# WHERE MILTON FRIEDMAN WENT WRONG

## DIANE CALDWELL

Between the black and the white, there is always the "gray" man. Between good and evil, there is always the "middle-of-the-roader". Such is the position of economist Milton Friedman. The economic ideas propounded by Friedman have just enough worth to tempt the ill-informed libertarian; and more than enough deceptions to implement dictatorship. Consequently, I plan to discuss, not what Friedman has said *for* capitalism, but what he has said *against* it.

**THE GOLD STANDARD AND CENTRAL BANKING**

Milton Friedman begins his most renowned works, *A Program for Monetary Stability* and *Capitalism and Freedom*, by emphatically proclaiming himself to be a 19th century liberal, i.e., a proponent of laissez-faire. Yet, in the same books, he attacks the most vital component of a free market society: the commodity (gold) standard. His criticisms serve as the foundation upon which all monetary theory is built; for in order to promote government issuance of paper money, he must first "prove" the inability of private enterprise to prosper without it.

Gold, he reasons, is costly to mine. Real resources must be "wasted" to allow for "necessary" increases in the money supply of a growing economy. Or, in a stationary economy, "production is needed solely to make good losses through wear and tear."[1] This inflationist tenet is based on the fallacious assumption that a static price level is the prerequisite of economic expansion. The unhampered market with a constant supply of gold experiences a gradual decline in prices with increasing productivity. In other words, a rising supply of goods raises the *purchasing power* of money. Hence, a *flexible* price level is the natural effect of economic growth. Money supply is irrelevant: what matters is the value in goods that each unit will buy.

There is a natural equilibrium, in the unhampered economy, between increasing and decreasing influences on the money supply. The effects of "wear and tear" may be dismissed as negligible. The major drain on the money supply occurs through gold exports to foreign countries; which are the result of mutually beneficial exchange. A secondary drain ensues from industrial consumption of gold; in which case gold is more valuable to the producer as a raw material than as money. Gold outflow, and accompanying scarcity of gold, produces a price decline attracting foreign gold back into the country. Also, the incentive to mine gold increases in direct proportion to the purchasing power of gold. The combination of the last two factors insures that the money supply is never reduced to the point at which economic calculation becomes unfeasible.

Having dismissed his first objection to the gold standard, let us proceed to the second:

> It (the commodity standard) has always tended to develop in the direction of a mixed system containing fiduciary elements such as bank notes and deposits, or government notes in addition to the monetary commodity. And once fiduciary ele-

**Economic Notes No. 53**

ISSN 0267-7164 ISBN 1 85637 231 6

An occasional publication of the Libertarian Alliance, 25 Chapter Chambers, Esterbrooke Street, London SW1P 4NN
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We have no idea who Diane Caldwell is, but trust that nobody will be offended by this reprinting without permission of an article which first appeared, entitled "Capitalism and Friedman", in *The Torch!*, Vol. III, No. 4-5, Feb 1, 1971, published by the Grove City Conservative Club, PA, USA.

The views expressed in this publication are those of its author, and not necessarily those of the Libertarian Alliance, its Committee, Advisory Council or subscribers.

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**FOR LIFE, LIBERTY AND PROPERTY**

> ments have been introduced, it has proved difficult to avoid governmental control over them, even when they were initially issued by private individuals. The reason is basically the difficulty of preventing counterfeiting or its economic equivalent.[2]

Admittedly there must be some agency to enforce contractual agreements; that function is directly related to outlawing initiated force. But how can this be construed as a justification of government seizure of monetary authority? The inducement for private banks to be rigorously honest exists only when they are *outside* the scope of government intervention. Credit expansion via the issuance of fiduciary media is severely limited in the unhampered market by three related factors: 1) maintenance of a good reputation, 2) fear of a run, and 3) legal enforcement of contractual agreements. Private banks would each be striving to stand highest in the estimation of the consumer — who wouldn't have been lulled to sleep by illusory government "protection". It isn't, in fact, improbable that a system of 100% reserves would emerge, whereby the banks would charge a slight fee for deposits. If not, banks might expand one or two percent at most. Any expansion beyond these limits would threaten the stability of the bank; for as unbacked checks circulated outside the bank's clientele, they would rapidly be deposited in competing banks who immediately demand payment. A sufficient amount of such demands would initiate a run in the original bank that would terminate in bankruptcy. Any depositors defrauded of their savings (assuming the bank guaranteed payment, either on demand or within a specified period of time) would then have the legal right to confiscate an equivalent value in property from the bank's owners. Inability to pay on the part of the owners would not legally liquidate their debt; hence the creditors would be entitled to a share of future earnings.

