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Benjamin Strong and Milton Friedman – Ironically, Something in Common?

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Benjamin Strong was the governor (now referred to as president) of the Federal Reserve Bank of New York from 1914 until October 1928, when he died. Milton Friedman argued that had Governor Strong lived, as the chairman of the Open Market Investment Committee Federal Reserve monetary policy would likely have been aggressively accommodative in 1930, preventing the banking crises that ensued and consequent sharp contraction in the U.S. money supply and bank credit (see *A Monetary History of the United States 1867 – 1960*, Milton Friedman and Anna Jacobson Schwartz, Princeton University Press, 1963, pp. 411 – 419). Whether or not Friedman's conjecture was correct that Federal Reserve monetary policy would have been materially different had Benjamin Strong not died in October 1928 (for an opposing view, see *Federal Reserve Monetary Policy, 1917 – 1933*, Elmus R. Wicker, Random House, 1966, p. 158) is beside the point for the purposes of this commentary. But I contend that had Milton Friedman not passed away in 2006 and were alive and writing today, he would be arguing forcefully in favor of continued Federal Reserve quantitative easing. Friedman argued that had Strong been alive to influence Federal Reserve policy in 1930 and 1931, the recession of 1929 would not have degenerated into the Great Depression. I am arguing that if Milton Friedman were alive today to influence the current Federal Reserve monetary policy debate, the near stagnant economic environment we find ourselves in would not need to persist.

I offer as evidence of my Friedman hypothesis an essay written by Milton Friedman for Stanford University Hoover Institution's *Hoover Digest* (April 30, 1998) entitled "Reviving Japan." The *Digest* introduces this essay as follows: "Nobel laureate and Hoover fellow Milton Friedman gives the Bank of Japan step-by-step instructions for resuscitating the Japanese economy. A monetary kiss of life." The Japanese economy was mired in a deflationary stagnation after the bursting of its asset-price bubble in the early 1990s, similar to the current U.S. economic environment.

Here are some excerpts from "Reviving Japan" that I deem relevant today for U.S. monetary policy:

"The surest road to a healthy economic recovery is to increase the rate of monetary growth …"

"Defenders of the Bank of Japan will say, 'How? The bank has already cut its discount rate to 0.5 percent. What more can it do to increase the quantity of money?'"

"The answer is straightforward. The Bank of Japan can buy government bonds on the open market, paying for them with either currency or deposits at the Bank of Japan …"

"There is no limit to the extent to which the Bank of Japan can increase the money supply if it wishes to do so. Higher monetary growth will have the same effect as always. After a year or so, the economy will expand more rapidly; output will grow, and after another delay, inflation will increase moderately."

"… [I]t is so misleading to judge monetary policy by interest rates. Low interest rates are generally a sign that money *has been tight* [emphasis added] …; high interest rates, that money *has been easy* [emphasis added]."

"Japan's recent experience of three years of near zero economic growth is an eerie, if less dramatic, replay of the great contraction in the United States. The Fed permitted the quantity of money to decline by one-third from 1929 to 1933, just as the Bank of Japan permitted monetary growth to be low or negative in recent years. … The United States revived when monetary growth resumed …"

"The Fed pointed to low interest rates as evidence that it was following an easy money policy and never mentioned the quantity of money. The governor of the Bank of Japan in a speech on June 27, 1997, referred to the 'drastic monetary measures' that the bank took in 1995 [a cut in the discount rate from 1.75 percent to 0.5 percent] as evidence of 'the easy stance of monetary policy.' He too did not mention the quantity of money."

"After the U.S. experience during the Great Depression, and after inflation and rising interest rates in the 1970s and disinflation and falling interest rates in the 1980s, I thought the *fallacy* [emphasis added] of identifying tight money with high interest rates and easy money with low interest rates was dead. Apparently, old fallacies never die."

I am told that Milton Friedman used to say that his students would be his legacy. Where are Milton Friedman's students now? Why are not Friedman's students writing op-ed commentaries dispelling the old fallacy that low interest rates are synonymous with easy money?

