# The making and dissemination of Milton Friedman's 1967 AEA Presidential Address

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By Beatrice 28/11/2017

**Joint with Aurélien Goutsmedt**

In a few weeks, the famous presidential address in which Milton Friedman is remembered to have introduced the notion of an equilibrium rate of unemployment and opposed the use of the Phillips curve in macroeconomic policy will turn 50. It has earned more that 8,000 citations, more than Arrow, Debreu and McKenzie's proofs of the existence of a general equilibrium combined, more than Lucas's 1976 critique. In one of the papers to be presented at the AEA anniversary session in January, Greg Mankiw and Ricardo Reis ask "what explains the huge influence of his work," one they interpret as "a starting point for Dynamic Stochastic General Equilibrium Models." Neither their paper nor Olivier Blanchard's contribution, however, unpack how Friedman's address captured macroeconomists' minds. This is a task historians of economics – who are altogether absent from the anniversary session – are better equipped to perform, and as it happens, some recent historical research indeed sheds light on the making and dissemination of Friedman's address.

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| **8:00 p.m.**<br>**SHERATON PARK**<br>**Sheraton Hall**<br>**AEA** | **PRESIDENTIAL ADDRESS**<br>Chairman: ARTHUR F. BURNS, Columbia Univ.<br>**The Role of Monetary Policy,** MILTON FRIEDMAN, Univ. of Chicago, President, AEA |

## The making of Friedman's presidential address

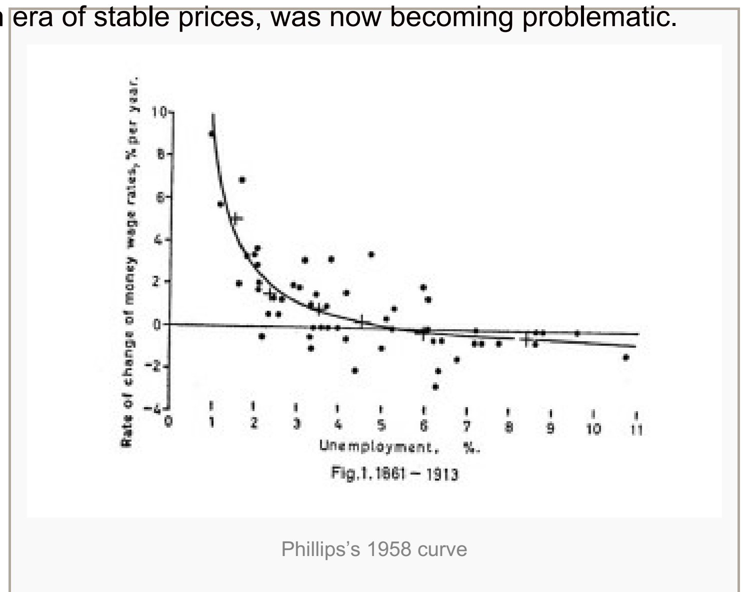
On a December 1967 Friday evening, in the Washington Sheraton Hall, AEA president Milton Friedman began his presidential address:

> *"There is wide agreement about the major goals of economic policy high employment stable prices and rapid growth. There is less agreement that these goals are mutually compatible, or, among those who regard them as incompatible, about the terms at which they can and should be substituted for one another. There is least agreement about the role that various instruments of policy can and should play in achieving the several goals. My topic for tonight is the role of one such instrument – monetary policy,"*

the published version reads. As explained by James Forder, Friedman had been thinking about his address for at least 6 months. In July, he had written down a first draft, entitled "Can full employment be a criterion of monetary policy?" At that time, Friedman intended to debunk the notion that there existed a tradeoff between inflation and unemployment. That "full employment […] can be and should be a specific criterion of monetary policy – that the monetary authority should be 'easy' when unemployment is high […] is so much taken for granted that it will be hard for you that […] this belief is wrong," he wrote. One reason for this was that there is a "natural rate of unemployment […] the level that would be ground out by the Walrasian system of general equilibrium equations," one that is difficult to target. He then proceeded to explain why there was, in fact, no long run tradeoff between inflation and unemployment.

Most of the argument was conducted without explicit reference to the "Phillips Curve," whose discussion was restricted to a couple pages. Friedman, who has, while staying at LSE in 1952, thoroughly discussed inflation and expectations with William Phillips and Phillip Cagan among others, explained that the former's conflation of

real and nominal wages, while understandable in an era of stable prices, was now becoming problematic. Indeed, as inflation pushes real wages (and unemployment) downwards, expectations adapt: “there is always a temporary trade-off between inflation and unemployment; there is no permanent trade-off. The temporary trade-off comes not from inflation per se, but from unanticipated inflation, which generally means, from a rising rate of inflation,” he concluded.