Now assume that the government establishes a central bank (the Federal Reserve System) in this unhampered market. Any bank engaging in credit expansion is thereby assured that it will be "rescued" in the event of a run. Credit expansion becomes a very profitable venture, and vast sums of new money are pumped into the system, via the government bank(s). Depositors are not defrauded outright, they are simply reimbursed with depreciated currency. Nor is the problem solved by requiring 100% reserves and increasing the money supply by other means. This system would prevent commercial banks from directly benefiting from inflation; but it would not reduce the depreciating effect that government issuance of new money has on deposited currency. Whether or not inflation can be employed to maintain a stable prive level is beside the point. Government increase of the money supply deprives depositors (savers) of value they would otherwise have kept or gained. When Friedman condones government control of money issuance he is condoning legalized fraud.

Friedman's final objection to the commodity standard is, curiously enough, that it is necessary to set some external limit on the issuance of fiduciary currency.[3] As demonstrated above, free enterprise has a built-in mechanism for rigid limitation of credit expanion. Does Friedman really believe he can improve upon that mechanism by abolishing the gold standard and authorizing a notoriously spendthrift government to print money at a government determined rate?

In regard to "the role of gold in the United States Monetary System" Friedman maintains:

> Only a cultural lag leads us still to think of gold as the central element in our monetary system. A more accurate description of the role of gold in U.S. policy is that it is primarily a commodity whose price is supported, like wheat or other agricultural products.[4]

The implication is that, if given a choice people would accept government paper of depreciating value over a precious metal that is almost universally accepted and has commodity value to guarantee that it will never become worthless. Rather than admit that paper had to be forced on the population via gold nationalization, Friedman postulates:

> The nationalization of gold was enacted to enable the government to reap the whole of the "paper" profit from the rise in the price of gold ...[5]

The government, *which prints the paper*, trying to reap a paper profit ...?

## INFLATION

Friedman is, of course, an inflationist; but not a hyperinflationist — only about 4% a year (to allow for economic "growth"). He proposes sweeping changes in the Federal Reserve System, the most sweeping of which are elimination of discounts and advances, a 100% reserve plan for commercial banks, and a concentration of Federal Reserve powers on the open market method of expanding the money supply. To comfort interventionist readers who fear he is attempting to decentralize the government, Friedman states:

> One likely criticism of the proposals made in this chapter is that the streamlining of tools suggested involves reducing the 'power' of the Federal Reserve System. Nothing could be farther from the truth.[6]

Without the irksome inefficiency of a discount rate, and with the granting of a new power — that of issuing its own securities — the influence of the Federal Reserve would, in fact, *increase*. Inflation could be accomplished much more rapidly, and to an enormous extent:

> Federal Reserve purchase of all outstanding marketable U.S. government securities would involve something like a quadrupling of the stock of money under the hypothetical arrangements ...[7]

Friedman assures us, however, that the Federal Reserve could be induced to keep the rate of inflation down to 4%.[8] Even granting this implausible premise, a policy of inflation could not succeed; as I shall proceed to prove.

Production forces are divided into two sectors: consumer goods industries and capital goods industries. Entrepreneurs react to an increase in demand for present goods, i.e., an increase in spending, by investing in the consumer goods industries. Similarly, they react to an increased demand for *future* goods (increase in saving) by investing in capital goods industries; which yield consumer goods at some date in the future. When people are saving, there is an increase in loanable funds; consequently interest rates will tend to decline. The interest rate acts, therefore, as a market signal for the entrepreneur to shift capital investment from consumer to capital goods industries.

