‘He Has Set a Standard’

By Milton Friedman

Over the course of a long friendship, Alan Greenspan and I have generally found ourselves in accord on monetary theory and policy, with one major exception. I have long favored the use of strict rules to control the amount of money created. Alan says I am wrong and that discretion is preferable, indeed essential. Now that his 18-year stint as chairman of the Fed is finished, I must confess that his performance has persuaded me that he is right—in his own case.

His performance has indeed been remarkable. There is no other period of comparable length in which the Federal Reserve System has performed so well. It is more than a difference of degree; it approaches a difference of kind. For the first 70 years after it opened in 1914, the Fed did far more harm than good, presiding over inflation in two World Wars, converting a moderate recession into the great depression, and then, in the 1970s, producing the most serious peacetime inflation in our nation’s history. We would clearly have been better off for those 70 years if the Federal Reserve System had never been established.

In 1979, Paul Volker was named chairman of the Fed (he had been appointed to the board by President Carter three years earlier). The great inflation of the 1970s was still raging and became a major issue in the 1980 presidential election. After the election, Ronald Reagan encouraged Mr. Volker to take whatever measures were necessary to tame the beast. Supported by President Reagan, Mr. Volker broke the back of inflation, in the process producing a recession. The recession produced a public reaction that seriously lowered the president’s popular standing. Fortunately, President Reagan did not waver in his support, reappointing Mr. Volker to a second term. He later appointed Alan to succeed him as chairman.

Figure 1, below, shows what a difference ending inflation made. It plots the year-to-year percentage change in the price index used to deflate the Gross Domestic Product. I use the price index because the key responsibility of the Fed is to keep the price level stable—and it is one source of Alan’s success that he recognized that effects. By greatly reducing the uncertainties, enterprises could use their resources more efficiently and steadily. Price stability fostered innovation and supported a high level of productivity. Figure 2, which plots every month of recession as a vertical line, is one way to illustrate the effect. Of the 379 months from January 1948 to Volker’s accession, 17.4% are months of recession; of the 220 months of Greenspan’s tenure, only 7.3% are.

Impressive Achievement

FIG. 1: PERCENTAGE CHANGE IN DEFlator, 1948-2005

FIG. 2: RECESSIONS, 1948-2005

Greater price stability had far-reaching

It has long been an open question whether central banks have the technical ability to maintain stable prices. Their repeated failures to do so suggested that they did not—whence, in part, my preference for rigid rules. Alan Greenspan’s great achievement is to have demonstrated that it is possible to maintain stable prices. He has set a standard. Other central banks around the world, whether independently or by following his example, are following suit. The timeworn excuses for central bank failure to stem inflation will no longer do. They will have to put up or shut up.

Mr. Friedman, the 1976 Nobel laureate in economics, is a senior research fellow at Stanford’s Hoover Institution. This is the second in a short series this week on Mr. Greenspan.