Confirmed Convictions

An Interview with Milton Friedman

Milton Friedman is one of the most widely known and influential economists of this century. Within the economics profession, he is the intellectual leader of Monetarism. He has made outstanding contributions to monetary history, the study of consumption, and the theory of monetary policy; his work in these areas earned him the Nobel Prize in 1976. Outside of the profession he is perhaps best known as a passionate advocate of free markets and circumscribed government. His books Capitalism and Freedom *and* Free to Choose *are classic statements of the connection between free markets and individual liberty. Friedman was interviewed by Christopher Ragan, Editor of* World Economic Affairs.

WEA: For many years you have been a passionate advocate of flexible exchange rates. Does the recent experience in Asia lead you to rethink your position, or does it convince you even more of the benefits of floating exchange rates?

Friedman: That misstates, a little bit, my position. What my position has been is that there are three alternatives. A really flexible exchange rate, a pegged exchange rate, or a truly unified exchange rate.

WEA: By the latter, you mean a common currency?

Friedman: A common currency or the equivalent. What I have always argued is that, for major countries, a floating exchange rate is almost surely the best solution. For smaller countries the best solution is what I call a unified currency, or what has come to be called a currency board. In such a case the community links its currency to that of its major trading partner. But in order for that to work there must be no central bank. And if the country insists on having a central bank then it should have a floating currency. An example of the unified currency in its fullest form is Panama, which essentially uses the US dollar as its currency. It has its own currency but its value is set at one to one. Panama is an extreme case; it uses the dollar as its currency and that has worked very well for a long time. More recent examples are Hong Kong with its currency board and Argentina with a currency board. In Hong Kong's case, its currency is unified with the United States.

The advantage of a currency board, rather than simply using the US dollar, is that Hong Kong can get the seigniorage on its currency. What Hong Kong does, essentially, is that for every 7.8 Hong Kong dollars there is an asset equal to one US dollar held in the form of interest-earning government securities, so it essentially acquires the interest on the currency. But what happens to its quantity of money depends entirely on Federal Reserve policy in the United States. It has no independent monetary policy.

WEA: Given your three descriptions of exchange-rate regimes, what do see as the main exchange-rate lesson from the Asian crisis?

Friedman: The main exchange-rate lesson from the Asian crisis is the same as the lesson from almost all previous currency crises—the combination of a pegged exchange rate, a central bank and an independent monetary policy is almost invariably a disaster. It is true not only for small countries—it is also what happened to Britain in the 1950s and 1960s. It is also what happened to Britain, Italy, and France in 1992-93 when there was a big problem with the European Monetary System.

WEA: So, unless a country is prepared to go all the way and have either a dollarised economy or a currency board, the recent events in Asia strengthen your advocacy of flexible exchange rates?

Friedman: Absolutely. It's just an illustration of what has happened every previous time. When you take all of the Latin American cases or the Israeli cases, they are all cases in which you have a pegged exchange rate plus a central bank, and that is not a viable mixture. Let me add one more thing. Equivalent to a currency board, of course, would be a pure commodity standard, a pure gold standard. That is no longer a feasible alternative but that was the alternative that ruled for many years before 1914.

The combination of a pegged exchange rate, a central bank, and an independent monetary policy is almost invariably a disaster.

WEA: Many people argue that the high degree of capital mobility these days leads inevitably to the conclusion that flexible exchange rates are not the way to go. How do you respond?

Friedman: Well, it's just the opposite. What makes *pegged* exchange rates particularly dangerous in the current circumstances is the free mobility of capital. If you are going to have capital moving freely, you want to have a very sensitive system to trigger problems, and a flexible exchange rate triggers problems. In contrast, a pegged exchange rate conceals them.

WEA: I have to presume that you don't see much of a role for a tax on international financial transactions—a so-called Tobin tax.

Friedman: I see none whatsoever. I believe that you want the maximum of freedom of movement of capital. It seems to me just insane to distort capital flows by a tax on such flows. It is difficult enough now—there are enough obstacles now to the movement of capital.

WEA: Some people argue that there are already distortions in foreign-exchange markets—that speculators generate negative externalities. The Tobin tax, they argue, would address those distortions. What's your view on that?

