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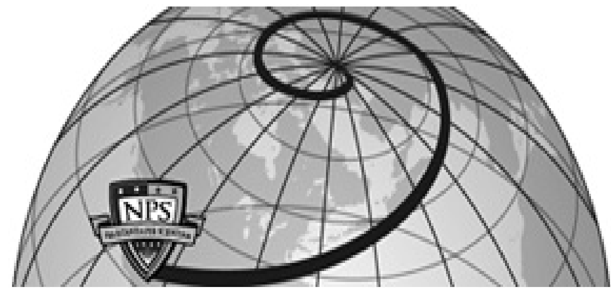

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Uncle Milties Ugly Fed Lesson

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Henderson, D. Uncle Milties Ugly Fed Lesson. TCS Daily, 2006.
http://hdl.handle.net/10945/61569

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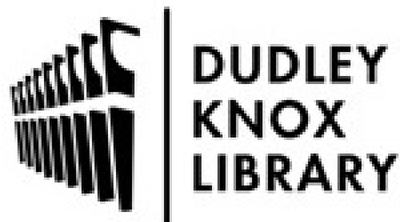

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Uncle Miltie's Ugly Fed Lesson

by David R. Henderson
Tech Central Station, January 26, 2006

"The right man in the right place at the right time."

That's a quote from an important article in Newsweek by economist Milton Friedman in which he claimed that the person about to be chairman of the Federal Reserve Board would be a good pick. No, Friedman didn't write that in 2005 about Ben Bernanke. Instead, he wrote it in 1970 about his friend and fellow inflation hawk, Arthur Burns, who, shortly after becoming Fed chairman, stoked the fires of inflation and turned out to be one of the worst Fed chairmen of the post-World War II years.

Moreover, Burns, a long-time foe of price controls, began to advocate economy-wide price controls, which President Nixon later imposed, and which led to major distortions in the U.S. economy, especially in the oil industry. In short, Milton Friedman turned out to be wrong -- and not just wrong, but spectacularly wrong. To his credit, Friedman recognized this quickly and denounced Burns's excessive growth in the money supply (which caused the high inflation of the early 1970s) as well as his advocacy of "incomes policy," a euphemism for wage and price controls.

Why do I raise this issue now? Although I, like many economists I've spoken to, think that Ben Bernanke is one of the best men for the job, we all need to be humble about our predictions of his good performance. That's the Milton Friedman/Arthur Burns lesson. Specifically, rather than give the kind of blanket endorsement Art Laffer gave Bernanke (see Arthur Laffer, "Ben Bernanke is the Right Person at the Right Time," Wall Street Journal, October 26, 2005, A18), we need to look at his record carefully, the minuses as well as the pluses. The job of Fed chairman, after all, is arguably the second-most-powerful job in the U.S. government, and this power can be used mainly for harm rather than for good.

I have no hidden agenda here. I know that Bernanke will hold that job within a week or two, and if I were able to vote for or against him for Fed chairman,

I would vote for him. But I've learned over the years not to ignore my doubts and, instead, to record and store information, the negatives along with the positives. As I see it, there are three main positives and two negatives.

Let's begin with the positives.

First, from everything I can tell, Bernanke is a first-rate economist.

Second, Bernanke has a solid understanding of what caused, and what lengthened, the Great Depression. Like Milton Friedman and Anna Schwartz, he understands the important role that contractions in the money supply played in causing the first few years of the Great Depression. One question that had many economists stumped, though, was why the large unemployment of the time didn't cause real wages to fall more quickly in some important sectors of the economy, making more workers employable. Bernanke, as well as other economists, solved the puzzle. They pointed out that government policies, beginning with President Hoover but especially under Franklin Roosevelt, kept real wages high. Starting in 1933, President Roosevelt's National Recovery Administration cartelized U.S. industries, keeping prices and wages high and slowing the growth of real output. Then, by 1935, when the Supreme Court ruled that the NRA was unconstitutional, federal labor legislation had given unions monopoly power, which they exploited to keep wages high. The result was that the Depression lasted much longer than it needed to. So the odds that Bernanke would let the money supply shrink enough to cause a major depression are extremely low, and the odds that if a recession started, Bernanke would advocate government policies to keep real wages artificially high, are also low.

The third positive is that Bernanke appears to be an inflation hawk, someone who thinks his main job is to keep inflation low, which means, as noted above, keeping the growth rate of the money supply low.

So, what's not to like?

Two things. In the introduction to his book Essays on the Great Depression (Princeton University Press, 2000), Bernanke writes: "Those who doubt that

there is much connection between the economy of the 1930s and supercharged information-age economy of the twenty-first century are invited to look at the current economic headlines -- about high unemployment, failing banks, volatile financial markets, currency crises, and even deflation." (italics added.) Recall that in 1933, the worst part of the Great Depression, the unemployment rate was 25 percent. In other words, one of 4 people in the U.S. labor force was out of work. In early 2000, presumably when Bernanke wrote his introduction, the U.S. unemployment rate was about 4 percent. Most economists, if asked the U.S. economy's "natural" unemployment rate -- when the economy is humming along at so-called "full employment" -- would answer, "About 4 to 6 percent." If Bernanke believes that 4 percent unemployment is high, what might he do to the growth of the money supply if the unemployment rate is, as it often will be, 4 percent or higher?

Now, you might argue that Bernanke was engaging in hype. But surely, all other things equal, hype is not good.

The second thing not to like is Bernanke's strong fear of deflation. He has made it clear that he favors price stability, which, he has pointed out, "means avoiding both deflation and inflation." Economists can tell you why inflation is bad: it's a tax on money and it's more hidden than most taxes. But one of the economists who studied the issue most carefully, Milton Friedman, concluded that the optimal growth rate of the money supply is one that yields deflation. Why? Friedman argues that the cost to the government of producing paper money is essentially zero and that, therefore, the cost of holding money should be zero so that people will hold the optimal amount of money. But the cost of holding money is simply the interest you give up by holding it. So the way to get the cost of holding money down to zero is to have a zero nominal interest rate. This would happen if we had deflation whose magnitude equaled the real interest rate -- that is, deflation of about 2 percent per year. By contrast, Bernanke's fear of deflation, as far as I can tell, is not based on economic reasoning.

My second objection may well be a quibble. So, why do I make it? As I said earlier, I believe in putting my doubts on record. Let's hope that it's only a

quibble. And let's hope that Bernanke's referring to 4 percent unemployment as high unemployment is pure hype and that, if so, he has decided to stop engaging in hype.