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Reflections on Milton Friedman's contributions to open economy money/macro

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A B S T R A C T

Friedman's central contributions to open economy macroeconomics are contained in his essay "The Case for Flexible Exchange Rates." The paper describes equilibrium in an open economy in terms of the flow market for domestic currency, and so presents the basic elements of The Monetary Approach to the Balance of Payments, which Mundell and Johnson developed later in the decade. An application of the argument includes the first definitive statement of the criteria which one finds in the literature on Optimum Currency Areas. The essay's model, in a better specified, more modern form, reappears in *A Monetary History* (with Anna Schwartz), where it serves as a basis for detailed analysis of particular episodes and as a framework for empirical work which continues to this day.

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1. Introduction

Milton Friedman has been widely recognized for his promotion in the early post-war period of the view that "money does matter," both for short-run fluctuations in output and for long-run impacts on the rate of inflation. The effects of the Great Depression and the theoretical framework provided by the Keynesian Revolution during the preceding decades had downplayed the importance of monetary factors.[1] Friedman was in the vanguard in reasserting their effects, and most economists have now found his argument to be persuasive in the context of a closed economy.

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[1] Friedman's (1956) introductory essay characterizes work done in conjunction with his students as representing the re-emergence of "an aberrant tradition" that had fallen into disrepute.

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We claim here that Friedman made contributions to open economy macro analysis which are comparable in their impact, but have gone unrecognized, because their influence was not acknowledged. His early "essay" (Friedman, 1953b), The Case for Flexible Exchange Rates, focuses on the "monetary phenomena" which he felt are the chief source of balance of payments problems. This work as well restores the important function played by price level changes, but now in the context of the classical international monetary mechanism.[2] He argues that private sector behavior would automatically restore international payments balance, if not frustrated by autonomous policy actions by the authorities. He points out that often a faster and smoother resolution of an imbalance would be obtained if it was "promptly offset by a movement in the exchange rate." In recognizing the essentially monetary natures of the balance of payments and of exchange rate changes, Friedman anticipated the Monetary Approach to the Balance of Payments, which flourished at the University of Chicago under Johnson and Mundell.

In addition, the essay contains the first definitive statement of the criteria for an Optimum Currency Area in much the same form in which it appears in the subsequent literature on the subject. Ironically, the title of the paper appears to have misled many readers into thinking that Friedman's endorsement of flexible exchange rates was unqualified.[3] More accurately, the essay is a policy memorandum designed to assert the viability of a flexible exchange rate regime, placing it on an equal footing with a rigidly fixed exchange rate. The essay provides numerous further insights concerning: pegged-but-adjustable exchange rate systems; elasticity pessimism; destabilizing speculation; the policy trilemma; and exchange rate overshooting.

In this early work the model is tenuous, but more precise specification of it is provided in his book with Anna Schwartz (Friedman and Schwartz, 1963), A Monetary History of the United States, 1867–1960. This is a monumental contribution which elucidates episodes in US experience, many of which had international repercussions during the ninety-four years which it covers. It contains solid empirical work, for example, on purchasing power parity, which continues to inspire researchers today.

These two pieces have had so much influence on the way in which the open economy macromodel has developed that Friedman must be seen as a giant in the field.

2. The model in Friedman's essay

The model in Friedman (1953b) is based on ideas which are associated with the classical international monetary adjustment process, known as "the price-specie-flow mechanism."[4] His emphasis is on how relative prices determine the international flows of money, and thereby the eventual equilibrium stocks of money in individual economies. In turn, these stocks determine the values of the price levels that prevail in those countries. For the short run, the analysis is conducted in a framework which is centered on the flow demand for and supply of domestic currency.

Here is how the model is phrased:

> "Holders of foreign currencies want to exchange them for the currency of a particular country in order to purchase commodities produced in that country, or to purchase securities or other capital assets in that country, or to pay interest on or repay debts to that country, or to make gifts to citizens of that country, or simply to hold for one of these uses or for resale…The amount of currency of a particular country that is demanded per unit of time for each of these purposes will, of course, depend in the first instance on the exchange rate—the number of units of a foreign currency that must be paid to acquire one unit of the domestic currency. Other things the same, the more expensive a given currency, that is, the higher the exchange rate, the less of

[2] Metzler (1948, 212) noted that "[t]he Keynesian revolution cast doubt… [on]…the central role… [which]…the classical mechanism…attributes to the monetary system."

[3] The title of Friedman's essay suggests that it is an exercise in normative economics, contrary to the title of the volume (Friedman, 1953a), Essays in Positive in Economics, in which it was published.

[4] Hume (1752) is usually viewed as making the first definitive statement of this process. In the two centuries since, many economists have made refinements of this original insight. Particularly noteworthy is work done at Harvard by Taussig (1927) 1966 and his students, especially Viner [1937] 1975.

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