Friedman: Well, I believe that speculators, far from generating negative externalities, provide a positive externality. Speculators serve a very useful function. In general, speculators can only make money if they stabilise. How do they make money? They make money by buying when things are cheap and selling when they are dear. In the process, they raise the value of the cheap things and they lower the value of the dear things. In other words, they stabilise. So I don't share the view of those who attribute all evil to speculation.

Capital Mobility

WEA: Let me continue with the theme of capital mobility. The events in Asia have naturally led to the debate over the costs and benefits of capital controls. As you know, Joseph Stiglitz and other noted economists have argued that in some situations capital controls are appropriate. What do you think?

Friedman: First of all, I think each individual country has to make its own decision. But in general, it seems to me that capital controls are highly inappropriate. I cannot conceive of any general circumstances under which capital controls would make any sense. The problem that people are trying to solve with capital controls really ties up with their attempt to peg exchange rates.

WEA: Because they are trying to prevent dramatic changes in the exchange rate?

Friedman: That's right. They're trying to keep exchange rates steady, to peg them, to keep them constant—because the distinction they are always making is between short-term financial flows and longer term direct investment. I can see no justification under any circumstances for trying to prevent foreign capital direct investment. How can a country be harmed by having somebody outside build factories for it in its own country? On the other hand, if you have a system of pegged exchange rates and you have commercial banks and a central bank then there is a strong temptation for short term funds to flow in. To take advantage of the differential in interest rates—the kind of thing that happened in Mexico and Thailand. The arguments for trying to limit short-term capital flows disappears if instead of a pegged exchange rate you have a floating exchange rate because then you don't get this free ride.

WEA: So you can imagine a situation where it's sensible for the country to have a policy of restricting short-term capital flows. But that policy would only be as sensible as the policy of the fixed exchange rate itself?

Friedman: Exactly.

WEA: How about Chile's policy? They have restricted capital inflows so that they are less vulnerable to outflows of so-called hot money.

Friedman: That's the short-term capital—that is what we were talking about. That is their attempt to keep their exchange rate from fluctuating as much as it otherwise would. But I think Chile would be better off if it did not do that—if it allowed the exchange rate to be determined freely and didn't try to manipulate it. I do not believe that governmental officials are smarter speculators than private individuals.

WEA: An increasing degree of capital mobility is at the heart of a process that has been dubbed "globalisation". Do you see a genuinely new process at work over the past two decades? And, if so, what do you see as the main challenges posed by this process?

What makes pegged exchange rates particularly dangerous in the current circumstances is the free mobility of capital.

Friedman: I don't see any new process at work. If you go back to the 19th century, the United States had very large capital in-flows. There were tremendous flows of capital funds from Europe to both North and South America. There is absolutely nothing new about so-called globalisation, except the word and the existence of a more efficient system of communication and of the transmission of funds.

WEA: So the communications and transportation-cost aspects of it are new, but not the trade itself?

Friedman: No, not the trade, not the movement of capital, not foreign investment.

WEA: Okay, suppose we reserve the word "globalisation" for the mere reduction in communication costs and transportation costs. Does globalisation limit what the government can and cannot do? Is it a threat to government policy?

Friedman: I think a major effect of the ability to communicate through the Internet may well be to reduce the capability of governments to impose taxes. Because with the Internet and with encryption it is far easier to evade government taxes—there is a new way to evade government taxes that is going to be very, very hard to check into. And one of the effects of that is to make it more difficult for governments to impose taxes.

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WEA: To impose new taxes? Or just to impose the same old taxes?

Friedman: To collect the old taxes and to impose new taxes. So one of the effects of globalisation may be to make governments less able to spend their citizens' money. I hope it's true. I hope globalisation makes governments less able to provide social programmes because I think that most of those programmes are a mistake—most do more harm than good.

WEA: But what happens if globalisation reduces the ability of the government to levy taxes to such an extent that it can't even levy the taxes to provide the basic public goods that I think you would agree are desirable?

Friedman: Globalisation will not have that effect. Governments will be able to impose taxes as long as they are providing services that people want. And if some other country tries to compete with them by not levying those taxes, that will become an unattractive place because it won't provide protection of property and it won't provide law and order. So I think this is a very healthy development disciplining governments. If competition among private enterprise is good why is competition among governments bad?