Although it is presumptuous of me to amend or edit the wisdom of arguably one of the greatest economic intellects of the 20th century, but where Professor Friedman refers to money, I would modestly suggest substituting monetary financial institution credit. Over the years as innovations in liability management have occurred, deposits, the largest component of common definitions of money, have diminished relatively as a funding source of the credit issued by private monetary financial institutions (commercial banks, S&Ls and credit unions). This is illustrated for the case of commercial banks in Chart 1. In 1952, total deposits represented over 104% of total commercial bank credit. In 2000, total deposits as a share of total bank credit had fallen to 70%. As the recent financial crisis set in and the perceived credit risk of banks increased, banks' suppliers of funds opted more for the safety and liquidity of deposits compared to other types of bank liabilities. As a result, total deposits rose to about 82% of total bank credit in 2009 and 2010. This downward trend in the relative importance of deposits as a funding vehicle of bank credit has caused the relationship between changes in money, largely bank deposits, and changes in the demand for goods and services to deteriorate over time. In contrast, the relationship between changes in private monetary financial institution credit and changes in the demand for goods and services has remained more stable over time. (For a fuller discussion of this, see my September 1, 2010 *Econtrarian* entitled "I Renounce Monetarism".)

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Chart 1

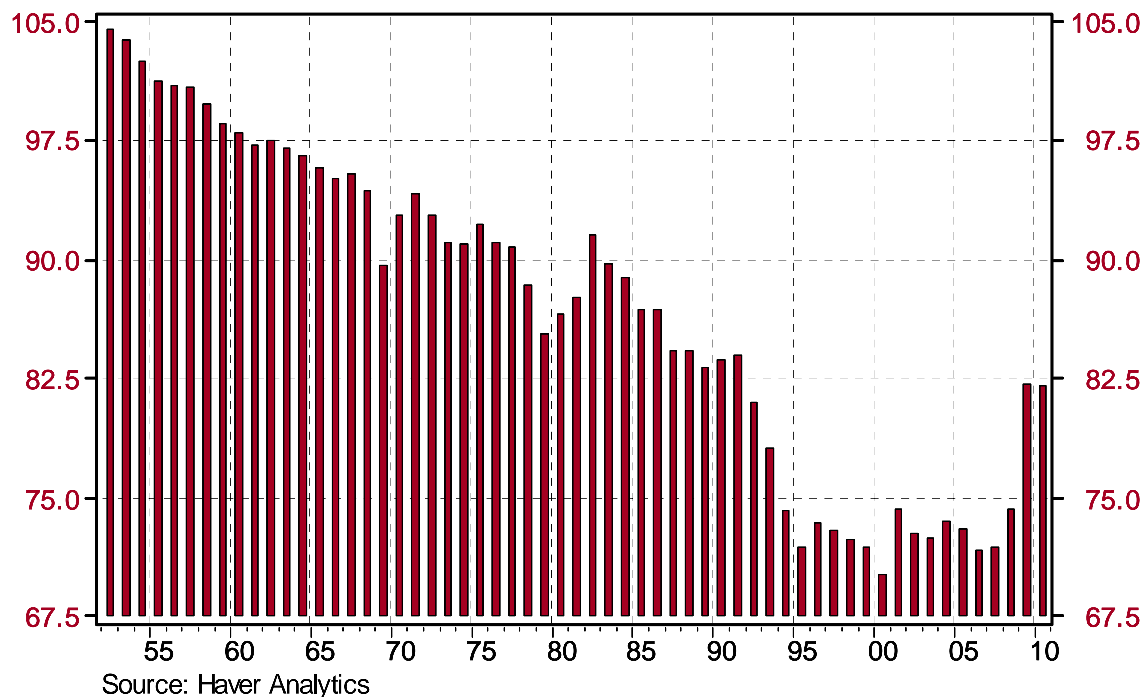

Chart 2 shows the relationship between year-over-year percent changes in private monetary financial institution credit (the sum of commercial bank, S&L and credit union credit) and year-over-year percent changes in gross domestic purchases. The contemporaneous correlation between the two series from Q1:1953 through Q2:2011 is 0.61. The average year-over-year percent change in private monetary financial institution credit is 7.4%. In Q2:2011 vs. Q2:2010, the year-over-year percent change in private monetary financial institution credit was *minus* 0.3%.