Inflation, by increasing the supply of loanable funds, produces the same effect on the interest rate as an increased demand for future goods. Hence it falsifies a market signal that is vital to economic adjustment. As entrepreneurs invest heavily in capital goods industries, the consumers, many of whom were favored by the irregular distribution of the new money, continue to assert a demand for *present* goods. The investments in capital goods were, therefore, *malinvestments* which must eventually be liquidated. The business failures induced by a program of 4% inflation would not be severe enough to cause a full-scale depression; instead there would be a series of minor recessions inducing a gradual decline in productivity. Now recall that Friedman's reasons for inflating were to achieve a "stable prive level" by offsetting the downward trend in prices that is caused by *increasing* productivity. Not only his goal, but his program for achieving that goal is fallacious.

## THE GREAT DEPRESSION

Friedman attempted, in *Capitalism and Freedom*, to give a summary of the Great Depression that related to his monetary theory. Without explaining why, he implies that the Federal Reserve "should not have allowed the money stock to decline by nearly three percent from August 1929 to October 1930."[9] He is correct in sensing that this decline initiated the bust; but his assertion that the decline should not have been allowed to occur is utterly mistaken. The inflationary program embarked upon by the Federal Reserve in 1924 resulted in a *sharp* increase of the money supply;[10] falsifying the rate of interest and stepping up production of capital goods to create the illusion of economic prosperity. As new money rapidly diffused throughout the economy, consumers began to spend their excess cash and bid up prices in the consumer goods industries. A competition arose between the two sectors of production as both struggled to attain more factors of production. Factor prices soared. Capital goods industries had to rely on artificially low interest rates to finance their excessive expansion. It was at this artificially low interest rates to finance their excessive expansion. It was at this point that the Federal Reserve chose to decrease the money supply, thereby increasing the rate of interest. Immediately the capital goods industries collapsed; causing the stock market crash, an abrupt decline in consumer demand for present goods, and a consequent collapse of consumer goods industries. It is essential to bear in mind that this collapse was *inevitable* as soon as inflation had taken effect in 1924. Attempts to avert it by continuing to increase the money supply in 1929, as Friedman would have done, would eventually terminate with either a depression more violent than the Great Depression, or with hyper-inflation (money supply so large that the paper is worthless) and total economic chaos.

It is obvious from the discussion above that cessation of the Federal Reserve's inflationary policies was the critical factor in initiating the Depression. Friedman, however, shifts the importance from this factor to the wave of bank failures in 1930 and 1931. He does not fully explain the failures of 1930, possibly because he would then be forced to connect them with the contraction of 1929. As thousands of businesses went bankrupt and unemployment became widespread, there was a furious rush to withdraw deposits. The banks, which were overexpanded via the Federal Reserve, could not cope with this situation effectively. When, in 1931, the Federal Reserve raised the discount rate, thus cutting off government funds to an even greater extent, commercial banks were forced to pay the full penalty of credit expansion and the contraction continued with renewed severity. Friedman advocates that, rather than raising the discount rate, the Federal Reserve should have *lowered* it, thus pumping money back into the economy and temporarily averting the deflation.[11] Again, he proposes to "cure" the economy with the same policies that caused its collapse. I contend that the members of the Federal Reserve Board should not merely have raised the discount rate; they should have resigned.

Friedman's proposal to require 100% reserves for commercial banks is, in his opinion, a sufficient solution to the problem of the trade cycle (boom and bust). What he refuses to recognize is that bank failures are an *effect*, not a cause of depressions. The manner in which the money supply is increased (open market or credit expansion) is totally irrelevant. Inflationary policies inevitably lead to the falsification of the market rate of interest, and to malinvestments which must be liquidated.