The Japanese Economy

WEA: Let's go on to Japan. Japan's economy has been in the doldrums for about six years and is now clearly in a mess. Real GDP is forecast to fall by about 2 percent this year. And despite repeated attempts at fiscal stimulus, not much seems to be happening. Do you think the Japanese authorities recognise the severity of their problems?

Friedman: I have no doubt the Japanese authorities recognise the severity of their problem. Let me give my view of the Japanese situation. I think it really traces back to the Louvre Agreement in 1987 which was an agreement by the G7 to try to support the US dollar and prevent it from depreciating further. The Plaza Agreement of the previous year was not relevant because all it did was to say that we recognise that the dollar is depreciating and that's okay. But the Louvre Agreement was an attempt to *stop* the depreciation of the dollar. How do you stop the depreciation of the dollar? By buying dollars. And with what do you buy dollars? You print yen to buy dollars. And so the Japanese participation in the Louvre Agreement led to a much more rapid expansion in the quantity of money than had been going on in Japan. In principle, they could have sterilised the expenditures, but they did not do so.

WEA: So that led to the Japanese speculative bubble?

Friedman: That's right. And when the bubble got bad enough the Bank of Japan stepped on the brakes and you had a drastic reduction in the rate of the monetary growth from 1990 to 1992—the quantity of money actually declined for awhile. And at this point you have essentially a repetition, on a much smaller scale, of the Great Depression of the United States. If you have a period of six years in which there is negligible growth in the quantity of money, you haven't repeated the Great Depression because in the Great Depression you had negative growth, you had the quantity of money decline by a third in four years. In Japan, you haven't had the money decline—you just had it stable. But coming after a period of inflation that's a very, very deflationary policy.

WEA: Your mention of the Great Depression brings to mind bank failures which, of course, happened on a massive scale in the United States. They haven't yet happened in Japan. But are they about to?

Friedman: We will never get the scale of bank failures in Japan that occurred in the United States because Japan did not have an absolute decline in the quantity of money. We will have the same kind of phenomenon but on a smaller scale. We will have bank failures—there is no doubt about that. But they won't be on the same scale as in the US case, where from 1929 to 1933 a third of the banks completely closed. We won't have anything on that scale in Japan.

They insisted on sticking to this relatively deflationary monetary policy and instead they proceeded to try a whole series of Keynesian policies, of fiscal policies, of changes in taxes and in spending, particularly in big public-works spending. The fact is that there is no empirical evidence that such programmes are expansionary.

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WEA: In Japan currently, or in general?

Friedman: In general. I have tried to examine cases in which monetary policy went one way and fiscal policy went the other—monetary policy was easy and fiscal policy was tight, or vice versa. And I have never found a case that wasn't controlled by the monetary policy. The evidence on that score has been greatly increased by the continued Japanese experiment. You have five or six experiments in an attempt to stimulate the economy through fiscal policy—every one of them has been a failure.

What the Japanese, in my opinion need to do, is to start increasing the money supply more rapidly. I am strongly in favour of their reducing taxes from a supply-side point of view, but not from a demand-side point of view. Tax rates in Japan are extremely high and their government spending is extremely high. It's fascinating. During the period that Japan was rising very rapidly, government spending as a fraction of national income was distinctly less in Japan than in the United States. In recent years it has been higher. So the policy package that I would recommend is a sharp cut in marginal tax rates plus a much more expansionary monetary policy.

WEA: Would that sharp tax cut be matched with cuts in spending, or would the deficit rise?

Friedman: It doesn't matter.

WEA: Because in your view the tax cuts are a supply-side benefit rather than a demand-side stimulus.

Friedman: Right. More generally, of course, I believe it would be desirable to have cuts in government spending. I believe the Japanese government, like the American government, is spending too large a fraction of its nation's income. But that is a structural problem, not a cyclical problem.

WEA: We hear some economists talk about the possibility that Japan is in a liquidity trap—that interests rates are very low and that monetary expansion will have no effect. What's your view?