Phillips’s 1958 curve

In the end, however, the address Friedman gave in December covered much more ground. The address began with a demonstration that monetary policy cannot not peg interest rates, and the section on the natural rate of unemployment was supplemented with reflections on how monetary policy should be conducted. In line with what he had advocated since 1948, Friedman suggested that monetary authorities should abide by three principles; (1) do not make monetary policy a disturbing force; (2) target magnitudes authorities can control, and (3) avoid sharp swings. These 3 principles were best combined when “adopting publicly the policy of achieving a steady rate of growth like a precise monetary total,” which became known as Friedman’s “k% rule.”

The usual interpretation of Friedman’s address is the one conveyed by Mankiw and Reis, that is, a reaction to Samuelson and Solow’s 1960 presentation of the Phillips curve as “the menu of choice between different degrees of unemployment and price stability.” Mankiw and Reis assume that this interpretation, with the qualification that the tradeoff may vary across time, was so widespread that they consider Samuelson, Solow and their disciples as the only audience Friedman meant to address. Yet, Forder and Robert Leeson, among others, provide substantial evidence that macroeconomists then already exhibited a much more subtle approach to unemployment targeting in monetary policy. The nature of expectations and the shape of expectations was widely discussed in the US and UK alike. Samuelson, Phelps, Cagan, Hicks or Phillips had repeatedly and publicly explained, in academic publications as well as newspapers, that the idea of a tradeoff should be seriously qualified in theory, and should in any case not guide monetary policy in the late 1960s. Friedman himself had already devoted a whole 1966 *Newsweek* chronicle to explain why “there will be an inflationary recession.”

This intellectual environment, as well as the changing focus of the final draft of his address led Forder to conclude that “there is no evidence that Friedman wished to emphasize any argument about expectations or the Phillips curve and […] that he would not have thought such as argument novel, surprising or interesting.” We disagree. For a presidential address was a forum Friedman would certainly not have overlooked, especially at a moment both academic and policy discussion on monetary policy were gaining momentum. The day after the address, John Hopkins’s William Poole presented a paper on “Monetary Policy in an Uncertain World.” 6 months afterwards, the Boston Fed held a conference titled “Controlling Monetary Aggregates.” Meant as the first of a “proposed series covering a wide range of financial and monetary problems,” its purpose was to foster exchanges on “one of the most pressing of current policy issues – the role of money in economic activity.” It brought together Samuelson, David Meiselman, James Tobin, Alan Meltzer, John Kareken on “the Federal reserve’s Modus Operandi,” James Duesenberry on “Tactics and Targets of Monetary Policy,” and Board member Sherman Maisel on “Controlling Monetary aggregates.” Opening the conference, Samuelson proposed that “the central issue that is debated these days in connection with macro-economics is the doctrine of monetarism,” citing, not Friedman’s recent address, but his 1963 *Monetary History* with Anna Schwartz. That same year, the *Journal of Money, Credit and Banking* was established, followed by the *Journal of Monetary Economics* in 1973. Economists had assumed a larger role at the Fed since 1965, when Ando and Modigliani were entrusted with the development of a large macroeconometric model, and the Green and Blue books were established.

Reflecting on “The Role of Monetary Policy” at such a catalyzing moment, Friedman thus tried to engage variegated audiences. This resulted in an address that was theoretical, historical and policy-oriented at the same time, waving together several lines of arguments with the purpose of proposing a convincing package. What makes tracking its dissemination and understanding its influence tricky is precisely that, faced with evolving contexts and scientific debates, those different audiences retained, emphasized and naturalized different bits of the package.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## Friedman’s address in the context of the 1970s

### *Academic dissemination*

Friedman’s most straightforward audience was academic macroeconomists. The canonical history (echoed by Mankiw and Reis) is that Friedman’s address paved the way for the decline of Keynesianism and the rise of New Classical economics, not to say DSGE. But some ongoing historical research carried by one of us (Aurélien) in collaboration with Goulven Rubin suggests that it was Keynesian economists – rather than New Classical ones – who were instrumental in spreading the natural rate of unemployment (NRU) hypothesis. A key protagonist was Robert Gordon, who had just completed his dissertation on *Problems in the Measurement of Real Investment in the U.S. Private Economy* under Solow at MIT when Friedman gave his address. He initially rejected the NRU hypothesis, only to later nest it into what would become the core textbook New Keynesian model of the 1970s.


