Milton Friedman and the financial crisis of 2008[1]

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Abstract

We find Milton Friedman, in part, guilty of leading to the monetary meltdown of fall 2008, at least, that is, his ideas, concerning gold, the Fed, monetary policy, flexible exchanges rates and other elements of international financial arrangements. However, contrary to the views of some Austrian economists, we take the position that had his 3% rule for the annual expansion of the money stock been followed by the Fed, the Austrian Business Cycle of late 2008 would not have occurred.

Key words: Gold; Austrian business cycle; Milton Friedman; monetarism

JEL Codes: E3, E32

INTRODUCTION

Is the intellectual legacy of Milton Friedman responsible for the fiscal crisis of 2008? Like the two handed economist of stage and screen, we answer "yes" and "no." On the one hand, he *is* guilty of contributing to the thinking of most mainstream economists on issues such as the appropriate level of aggregation for macroeconomic analysis (he actually used a more aggregated analysis than Keynes), gold, the depression of the 1930s, flexible or floating exchange rates and support of the Federal Reserve System (the Fed). And on those issues his analyses have been wrong; the policy prescriptions he thought followed therefrom have been deleterious. On the other hand, had his policy prescription for the money stock been followed (a slow and steady increase at an annual rate of about 3-5%), it is our view that it would not have given rise to the present Austrian Business Cycle (ABC).

In section II we put forth our thesis: Friedman, that is, his ideas, is indeed responsible for our financial meltdown, in general; however, his specific 3% monetary increase rule

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for the Fed is not. Section III is devoted to several objections. We conclude in section IV.

THESIS

Let us consider some of the specifics, as the “devil is often found in the details.”

Why gold? This precious metal serves as a check on the avaricious, greedy tendency for government to grab up more and more of the nation’s wealth. They have only three ways of doing so, other than straight out confiscation, compensated or not – just ask Mrs. Kelo: taxation, borrowing and inflation. The recent massive bailouts will at most be financed only partially with additional taxes. Moreover, the American private sector and the U.S. Government are pretty much borrowed out – any credit financing would have to come in large part from foreigners, especially foreign governments and Sovereign Wealth Funds. That leaves inflation, the most insidious of the three techniques. With gold as money, the Federales’ ability to raise money in this manner would be severely truncated. Yet Friedman was all his life a staunch opponent of the gold standard, much to his discredit as a free enterpriser.

His analysis of the 1930s depression (Friedman and Schwartz, 1963) is also problematic in this regard. He ignores the huge, but unwarranted, credit expansion of the 1920s which set the stage for the economic debacle, and, instead, focuses on the fact that the Fed allowed the money stock to decrease by about one third during the Great Depression. His prescription for the Fed during a crisis (we can extrapolate and infer he would take such a position at present) is by all means *do not allow anything like that to happen again*.[2] Such is Friedman’s stature in the economics profession that we need have no fear that Ben Bernanke will ignore this analysis and advice. No, the monetary base has skyrocketed as of late, and the expectation is for more of the same. Yes, ordinarily, the Friedman public policy calls for a slow steady growth in money. But, during a crisis, he was a bitter opponent of monetary deflation, and thus a champion of price inflation.

[2] “…Ben Bernanke apologized to Friedman publicly for the Fed's failure to inflate during the early 1930s and promised it would not make the same mistake again.” See Bernanke 2002. http://www.libertyasylum.com/FreidmanMyth.htm

But as Ron Paul asked Fed Chairman Ben Bernanke: "How in the world can we expect to solve the problems of inflation, that is, the increase in the stock of money, with more inflation?"[3] And according to F.A. Hayek: "To combat the depression by a forced credit expansion is to attempt to cure the evil by the very means which brought it about; because we are suffering from a misdirection of production, we want to create further misdirection – a procedure that can only lead to a much more severe crisis as soon as the credit expansion comes to an end."[4] Or, to put this is much more practical terms, you cannot put out a fire started with gasoline, by pumping more gasoline onto it.

In the international arena, Milton Friedman was a champion of flexible or floating exchange rates between the different national fiat currencies. He based this on the idea that fixed exchange rates would be akin to price controls, anathema to all supporters of free enterprise. At least with fixed exchange rates in international trade there is a limit on inflation on the part of all the countries in the world. Unless they inflate in tandem, an unlikely event over any extended time period, those with the loosest monetary policy will face balance of payments problems. Not so with flexible exchange rates. Here, the currency of the inflationary countries will tend to decline in value, but this is less likely to serve as a barrier to inflation. So, again, Milton Friedman allies himself with the forces of easy money and inflation.