Friedman: Japan is not in the liquidity trap in the sense that there is nothing whatsoever to prevent Japan from expanding the money supply more rapidly. The money supply in Japan has been going up at only about 2%-3% per year. It is not expanding rapidly. Now, people note that they have got the long-term interest rates down to 1.2%. This is true, but there is absolutely nothing to prevent them from buying up more government securities. If they drive the interest rate down to 1% or to 0.5%, so be it.

WEA: Suppose Japan increases the monetary growth rate significantly and it reduces interest rates. But what if the lower interest rates just don't stimulate investment and consumption. What then?

Friedman: That won't happen. Or, I shouldn't say it won't happen, I should say there is no case on record in which it

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has been observed to happen. If they increase the money supply that will increase the reserves in the banking system. There is nothing that would do more to help the banks out of their present situation. It would put the banks in a highly liquid position in which they could start making loans again. The problem in Japan is not that there is no demand for loans. The problem in Japan is that the banks are in a bind in which they can't make loans and the way to get out of that bind is to liquify the banks.

The policy package I would recommend for Japan is a sharp cut in marginal tax rates plus a much more expansionary monetary policy.

WEA: How confident are you that the Japanese authorities understand what you have just said and are prepared to do what you have just recommended?

Friedman: First of all, there is no such thing as a Japanese authority. There are a lot of people there. There are some people who understand it and some people who don't. In the central bank of Japan they've had a change in their regulations and rules recently by which they have sort of a committee running it instead of single governor. And at least one member of that committee has come out publicly expressing the same view that I have just expressed. So at least there are some people who have the same view. But it is not a monolithic group.

The Role of the IMF

WEA: The IMF is under renewed scrutiny for their response to the Asian crisis. What do you think they should be doing in Asia? And what grade would you give it for its past performance?

Friedman: First of all, let's go back to where the IMF comes from. The IMF was established in 1944-45 as part of the Bretton Woods agreement. It was established with a very definite purpose. Its function was to supervise a fixed-exchange-rate system—a system in which a set of countries agreed to maintain fixed rates between their currencies. In 1971 that system came to an end when Nixon closed the gold window. It was officially recognised as terminated in 1973. At that point, the IMF lost the function that it was set up for and the right action would have been to terminate it then. But nothing is so permanent as a government agency, especially an international government agency.

And so the IMF looked around to see what function it could perform. It went through three stages. In the first stage it just turned itself into a kind of consulting agency. But unlike most consulting agencies, instead of charging a fee, it paid the country to allow it to consult for it. It was a very attractive consulting agency—because it brought money along with advice. And that went on for quite a long time with small efforts here and there, some successful and some unsuccessful. In the second stage it was converting itself from a consulting agency to a junior World Bank—it was essentially getting involved in development assistance in various countries.

The Mexican situation ushered in the third stage. The Mexican situation, which I believe is the key to the Asian problem, led to a very large-scale bail-out and convinced the IMF that it could function as a lender of last resort—that it could perform a function in the international scene that individual central banks perform in their local scene. I believe that is a great mistake. The IMF cannot function as a central bank, as a lender of last resort. A lender of last resort in the domestic situation has the function of providing liquidity, to enable banks that are ultimately solvent but that are facing a liquidity problem to get over the liquidity drag. A central bank can do it because it can print money and because it acts quickly. It can really move in there and bail out an illiquid bank. A central bank is violating its function as a lender of last resort if it lends to insolvent institutions. That's the difference between a true lender of last resort and a sort of bail-out agency.

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The IMF cannot be a true lender of last resort. It does not print money. It can't act quickly, it has to get agreement from its executive board for any major loan. It has to work out a deal with the country in question. And I believe the result is that, far from reducing the problems of international financial difficulty, the IMF makes them far worse. We talked about the IMF and other countries having bailed out Mexico. That is a misnomer—they did not bail out Mexico, they bailed out lenders to Mexico. They bailed out the banks in New York and London and Berlin who had been making loans to Mexico under the assumption that the exchange rate was going to be held.

WEA: I guess the truth is that the IMF did not bail out anybody, it was taxpayers around the world that bailed them out.