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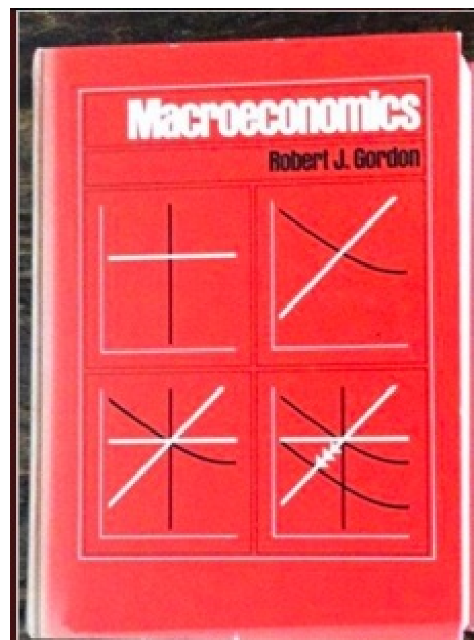
What changed his mind was not the theory. It was the empirics: in the Phillips curve with wage inflation driven by inflation expectations and unemployment he and Solow separately estimated in 1970, the parameter on inflation expectation was extremely small, which he believed dismissed Friedman’s accelerationist argument. Gordon therefore found the impact of the change in the age-sex labor force composition on the structural rate of unemployment, highlighted by George Perry, a better explanation for the growing inflation of the late 1960s. By 1973, the parameter had soared enough for the Keynesian economist to change his mind. He imported the NRU in a non-clearing model with imperfect competition and wage rigidities, which allowed for non-voluntary unemployment, and, most important, preserved the rationale for active monetary stabilization policies.

The 1978 textbook in which Gordon introduced his AS-AD framework exhibited a whole chapter on the Phillips curve, in which he explicitly relied on Friedman's address to explain why the curve was assumed to be vertical on the long-run. Later editions kept referring to the NRU and the long run verticality, yet rather explained by imperfect competition and wage rigidity mechanisms. 1978 was also the year Stanley Fischer and Rudiger Dornbusch's famed *Macroeconomics* (the blueprint for subsequent macro textbooks) came out. The pair alluded to a possible long run trade-off, but like Gordon, settled on a vertical long-run Phillips curve. Unlike Gordon though, they immediately endorsed "Keynesian" foundations.




At the same time, New Classical economists were going down a slightly different, yet  famous route. They labored to 'improve' Friedman's claim by making it consistent with rational expectations, pointing out the theoretical consequence of this new class of models for monetary policy. In 1972, Robert Lucas made it clear that Friedman's K-% rule is optimal in his rational expectation model with information asymmetry, and Thomas Sargent and Neil Wallace soon confirmed that "an X percent growth rule for the money supply is optimal in this model, from the point of view of minimizing the variance of real output". Lucas's 1976 critique additionally underscored the gap between the content of Keynesian structural macroeconometrics models of the kind the Fed was using and Friedman's argument.

### *Policy Impact*

Several economists in the Washington Sheraton Hall, including Friedman himself, were soon tasked with assessing the relevance of the address for policy. Chairing the 1968 AEA session was Arthur Burns, the NBER business cycle researcher and Rutgers economist who convinced young Friedman to pursue an economic career. He walked out of the room convinced by Friedman's view that inflation was driven by adaptive expectations. In a December 1969 confirmation hearing to the Congress, he declared: "I think the Phillips curve is a generalization, a very rough generalization, for short-run movements, and I think even for he short run the Phillips curve can be changed." A few weeks afterwards, he was nominated federal board chairman. Edward Nelson documents how, to Friedman's great dismay, Burns' shifting views quickly led him to endorse Nixon's proposed wage-price controls, implemented in August 1971. In reaction, monetarists Karl Brunner and Allan Meltzer founded the Shadow Open Market Committee in 1973. As Meltzer later explained, "Karl Brunner and I decided to organize a group to criticize the decision and point out the error in the claim that controls could stop inflation."

