

Marketplace



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'Ben Bernanke promised Milton Friedman that the mistakes of the Great Depression would not be repeated. Has he broken that promise?'

On 12 July 2002, at a 90th birthday reception organised by the University of Chicago, one leading economist promised another economist of even greater fame: "Regarding the Great Depression, you're right. We're very sorry. But, thanks to you, we won't do it again."

The leading economist was Ben Bernanke, who at that time had been a governor of the US Federal Reserve for four months. He was making a commitment, on behalf of the Fed, to Milton Friedman that it would not repeat its blunders of the Great Depression. Friedman and his co-author, Anna Schwartz, had shown in the classic *A Monetary History of the USA* that an almost 40 per cent fall in the quantity of money had been responsible for the drastic plunges in US output and employment in the early 1930s.

When Bernanke made his promise, he could not have known that in late 2008, the US would be confronted by a crisis in financial markets with some resemblances to that of late 1929. As Bernanke is thought to admire Friedman, he would have been expected to follow his advice to prevent a slump. Friedman died in 2006, but every economist knows a key message of the *Monetary History*. This was that the Fed should have organised expansionary open-market operations (i.e. operations to boost the quantity of money) in the early 1930s and that, if again confronted by a comparable challenge, expansionary open-market operations should be the first item on the agenda.

In the heat of the immediate crisis, Bernanke behaved as if the *Monetary History* were his favourite bedtime reading. Between September 2008 and January 2009, the Fed purchased hundreds of billions of dollars of commercial paper, causing rapid expansion of both the quantity of money as such (currency and bank deposits held by the public) and the monetary base (the banks' own cash reserves).

For nearly all his career, Friedman had focused on the M2 money measure as the lynchpin of macroeconomic analysis. In the five months from mid-September 2008, M2 jumped by 7.5 per cent. That may not sound like much, but—if that post-September pace of monetary growth had continued for a full year—M2 would have been up by more than 20 per cent. If the lessons of history meant anything, 2009 would not be like 1930. Full marks to Bernanke and his Fed colleagues.

But, while at that stage of the crisis no one could have complained about Bernanke's actions, his vocabulary would probably have annoyed Friedman, who waged a war of words against most other economists (and not a few non-economists), with an insistence that what mattered was "money", not "credit". He repudiated the claim that bank-lending was important to expenditure by pointing out that a money balance could be spent many times, whereas a loan financed a purchase only once.

In early 2009, Bernanke wanted market participants to know that his objective was *not* to raise the *quantity* of money. When commentators referred to the Fed's asset purchases as *quantitative* easing, Bernanke tried to correct them by saying that they should instead be described as *credit* easing. The emphasis on credit had its roots in Bernanke's academic work, where he had devised a "credit channel" approach to monetary economics. In this approach, little or no attention is paid to the quantity of money and outright sneers are directed at so-called "broadly-defined measures of money". Broadly-defined money includes *all or nearly all* bank deposits, with M2 as a leading example.

As 2009 has gone by, it has become increasingly clear that Bernanke is not interested in the quantity of money on any definition. To the extent that he relates practice and theory, his focus is on the credit variables of which he was so fond in his academic work. The nearest contemporary analogue to the quantity of money in *Monetary History* is actually the very broad measure, M3. The Fed stopped publishing M3 numbers in 2006. But since then, independent analysts at the research firm, Shadow Government Statistics, have put together a private M3 series.

The latest M3 numbers are a horror story. In late 2008 and early 2009, this measure of money continued to grow, but since June M3 has started to fall. The rate of decline has not been as extreme as in the Great Depression (typically about one per cent a month), but it has been at about half of one per cent a month. Has Bernanke broken his promise to Friedman? Will recession and deflation persist in the world's largest economy? This year will be interesting for the American economy and the commentators who debate its ever-changing fortunes.