of England spontaneously decided to have an early meeting out of cycle and spontaneously decided to cut our interest rates in line with the world view recommended by finance ministers. But it wouldn't have done it on its own.

So I would say that you have, in a democracy, to trust the sovereign politicians you elect and when you no longer trust them you get rid of them at the first available democratic opportunity.

They will make mistakes but they have access to all the best advice of the times, sometimes it serves them in good stead, sometimes it lets them down because they follow the best advice of the time and it can be disastrous.

But we've been discussing tonight how there has been a war of words and a war of theories going on for fifty years or so over how you conduct economic policy. All too often it is the people whose economic theories don't work who are in the ascendency and if you have no political sovereign to control them the outturns could be worse than if the political sovereign, being accountable, has some impact upon them.

**Niall Ferguson:** I think I am going to give the final word to Milton Friedman because I think his answer would have been slightly different from John's.

Of course John's a politician so he's bound to say let us do the decided not technocrats but that's not what Milton Friedman would have said:

Let’s reduce the power of the state so that neither the politicians nor the technocrats have too much power.

Here he is in vintage form:

‘The Strongest argument for free enterprise is that it prevents anybody from having too much power, whether that person is a government official, a trade union official or a business executive. It forces them to put up or shut up, they either have to deliver the goods, produce something that people are willing to pay for, are willing to buy, or else they have to go into a different business’

Amen to those stirring words.

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