When I was an undergraduate student at UVIC in the early 1980s, I fell in love with economics just a few weeks into an introductory course taught by John Schofield. I had found a way of thinking that immediately agreed with me. By the time I was a senior undergraduate, the attraction had only increased, but I also recognized a clear split in my view of the subject. Microeconomics was intuitive, precise, and straightforward. There was usually a single decision-maker, a sensible objective, and an obvious set of constraints. Even when the various decision makers were aggregated into a single market, it was easy to see what was going on. Macroeconomics, on the other hand, was much messier and I found it harder to get it straight in my mind. The equations and graphs were clear enough, but it was obvious that there was much more going on than in micro, and often the action appeared to be going on behind the scenes, thanks in part to Walras’ Law. I made it over the necessary hurdles in terms of shifting curves and solving systems, but I couldn’t shake the feeling that I still didn’t fully “get it” — or, as I now describe the process to my students, the various pieces of the macro puzzle had not yet “clicked” into place.

Despite the messiness of macroeconomics, however, there was no question that I found it more appealing than micro. In fact, I now realize that the messiness — which naturally comes from the combination of general equilibrium, expectations and uncertainty, and real-world institutions and policy dilemmas — is one of the things that attracts me most about studying macroeconomics, and especially macroeconomic policy.

When I arrived at Queen’s University enrolled in the Master’s program in September 1984, I realized that macroeconomics was going to get a lot messier. I recall in particular solving rational expectations models using the method of undetermined coefficients. This struck me at the time as a bizarre and unintuitive approach, and didn’t seem to help me get the big picture of what was going on or why it mattered. But I had the pleasure and extreme good fortune of taking my first graduate macroeconomics course from Doug Purvis, and received some of the benefits of his
basics-intensive Chicago training, his considerable policy savvy, and, most important, his ability to draw the link between theory and reality. With Doug Purvis, macroeconomics really came alive, and this excitement continued the following year when I was lucky enough to learn macroeconomics at MIT from Doug’s Chicago classmate Rudi Dornbusch.

It was at Queen’s that I first read Milton Friedman’s Presidential Address to the American Economic Association, “The Role of Monetary Policy”, published in the American Economic Review in March 1968. As a budding economist, entranced by the fascinating but complex puzzle of macroeconomics, this paper was a godsend. As I read Friedman, there was an audible “click” as the various pieces of macroeconomics began falling into place in my mind. His vision of the way the economy worked was so clear that it seemed to make macroeconomics straightforward — perhaps deceptively so. His paper has been criticized by some, but there is no question of its enormous influence on the economics profession. Friedman’s Presidential Address was then, and is still, considered by many to be the most influential work on monetary theory and policy in the past fifty years. It was easy for me to see why.

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The motivation for Friedman’s Presidential Address was his growing concern in the late 1960s that economists and policy makers were beginning to put too much faith in monetary policy as a means of achieving goals such as low unemployment and the stabilization of national income. This growing faith followed very different views from earlier decades. In the 1920s, the dominant view was that monetary policy’s goal was to maintain stable prices and support the existing Gold Standard. By the 1950s, after the Great Depression and Keynes’ influential promotion of activist fiscal policy, monetary policy was very much the poor cousin; its sole use was seen to be maintaining low interest rates on government debt. By the 1960s, however, monetary policy was back in the good books — money clearly mattered. There was an emerging belief that monetary policy could be effectively used to fine-tune the economy and to promote high and stable employment. In some circles, especially after the arrival of the Phillips Curve, monetary policy could even be used to choose between various inflation/unemployment combinations. Friedman was concerned that economists, by failing to understand its limitations, may come to expect too much from monetary policy. A result of this excessive monetary zeal would be a world in which
monetary policy was seriously abused and thus prevented from making the real and significant contribution that was well within its reach.

Friedman divides his arguments into two halves. In the first he provides the positive analysis of what monetary policy can and cannot achieve. In the second half he discusses the normative issue of how monetary policy should be conducted. The first half has revolutionized the way the profession thinks and teaches its students. Here we see the important role of inflation expectations and how sensible workers and firms who adapt their expectations to changes in their economic environment imply the disappearance of what before Friedman was thought to be a stable relationship between inflation and unemployment. Friedman’s views represent what is now the standard treatment of the short-run and long-run Phillips Curves. Indeed, his views have become so much a part of the mainstream that in our textbooks we often no longer attribute the views to him — the true test of a seminal contribution.

The normative half of Friedman’s paper has been less influential. Though his guiding principles here are well-accepted by most economists, his specific policy recommendations are held by only a minority. Most economists agree that monetary policy can be the source of a great deal of uncertainty and that monetary policy should be conducted in such a way as to provide greater stability in the economic environment. But at this point the agreement ends. Friedman takes the strong Monetarist position that central banks should target monetary aggregates because, first, such aggregates are most closely linked to the central bank’s policy instrument and, second, growth in such aggregates is ultimately what drives inflation. He goes so far as to advocate a constant growth rate for such aggregates. Most economists, however, take the view that monetary policy, though ultimately responsible for determining the path of inflation, is more successfully conducted by focusing on variables other than just measures of the money supply.

How has Friedman’s thinking influenced policy decisions in the world’s central banks? The adoption in Canada and elsewhere of formal inflation targets reflects both the influence of Friedman’s positive arguments and the controversy surrounding his normative arguments. These central banks have apparently adopted Friedman’s arguments that the long-run effects of monetary policy are only on nominal variables, especially on the rate of inflation. Sustained inflation is widely viewed as being fundamentally a monetary phenomenon. However, though these same central banks probably accept Friedman’s point that monetary aggregates are more closely linked
to the central bank’s policy instrument than is the rate of inflation, they also realize that instability of money demand makes strict monetary targeting an ineffective way to conduct monetary policy. Since inflation is ultimately driven by monetary policy, there is some obvious sense in making it the formal target of the policy.

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Friedman’s “The Role of Monetary Policy” has fundamentally altered the way academic macroeconomists and policy makers think about what monetary policy is able to do as well as how it should be conducted. It was instrumental in putting me on track for getting my macroeconomic thoughts in order. And I’m not alone. Friedman’s ideas have earned a central place within the core of macroeconomic principles that we teach to thousands of undergraduates every year. It has been on my reading lists at McGill — both graduate and undergraduate courses — since I began, and I see no reason why it will be removed. I re-read it every few years and am amazed at the new (or perhaps forgotten) insights that I receive each time. I encourage all who have an interest in monetary policy, and even those who don’t, to spend a comfortable hour revisiting this wonderful paper.