## MONOPOLY

In discussing monopolies, Friedman exhibits a gross miscomprehension of capitalism and freedom. After defining monopoly as existing "when a specific individual or enterprise has sufficient control over a particular product or service to determine significantly the terms on which other individuals shall have access to it," he adds:

> ... the existence of monopoly means a limitation on voluntary exchange through a reduction in the alternatives available to individuals.[12]

His definition contains the fallacy of sovereignty of the consumer; implying that consumers are in control of the competitive producer's prices. How can this be in a private property order where each individual is free to sell his own goods and services for as much or as little as he desires? Consumers can accept or reject specific prices but they cannot *control* what those prices will be. All producers will naturally tend to set their prices at a level that *maximizes income*. Supply is *always* restricted to correspond to this level. A so-called "monopolist" who restricts his supply in order to charge a higher price is merely exercising the individual *right* to dispose of his property on the most profitable terms freely obtainable. The coerced denial of this right is the worse possible "limitation on voluntary exchange". (Another limitation is the government grant of monopoly privileges, excluding all newcomers from a sphere of production.) A producer who is compelled to sell at a lower than desirable price must make exchanges he would not otherwise have made. Consumers are wholly unjustified in demanding that an individual make more "alternatives available".

As may be expected, Friedman postulates government intervention as a solution to the monopoly "problem":

> The first and most urgent necessity in the area of government policy is the elimination of those measures which directly support monopoly whether enterprise monopoly or labor monopoly, and an even-handed enforcement of the laws on enterprises and labor unions alike. Both should be subjected to the anti-trust laws ...[13]

The alleged purpose of the anti-trust laws is to prohibit "restraint of trade". What they are, in effect, is a violation of the right to private property, and an obstruction to progress. Businesses most likely to be condemned for "restraint of trade" are those that have achieved widespread popularity for their products via low prices and a high degree of efficiency. These businesses make it difficult for newcomers to enter the field, because the newcomers must manufacture a superior, or at least equal product. Any business in a relatively non-competitive field that operated inefficiently and charged extravagant prices would be practically inviting competitors and thus could not justly be accused of "restraining trade". Prohibition of trade "restraint" is prohibition of competence!

## WELFARE

On the topic of welfare, Friedman comes forth with a brilliant proposal: the negative income tax. Under this arrangement, every "poverty stricken" individual is guaranteed a minimum income; which is generously coerced from individuals who continue to fully earn their incomes.[14] Let us assume the minimum income is $300. The government subsidizes everyone whoses earnings do not exceed $300 with the amount that is lacking. Immediately all subsidized parties find themselves unemployed: "accidentally" of course. They are then able to collect the maximum subsidy of $300. Meanwhile, workers whose incomes slightly exceed $300 realize that they are actually working for only the difference between their wages and the subsidy. The smaller this difference, the more eager they will be to join the ranks of the unemployed. Masses of people on relief will increase tremendously the burden of taxes on any remaining labor, and the greater this burden, the less the difference between their wages and the subsidy ... And naturally, declining productivity resulting from increased scarcity of labor would convince government officials that it was their humanitarian duty to raise the subsidy. Friedman's proposal would not benefit the poor; it would devastate the nation.

## COMPROMISE IS AT THE ROOT OF CAPITALISM'S DECLINE

Milton Friedman is not a champion of freedom, but a champion of coercion. Socialists and interventionists are highly adept at furthering Friedmanite ideas such as those illustrated above; while politely ignoring those that would be of any benefit in reversing the trend toward dictatorship. Compromise is at the root of capitalism's decline. To preserve freedom we must not support ideas that benefit its enemies!

### NOTES


1. Milton Friedman, *A Program for Monetary Stability*, Fordham University Press, New York, 1959, p. 5.
2. Friedman, *Capitalism and Freedom*, University of Chicago Press, 1962, p. 41.
3. Friedman, *A Program*, p. 8.
4. Friedman, *Capitalism*, p. 58.
5. Ibid., p. 60.
6. *A Program*, p. 51.
7. Ibid., p. 34.
8. Ibid., p. 100.
9. *Capitalism*, p. 46.
10. Hans Sennholz, *The Causes of the Great Depression*, Constitutional Alliance (later Bramble Minibooks), Lansing, Michigan, 1969, p. 6.
11. *Capitalism*, p. 49.
12. Ibid., p. 120.
13. Ibid., p. 132.