Friedman and Burns

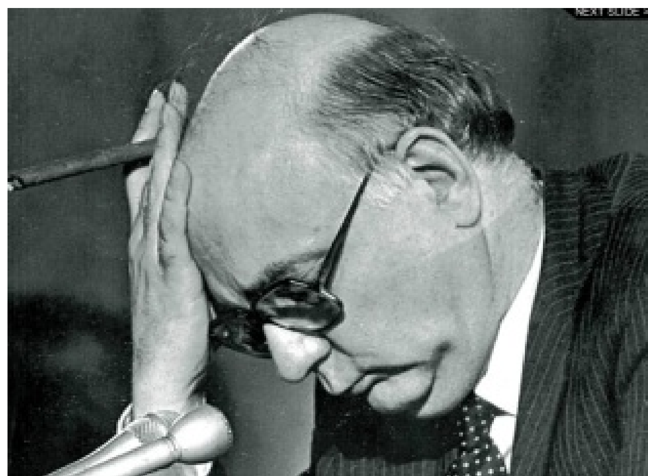
While the price and wage controls were removed in 1974, the CPI index suddenly soared by 12% (following the October 1973 oil shock), at a moment unemployment was on the way to reach 9% in 1975. The double plague, which British politician Ian MacLeod had dubbed "stagflation" in 1965, deeply divided the country (as well as economists, as shown by the famous 1971 *Time* cover). What should be addressed first, unemployment or inflation? In 1975, Senator Proxmire, chairman of the Committee on Banking of the Senate, submitted a resolution that would force the Fed into coordinating with the Congress, taking into account production increase & "maximum employment" alongside stable prices in its goals, and disclosing "numerical ranges" of monetary growth. Friedman was called to testify, and the resulting Senate report strikingly echoed the "no long-term tradeoff" claim of the 1968 address:

> *"there appears to be no long-run trade-off. Therefore, there is no need to choose between unemployment and inflation. Rather, maximum employment and stable prices are compatible goals as a log-run matter provided stability is achieved in the growth of the monetary and credit aggregates commensurate with the growth of the economy's productive potential."*

If there was no long-term trade-off, then explicitly pursuing maximum employment wasn't necessary. Price-stability would bring about employment, and Friedman's policy program would be vindicated.

The resulting *Concurrent Resolution 133* however did not prevent the Fed staff from undermining congressional attempts at controlling monetary policy: their strategy was to present a confusing set of five different measure of monetary and credit aggregates. Meanwhile, other assaults on the Fed mandate were gaining strength. Employment activists, in particular those who, in the wake of Coretta Scott King, were pointing out that black workers were especially hit by mounting unemployment, were organizing protests after protests. In 1973, black California congressman Augustus Hawkins convened a UCLA symposium to draw the contours of "a full employment policy for America." Participants were asked to discussed early drafts of a bill jointly submitted by Hawkins and Minnesota senator Hubert Humphrey, member of the Joint Economic Committee. Passed in 1978 as the "Full Employment ad Balanced Growth Act," it enacted Congressional oversight of monetary policy. It required that the Fed formally report twice a year to Congress, and establish and follow a monetary policy rule that would term both inflation and unemployment. The consequences of the bill were hotly debated as soon as 1976 at the AEA, in the *Journal of Monetary Economics*, or in *Challenge.* The heat the bill generated contrasted with its effect on monetary policy, which, again, was minimal. The following year, Paul Volcker became Fed chairman, and in October, he abruptly announced that the Fed would set binding rules for reserve aggregate creation and let interests rates drift away if necessary.

### *A convoluted academia-policy pipeline?*



The 1967 address thus initially circulated both in the academia and in public policy circles, with effects that Friedman did not always welcome. The natural rate of unemployment was adopted by some Keynesian economists because it seemed empirically robust, or at least useful, yet it was nested in models supporting active discretionary monetary policy. Monetary policy rules became gradually embedded in the legal framework presiding over the conduct of monetary policy, but this was with the purpose of reorienting the Fed toward the pursuit of maximum unemployment. Paradoxically, New Classical research, usually considered the key pipeline whereby the address was disseminated within and beyond economics, seemed only loosely connected to policy.

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VOLCKER SAYS JUMP IN SUPPLY OF MONEY SHARPENS INFLATION

BID TO CUT GROWTH IS HINTED

Reserve Nominee Stresses Price Stability — Duncan Backed in Senate for Energy Post

By CLYDE H. FARNSWORTH

Special to The New York Times

WASHINGTON, July 30 — Paul A. Volcker, chairman-designate of the Federal Reserve Board, said today that inflation had been caused by excessive growth of the money supply and suggested he would press for a reduction even if it should mean still higher interest rates.