Now, for the “other hand” side of this issue. First, Milton Friedman was interviewed[5] in 2006. At the very end of the interview, Friedman does say that the Fed cannot be expected to stick to his monetary rule. However, he does not apologize for long advocating this system. This Nobel Prize winner said that he should have leaned more heavily on Public Choice Theory, and realized that no group of high paid bureaucrats who sought prestige would confine themselves to limiting money stock increases to anything like the 3-5% range. That is all to the good. And, so is the fact that *had* this advice been followed (Friedman, 1960), it is unlikely that we would now be facing the sort of economic meltdown besetting us. Indeed, strict adherence to this rule would

[3] http://www.whiskeyandgunpowder.com/Archives/2007/20071113.html
[4] http://www.lvrj.com/blogs/vin/Attempts_to_prevent_liquidation_once_the_crisis_had_come.html
[5] http://www.reason.com/news/show/38384.html; we owe this cite to Jeff Herbener. Also, see this pertinent interview with Friedman: http://www.econlib.org/library/Columns/y2006/Friedmantranscript.html; we owe this cite to James Chappelow, and Christopher Westley.

have made the U.S. currency by far the strongest, hardest (e.g., least inflationary) in the entire world.[6]

Do we favor Friedman's Fed rule for a 3% annual monetary growth? Indubitably not. First, we urge the abolition of the Fed in its entirety (Rothbard, 1962), and its replacement with a 100% gold backed dollar, with no fractional reserve banking,[7] no legal tender laws, no monopoly of the mint, etc.[8] Second, even this modest increase in money will have deleterious effects. Resources will be misallocated, and will continue to be misallocated (Block, 1999). But this will resemble, more, a low grade fever, where we do not grow as fast (or even decline gradually), and are not as prosperous, as we could have been in the absence of Friedman's pernicious 3% rule. Call it a series of minor recessions if you will, but the Friedman rule will not give rise to anything like the monetary debacle from which we are now suffering, as of fall 2008. It is a staple of Austrian Business Cycle Theory (ABCT) that *any* change in the fiat money stock that flows through the credit market will eventuate in a misallocation of resources.[9] But, it is a misinterpretation of this view to claim that even a very *slight* increase thereof[10] will call forth the ABC.

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[6] See on this Gwartney, Lawson and Block, 1996, table 1a, pp. 244-246; Gwartney, and Lawson, 2007, pp. 39-181

[7] In fact, we go further. We oppose the intertemporal carry trade; i.e., the practice of borrowing short and lending long, of which fractional-reserve banking is but one form (Barnett and Block, 2008B).

[8] If we abolish the Mint, legal tender laws, etc., how do we propose to outlaw the intertemporal carry trade unless there is an extremely ruthless government bureaucracy regulating everything? Indeed, how do we get to a 100% gold backed dollar in the first place? Fractional reserve banking historically was not the product of government but of the market. What is to prevent banks from engaging in this behavior without regulation? Our answer to these questions, posed by a referee of This Journal, is that yes, of course, we favor regulation: against murder, theft, rape, arson, and, why not also fraud, of which of borrowing short and lending long (including fractional reserve banking) is an aspect? Presumably, the forces of law and order, whomever they may be, can take care of all such lawlessness. But this does not imply "regulating everything." It merely requires that criminality be put down (to specify precisely how this would occur would take us too far from our present concerns.) It cannot be denied that fractional reserve banking historically was not the product of government but of the market. But the state allowed this criminal behavior to occur, and even encouraged it. In any case, if private crime takes place, this is all the more reason to favor its extirpation. What will prevent banks from engaging in this behavior is precisely regulation, of the sort that protects against fraud and theft.

[9] No change in gold money results in a cycle regardless of the nature of the change; e.g., jewelry to coins or vice versa, and how the change is effectuated; e.g., lending or spending any new gold money into existence or removing from the supply of credit and stock of money, any interest or principle payments by making jewelry out of the coins so repaid.

[10] See section III of this paper, below.