Friedman: Of course it was the taxpayers! And I have never been able to understand why I, as a tax payer in the United States, should be bailing out one of our bankers in New York, or a banker in London, or somewhere else. And now when you come to East Asia, the experience of Mexico persuaded lenders around the world, understandably, that they could take chances on those pegged exchange rates because if anything happened to them the IMF would come in and bail them out.

WEA: So the IMF creates one of the bigger moral-hazard problems?

Friedman: Oh, I think the IMF is a big one. I believe that if there had been no IMF, if the IMF had been terminated in 1973, we would not have an Asian crisis today. In the course of the period since then, one or another of these countries might have got into trouble. But you wouldn't have had the sort of general, universal problem. Now aside from the IMF, Japan is a major source of the Asian problem, and that does not have anything to do with the IMF.

WEA: I want to go back to your statement that in the absence of the IMF there would probably not have been an Asian crisis. Part of that Asian crisis, you have agreed, came from the presence of pegged exchange rates and policies, like monetary expansion, that were inconsistent with them.

Friedman: Right.

WEA: Would those policies not have been there if the IMF hadn't existed?

Friedman: The policies might have been, but the pegged exchange rate could not have been maintained. They would have collapsed much earlier and you would have had a series of adjustments instead of what happened, which is that you let all problems accumulate to a big point.

Now, I want to say that, aside from the IMF, there are two other factors that played a role in the Asian crisis. One I have already mentioned, which is Japan. Undoubtedly, Japan is a major lender to that area and they can't serve as such under current conditions. But the second thing that played a role was the appreciation of the US dollar. This was a problem because those currencies were pegged to the US dollar. And as the US dollar appreciated relative to the yen, so did their currencies. If all of those countries had had their currencies pegged to the yen rather than to the dollar, they would be in nothing like so bad a situation as they currently are. Those pegged exchange rates would have depreciated relative to the US dollar. Instead, by being pegged to the dollar their currencies appreciated relative to both the yen and the European currencies.

WEA: So, as far as you are concerned, the IMF should close its doors.

Friedman: Yes, I believe the IMF should be terminated. There is no justification for its existence. It does more harm than good, and I cannot see how we can justify using taxpayers' money to finance it. Don't misunderstand me. There are some very able people at the IMF. They are trying to do their best. I am criticising a system, not individual people.

Deflation and Recession

WEA: As we see Japan probably get worse before it gets better, and South East Asia, Russia, and Latin America continue to deteriorate, do you see a world recession on the near horizon?

Friedman: No, I do not. I believe that what happens to the United States will depend on the policy within the United States. It will be affected by external events but not determined by them. Different countries around the world are affected by different forces. There is no uniform set of forces influencing them all. There may be recessions in individual countries, but that does not mean a recession for the world as a whole.

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WEA: But those individual recessions spread, don't they? Through trade flows and banks' balance sheets?

Friedman: They do spread, but there are also countervailing influences. Right now, for example, is Asia benefiting us or harming us? At the moment, it's mostly benefiting us by reducing the cost of imports and enabling our citizens to have a higher standard of living than otherwise. It's also helping us by promoting an inflow of funds from those countries that are seeking safe havens. Surely, one of the reasons why the 30-year government bond rate is so low is because of funds from abroad that have come in and bought those bonds. Roughly a third of our government debt is now owned by non-residents.

WEA: You say that it has helped America. That's the supply-side aspect to the Asian crisis—where we still have healthy growth in the United States but lower inflation than before?

Friedman: That's right. Of course, there are individual companies that have suffered lower earnings, but the US economy as a whole has benefited.