In confirmation hearings before the Senate Banking Committee, he proclaimed his independence of the Carter

Paul A. Volcker at Senate hearing

Indeed, one has to read closely the seminal 1970s papers usually associated with the "New Classical Revolution" to find mentions of the troubled policy context. The framing of Finn Kydland and Edward Prescott's "rule vs discretion" paper, in which the use of rational expectations raised credibility and time consistency issues, was altogether theoretical. It closed with the cryptic statement that "there could be institutional arrangements which make it a difficult and time-consuming process to change the policy rules in all but emergency situations. One possible institutional arrangement is for Congress to legislate monetary and fiscal policy rules and these rules become effective only after a 2-year delay. This would make discretionary policy all but impossible." Likewise, Sargent and Wallace opened their "unpleasant monetarist arithmetic" 1981 paper with a discussion of Friedman's presidential address, but quickly added that the paper was intended as a theoretical demonstration of the impossibility to control inflation. None of the institutional controversies were mentioned, but the author ended an earlier draft with this sentence: "we wrote this paper, not because we think that our assumption about the game played by the monetary and fiscal authorities describes the way monetary and fiscal policies should be coordinated, but out of a fear that it may describe the way the game is now being played."

Lucas was the only one to write a paper that explicitly discussed Friedman's monetary program, and why it had 'so limited an impact." Presented at a 1978 NBER conference, he was asked to discuss "what policy should have been in 1973-1975," but declined. The question was "ill-posed," he wrote. The source of the 1970s economic mess, he continued, was to be found in the failure to build appropriate monetary and fiscal institutions, which he proceeded to discuss extensively. Mentioning the "tax revolt," he praised the California Proposition 13 designed to limit property taxes. He then defended Resolution 133's requirement that the Fed announces monetary growth targets in advance, hoping for a more binding extension.

This collective distance contrasts with both Monetarist and Keynesian economists' willingness to discuss existing US monetary institutional arrangements in academic writings and in the press alike. It is especially puzzling given that those economists were working within the eye of the (institutional) storm. Sargent, Wallace and Prescott were then in-house economists at the Minneapolis Fed, and the Sargent-Wallace paper mentioned above was published by the bank's *Quarterly Review*. Though none of them seemed primarily concerned with policy debates, their intellectual influence was, on the other hand, evident from the Minneapolis board's statements. Chairman Mark Willes, a former Columbia PhD student in monetary economics, was eager to preach the New Classical Gospel at the FOMC. "There is no tradeoff between inflation and unemployment," he hammered in a 1977 lecture at the University of Minnesota. He later added that:

> *"it is of course primarily to the academic community and other research groups that we look for … if we are to have effective economic policy you must have a coherent theory of how the economy works…Friedman doesn't seem completely convincing either. Perhaps the rational expectationists here …. Have the ultimate answer. At this point only Heaven, Neil Wallace, and Tom Sargent know for sure."*

If debates were raging at the Minneapolis Fed as well as within the university of Minnesota's boundaries, it was because the policies designed to reach maximum unemployment were designed by the Minnesota senator, Humphrey, himself advised by a famous colleague of Sargent and Wallace, Keynesian economist, former CEA chair and architect of the 1964 Kennedy tax cut Walter Heller.

## The independent life of "Friedman 1968" in the 1980s and 1990s?

Friedman's presidential address seem to have experienced a renewed citation pattern in the 1980s and 1990s, but this is yet an hypothesis that needs to be documented. Our bet is that macroeconomists came to re-read the address in the wake of the deterioration of economic conditions they associated with Volcker's targeting. After the monetary targeting experience was discontinued in 1982, macroeconomists increasingly researched actual institutional arrangements and policy instruments. We believe that this shift is best reflected in John Taylor's writings. Leeson recounts how, a senior student at the time Friedman pronounced his presidential address, Taylor's research focused on the theory of monetary policy. His two stints as CEA economist got him obsessed with how to make monetary policy more tractable. He increasingly leaned toward including monetary "practices in the analysis, a process which culminated in the formulation of the Taylor rule in 1993 (a paper more cited that Friedman's presidential address). Shifting academic interest, which can be interpreted as more in line with the spirit, if not the content, of Friedman's address, were also seen in 1980s discussions of nominal income targets. Here, academic debates preceded policy reforms, with the Fed's dual inflation/employment mandate being only appeared in a FOMC statement under Ben Bernanke in 2010, in the wake of the financial crisis (see this thread by Claudia Sahm). This late recognition may, again, provide a new readership to the 1968 AEA presidential address, an old lady whose charms appear timeless.

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# THE ROLE OF MONETARY POLICY*

*By* MILTON FRIEDMAN**

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