OBJECTIONS

What might a critic of Austrian economics say to the foregoing? Here are some possibilities:

A. Since there exists economic growth, over the long-term a stable currency base will cause deflation *unless* it is generally offset by a precisely equivalent rise in the velocity of money. This is not generally a problem except that existing contracts all presuppose inflated money and thus not only a change in velocity but also in the money supply. This would require a one-time contractual downward adjustment to all contractual interest rates. Otherwise, it will be impossible for debtors to meet their obligations and creditors will realize an unanticipated and ill-gotten gain on their investment merely because of the switch. This switch will cause a misallocation of resources because deflationary times will result in many contracts going "underwater" unless this downward adjustment occurs (it is necessary for such contracts to be such that they will generally anticipate reducing the principal faster than the projected deflation or else you end up with underwater contracts, which may lead to strategic default). It is true that this can be alleviated by increasing down payments but we must deal with the transition and a conversion to the ABCT would be disastrous unless these considerations are made. It is for this reason that a Friedman 3%-5% solution is a preferred intermediate solution with full-backed Austrian gold standard only occurring some 30 years in the future. Friedman was anything if not practical and presumably would agree with this prescription as a precondition for even *considering* a gold standard.

The second point raised is one of prudential judgment: gradualism vs. immediacy / instantaneity. People act on expectations. *Anytime* someone acts upon what turns out in retrospect to be incorrect forecasts, resources are misallocated. First, this objector maintains, "existing contracts all presuppose inflated money." This is a conjecture on his part. Certainly, historically low rates of interest, both currently and for some time past, would seem to contradict this position. There is no way to recover from the disastrous situation we find ourselves in (circa 2011) without recognizing the massive mis-allocations of resources, both past and present, by reallocating them in accordance with real preferences, in contradistinction to their apparent preferences as seen through the

lenses of artificial interest rates, and accepting the financial losses which are the counterpart of these economic losses. Moreover, it is not at all clear who the winners and losers are and would be. Currently, many responsible people who worked hard and saved for the future are forced to accept either negative real rates of return on their savings or speculate in the hope of at least maintaining their capital in real terms. Furthermore, gradualism is what turned the depression that began in 1929 into the Great Depression that lasted for more than a decade. We contend that had the government followed the same type of policies it followed in the "depression of 1920-1921," what became the "Great Depression of the 1930s" would be known, instead, as the "depression of 1929-1930/31." Second, his point is similar to Fisher's Debt-Deflation theory. The idea is that excessive debt results in deflation which causes depression. This may be true, but it tells us nothing about the duration and severity of the depression. Allowing markets to work, without increasing or decreasing the amount of fiat money/credit is the best way to shorten a depression caused by excess leverage resulting from increased fiat money/credit.

As to Freidman "considering" gold as money, this is unlikely in the extreme, certainly not on the basis of any such assumptions as posed in this objection. Freidman's antipathy to the gold standard is of such severity, and long duration that, in our opinion, there is virtually nothing that would have changed his mind on this matter.[11]

VIOLATION OF ABCT

"As people adjust their expectations to the 3% rate of monetary expansion, the nominal and real interest rates will inevitably rise and some investment projects will be revealed as unsustainable. The Fed will then be faced with a dilemma: increase the rate of monetary expansion to push interest rates down again to avoid recession or stand pat and allow the recession to occur. The recession may be minor, but it will occur sooner

[11] For Friedman's withering criticism of gold as money, see Freidman (1960). For an Austrian critique, see Barnett and Block, 2009C, Block, 1999.

or later."[12] (Obviously, this refers to a fiat-money expansion, as there is no way any government can maintain a commodity-money expansion at 3% or any other rate.).

One reaction of ours to this possible criticism (made by a fellow Austrian economist) is that this constitutes more of a verbal dispute than a substantive one. What this critic says about expectations cannot be denied. But, we are choosing to call what would ensue a “low grade fever,” while he characterizes it as a “minor recession.”

But there is a substantive point involved here, too; two of them, actually. First, there is the continuum issue (Block and Barnett, 2008A). As stated, our critic’s view cannot be maintained. For, suppose that Friedman’s rule was changed from a 3% annual money growth to an annual money growth of 0.0000003%. To give you some idea of the magnitudes involved, according to the St. Louis Fed, M1, currently, is approximately $1.5 trillion. The percentage we hypothesized, arguendo, would mean an increase of some $4,500 in the first year, and $4,500.0000135 in the second year, etc.[13] It seems absurd to insist that the consequent misallocation of resources that would result from such a policy, even if significant to the individuals suffering therefrom, would be of much consequence from an overall point of view of the economy, much less of a magnitude to cause a business cycle. The point is, if our critic is correct, a “minor recession” would follow even such a trivial increase in the money stock, and that is just plain wrong.