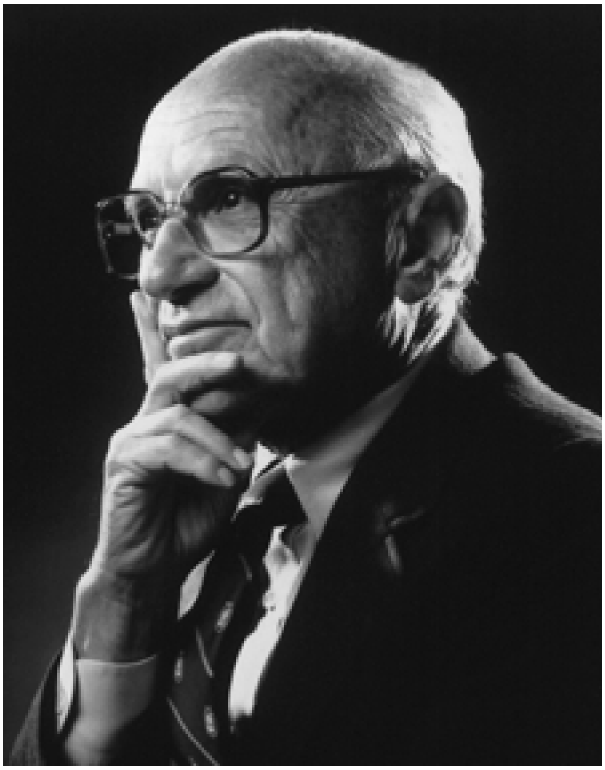
WEA: Some people are concerned about the possibility of deflation. Does a mild deflation worry you, or is it no more serious than an equally mild inflation?

Friedman: A mild deflation no more serious than a mild inflation, and if there is one thing we know, it is how to prevent a mild deflation from turning into a serious deflation. We just have to print money.

Challenges Ahead

WEA: What do you see as the single most pressing challenge facing the world economy over the next decade or so?

Friedman: The most serious challenge is whether countries will be able to contain the growth of government. The most serious challenge is that governments almost everywhere are too large and too intrusive for the good of their people. And that all of the pressures tend to be continuing pressures to expand rather than to reduce government. There is an interesting contrast in the world between rhetoric and reality. So far as rhetoric is concerned, so far as the climate of opinion is concerned, everybody is now in favour of capitalism and the free market. Very seldom do you hear any voice arguing that you ought not to have market freedom. On the other hand, if you look at the reality, the market is far less free today than it was 50



years ago. Fifty years ago government spending was of the order of 25% or 30% of the national income—its close to 50% now. The rhetoric has been moving in the opposite direction. The real challenge for the next decade is whether the change in rhetoric will make itself effective on reality.

WEA: Are you optimistic?

Friedman: In some ways yes, in some ways no. For example, I believe that in the United States we are clearly moving toward large-scale privatisation of Social Security. I think that is one area in which the role of government will be reduced in terms of the actual handling of the money. On the other hand, and more generally, if you look back at history you will find that there is a very long lag between the change of the climate of opinion and a change in actual policies. Adam Smith wrote *The Wealth of Nations* in 1776. But it wasn't until the 1820s or 30s in Britain that you got genuine free trade. The Fabian Society became important in the 1880s and 1890s. Intellectuals moved toward socialism in Britain before World War I, but certainly in both Britain and the United States by the 1920s. But it took 20, 30, or 40 years before we really had an expansion of the role of government in response to that set of ideas.

WEA: Is it possible that the swing of the pendulum we are now seeing, toward freer markets and smaller government, is just temporary?

Friedman: It could be. That's the challenge because I think it is easier in many ways to expand government than it is to cut it down.

WEA: It certainly involves far fewer politically tough choices.

Friedman: That's right. So it might be temporary, but I believe it is more than that because these swings in ideas, in the climate of opinion, tend to have a considerable amount of permanency that are not reversed very quickly. After all, there has been a very strong reaction against what people perceive as a failure of government. I mentioned the one area—Social Security—where I believe we are going to move. Another area where I am optimistic is the area of elementary and secondary education.

WEA: Do you see a move toward the voucher system?

Friedman: The voucher system is on the road, it's on the march. You have it on a small scale in Milwaukee and Cleveland and you have pressure for it everywhere across the country. I think the dam is broken and within the next five or ten years there will be a big expansion in parental choice. So I think there are optimistic signs as well as danger signals.

WEA: How are *Capitalism and Freedom* and *Free to Choose* selling these days?

Friedman: They both continue to sell. In fact, we just now had a contract signed for a translation of *Capitalism and Freedom*—I think it was into Latvian. We have been fascinated at how both of those books continue to grow.

WEA: I'm pleased to see it. Thank you very much for the interview today. ◆