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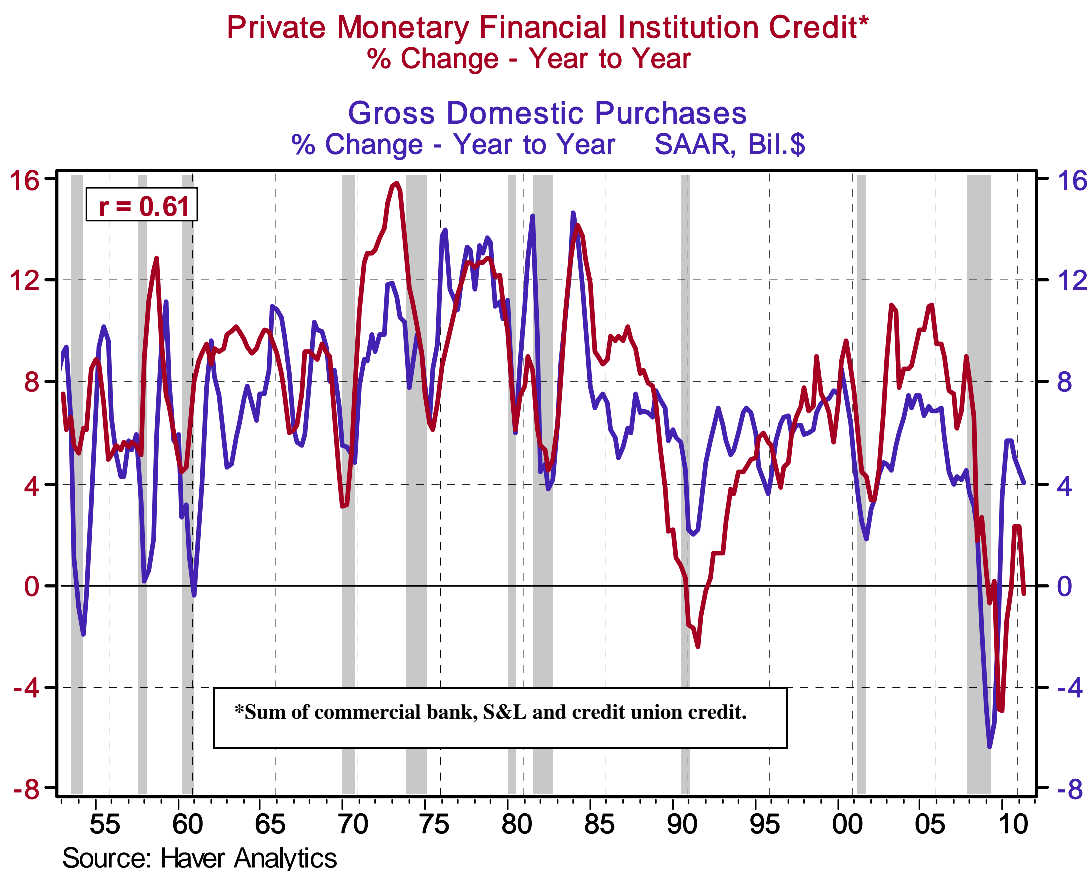
Chart 2



Today we hear from allegedly informed economic commentators as well as some Federal Reserve officials that U.S. monetary policy is already excessively easy *because* U.S. interest rates are at very low levels. The Federal Reserve's policy responses to the economy's failure to grow faster in the face of exceptionally low interest rates is to announce that short-term interest rates will remain low for an extended period of time and/or to re-allocate the Federal Reserve's securities portfolio away from shorter-maturity issues to longer-maturity issues in hopes of bringing down further the yields on longer-maturity securities. I can just hear Fed officials saying when the microphone is off, "What more can we do?"

If Milton Friedman were still alive, I suspect he would write another Hoover Institution essay, this one entitled, "Reviving America," in which he would recommend to the Fed that it purchase securities on the open market such that the *combined* credit of the Federal Reserve and private monetary financial institutions grow at a steady annual rate closer to 7.4% than zero. And then Friedman might end his essay with: "**I thought the fallacy of identifying tight**

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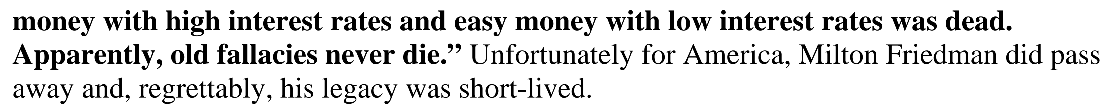

money with high interest rates and easy money with low interest rates was dead. Apparently, old fallacies never die." Unfortunately for America, Milton Friedman did pass away and, regrettably, his legacy was short-lived.

Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy

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