Second, there is the distinction that must be made between praxeology and thymology in Austrian economics. From a praxeological point of view, there is no reason to think that even if *everyone* adjusts their expectations to a 3% rate of fiat-money expansion that their expectations about price inflation or other relevant variables will converge. This is the case if for no other reason than that relative prices change and different individuals buy different goods. Moreover, in such a situation there is no a priori reason to think that both nominal and real interest rates will increase. To the extent that such a policy reduced uncertainty, it can be expected to reduce real interest rates, in

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[12] "But even if the money supply is increased just sufficiently to prevent a fall in prices, it must have basically the same effect on the structure of production as any other expansion in the quantity of money not 'justified' by an increase in output" (Hayek, 1984. p. 94); see also Skousen (1990, pp. 355-56).

[13] If the money stock is $15 trillion in year one, and it increases by 0.000000003% ($4,500) the next year, year two, it will be $15 trillion + $4,500. If it again increases by 0.000000003%, the increase will be $4,500 + $0.0000315, or $4,500.0000135

general, although real world barriers to perfect arbitrage might prevent such a result from being universal. And, the nominal interest rate premia over the relevant real interest rates might be expected to be 3%, but again there are barriers to arbitrage and differences in expectations about price inflation, even given identical expectations about fiat-monetary growth.

Moreover, in our thymological judgment, particularly assuming, arguendo, Friedman's supposition of a 3% annual real growth rate in the economy, his plan for the Fed would not result in anything deserving the name "recession." That is, we are now involved in an *empirical* dispute with our critic, not one involving Austrian principles. Just how serious an economic disruption would occur? As a matter of prudential judgment, our critic is far more pessimistic than we are on this issue.

With regard to this objection, what we have is a disagreement about an empirical issue. There is no doubt that, in the Austrian tradition, lending new fiat money into existence, no matter how tiny the amount, causes a misallocation of resources, and that the greater the quantity of new money so injected in a given time period the greater is the misallocation of resources.

However, not all such injections cause a business cycle. For example, we cannot believe that any rational man would think that, with our current monetary system, an increase in the money stock of $1 per year would cause a business cycle, even if this increase were to continue ad infinitum. So there are two empirical issues. First, in a particular society what rate of growth of the money stock would be the minimum that would cause a misallocation of resources of sufficient magnitude to be worthy of the designation "business cycle?" (This would, in our opinion, vary depending on the specific details of the injections.) Second, could and would a government be able to limit itself, and its accomplices, to sufficiently low such rates that it would not eventually exceed the relevant limits and set off a business cycle?

Although, obviously, we do not know the answer to the first question, but suspect that Friedman's 3% rule, strictly adhered to, might be very near, though below, the critical limit. Of course, we may well be wrong, and it might be significantly higher than that limit. Nevertheless, unless one is prepared to argue that a $1 increase in the fiat money

system each year is sufficient to set off an Austrian Business Cycle, one must admit that this is not a matter of praxeology, but, rather, an empirical matter. The answer, then, depends upon evidence not currently available or likely to become available, as no government has ever followed Friedman's rule, nor does it seem at all likely that any one will do so in the future. So we are left to speculate.

As to the second question, we think history provides the clear answer: NO!

Disclaimer: Nothing in the foregoing should be read to mean that we support Friedman's analysis or his policy prescription; on the contrary, we favor 100% commodity money or monies, as individuals may freely choose, and oppose fractional-reserve banking, as well as the practice of financial intermediaries borrowing short and lending long (Barnett and Block, 2008B).

But our fellow Austrian economist is not the only one to call our analysis into question. An unusually active and insightful referee of this Journal poses this challenge to our views:

> "I am unclear as to what it means to say that 'As people adjust their expectations to the 3% rate of monetary expansion, the nominal and real interest rates will inevitably rise and some investment projects will be revealed as unsustainable.' If by this it is meant that if people adjusted to a 3% rate of monetary expansion based on the presupposition of a gold standard, then, yes, nominal and real interest rates would rise with the inevitable inflation (the real interest rate would rise due to increased volatility of individual investments as inflation rises and the nominal interest rate would rise with inflation). However, if we begin with the current regime of fiat money, then I do not understand this statement. A 3% rate of monetary expansion guaranteed by law should reduce both nominal and real interest rates dramatically as inflation would fall to near 0% given the long-term growth pattern of the economy is about 3%."

We respond to this query as follows. Insofar as this point is concerned, the referee only has a problem re fiat money. First, no government can "guarantee" a "3% [or any other] rate of monetary expansion. Moreover, even if governments could guarantee a 3% increase in the monetary stock, changes in the financial sector (and other factors) have in the past, and almost certainly will in the future, affect the degree of hoarding (aka the velocity of money). Second, fiscal and regulatory policies affect rates of real growth. Therefore, even if people were to adjust their expectations to a 3% rate of growth of fiat money, there is no reason to think that their expectations as to other variables would converge. Furthermore, given changes in hoarding and possible fiscal

and regulatory changes that could affect real growth rates, it is not at all clear what would happen to nominal and real interest rates. It is hard to imagine that current (2011) nominal rates at historically low levels and negative real rates would or could fall "dramatically." Nominal interest rates are set in credit markets and, to the extent they exist objectively, so are real rates. Buyers and sellers of debt agree to credit transactions based on a number of factors, not merely the rate of growth of the fiat money stock.

This referee also objects to our analysis on these grounds: "Friedman also supported the 100% reserve system, so there is really a question about the quote from Hayek: 'But even if the money supply is increased just sufficiently to prevent a fall in prices, it must have basically the same effect on the structure of production as any other expansion in the quantity of money not "justified" by an increase in output.' Under a 100% reserve system and, assuming constant velocity of money, a money supply increase that would be sufficient to prevent such a price decline would absolutely be justified only by the equivalent increase in output. Therefore, I don't understand the rationale for this quote and question whether it is misapplied to a fractional reserve system (which Friedman opposed)."

Here is our response: the Hayek quote has nothing to do with 100% reserve banking. Rather, it concerns an increase in the stock of fiat money barely sufficient to keep prices from falling in a growing economy. Hayek's point is that: "The expectation that prices will not change calls forth an excessive rise in output for the future…. In just the same way as in the cases previously discussed, however, the quantities of present goods which producers want to obtain at the given price [sic] will not be available, precisely because of the expansion of output for the future" (Hayek, 1984, 93). That is, Hayek makes the case that an increase in the stock of fiat money barely sufficient to maintain a constant level of prices in a growing economy with "[t]he expectation that prices will not change" nevertheless distorts the structure of prices in such way as to cause an inter-temporal misallocation of resources. Therefore, regardless of whether there is 100% reserve banking or fractional-reserve banking, an increase in the money supply that maintains

price level constancy nevertheless causes a business cycle, assuming always that the magnitudes involved are sufficiently large.

ANALOGY FROM MINIMUM WAGES

"… Next you'll tell me that increasing the minimum wage by a dime does not necessarily cause unemployment. Well, OK, but why in the world would one make such an argument on a libertarian site?" Our answer to this objection is as follows. More apt would be raising the minimum wage from *zero* to $3.00 per hour. There would be some unemployment created if this were done, but it would be very small. How many workers, after all, have labor productivies between these two points? Indeed, even raising it from zero to $5.00 in the present situation wouldn't create much unemployment (except for child labor, mentally handicapped) in our *empirical* judgement. We are talking prudential judgement, keeping a sense of proportion, here, not praxeology. In contrast, raising the present minimum legal wage by a dime would eventually unemploy thousands of people whose productivity lies between the old minimum wage and the new one.

FISHER

Your thesis supports "Fisherism-Friedmanism as versus Mises, Hayek, Rothbard, and Hazlitt. These latter economists can be wrong, but not on inflationism and the business cycle…". We are not at all communicating if anyone thinks this is an issue of Fisherism-Friedmanism versus Mises, Hayek, Rothbard, and Hazlitt, at least not in our view. As we see matters, the first objection, supra, holds, in effect, that if the Fed increases the money stock by so much as $1 per year, this will cause a "minor" ABC. The present authors, in sharp contrast, are saying that this is silly. Yes, an increase in the money stock by $1 per year will give the economy a (*very* slight) fever in the form of mis-allocated resources, but that this won't rise to the level of an ABC, not even a "minor" one. In a sense, all this constitutes a verbal dispute. However, there is a substantive dispute, too, as concerns proportionality. Consider the following: Michael Jordan jumps high into the air in order to dunk a basketball. Now, at this point in time, there are not one but two things that are true:

1. The mass of the earth is distorting space-time in such fashion as to pull Michael Jordan back to the earth with its gravitational force.
2. Michael Jordan's mass is distorting space-time in such a fashion as to pull the earth back to *him* with *his* gravitational force.

However, this superlative athlete has a mass of only some 100 kilograms. The earth, in sharp contrast, has a much greater mass, approximately $6 \cdot 10^{24}$ kilograms. Yes, it cannot be denied, *each* of these bodies exerts a gravitational force upon the other. But, as anyone with a modicum of common sense will acknowledge, the disparity in their masses is so overwhelming as to render the ignorance of one of these "forces" a reasonable one. That is, we may safely ignore the second of the two propositions above.

We suggest that, just as in the Michael Jordan gravitational case, a tiny increase in the money stock will indeed have deleterious effects, but, we insist, *very small* ones, just as this basketball player exerts on the entire planet. As long as the government can maintain its 3% annual money stock increase, no ABC will likely emerge. ABCs come about only when the Fed is forced, due to fear of runaway inflation, to cut back. But, our thymological expectation is that a 3% money increase would not be sufficient to do this. This is particularly true when we realize that such an annual rise in the money stock would be, by far, the lowest of all national currencies. This would render the U.S. dollar the hardest of hard currencies in the entire world. It is difficult to see what forces would compel such a Fed to pull back, thus creating an ABC. The Friedmanian 3% rule would cause a slow fever for the economy. It would not be as vigorous as otherwise it might be. But, his rule would not give rise to an ABC.[14]

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[14] Shostak (2008), with which we are in full agreement, comes close to being relevant to our concerns, but does not quite fully connect with our present paper. He states: "Let us, however, make the unrealistic assumption that the central bank is successful in maintaining the money-supply rate of growth at a fixed number. Will this lead to economic stability as suggested by Milton Friedman? . . . We have seen that printing money always creates false nonproductive activities. So if the fixed-money rule were to be enforced, over time it would lead to the expansion of false nonproductive activities. This, as we have seen, is going to weaken the wealth generators and thus undermine the real economy. The longer that Friedman's rule is implemented, the worse it is going to be for wealth generators and hence for the foundations of the economy. At some stage, once the percentage of false activities surpasses the 50% mark, the economy is going to collapse. . . . We can thus conclude that Friedman's monetary rule is another way of tampering with the economy; it cannot lead to economic stability."

INNOVATION AND ABUSE OF FINANCIAL DERIVATIVES IN WALL STREET

Is it possible that the innovation and abuse of financial derivatives in Wall Street has been responsible for the present economic debacle, and not any of the considerations (fractional reserve banking, fiat currency, the FDIC, legal tender laws, absence of the gold standard) which form the mainstay of Austrian economic analysis? If so, this would serve as a condemnation of the present paper. In our view, this is not likely[15] true. Let us try to address this important issue.

What are financial derivatives? They are financial instruments that rely for their value on the prices of the constituent elements of which they are comprised. A mutual fund is a company whose main purpose is to own stocks in, and bonds of, other firms, as well as cash, money market instruments and other such holdings. It is not usually thought of as a financial derivative, but it fits the criteria thereof. Simple derivatives include futures, forwards, options, and swaps. What all these have in common is that they are attempts on the part of market participants to reduce risk. But this is just the tip of the iceberg. In the modern era, at the beginning of the teen decade, there are numerous very complex financial derivatives, an examination of all of which would take us too far afield for the purposes of the present paper. However, it is incumbent upon us to address the question of whether or not they are responsible for the present economic meltdown, contrary to our thesis.

Although this can only be a general presumption, given that we are not scrutinizing the entire gigantic panoply of financial derivatives, there are reasons to think this is not the case. First and foremost, they all consist of voluntary contractual arrangements. Market participants necessarily gain, in the ex ante sense, whenever they give up something as part of a trade, for something they value even more. This sort of arrangement makes bad straw for the bricks of economic debacle. Second, "Financial

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The reason Shostak (2008) is orthogonal to our concerns is that he does not address himself to a Freidmanite type rule calling for an exceedingly *small* increase in the money stock, as we have done, supra.

[15] Our reservation does not involve the typical anti market critiques of these institutions. Rather, there are so many of these, many but not all are relatively new, and complex, we have not yet determined whether or not any of them run contrary to our concerns about time mismatching. See on this Barnett and Block, 2009A, 2009B.

derivatives are not new; they have been around for years" (Siems, 1997), some, even, since the time of Aristotle. Given the truth of this statement, it is difficult to understand why they would only be creating the havoc for which they have been charged in recent times. Third, as a generalization, financial derivatives are methods of shifting risk from those who do not wish to bear it, and are willing to pay others for the service of taking it off their hands, and to those who are willing to take on these responsibilities, for a fee. If it is not disruptive for some people to clean the houses of others who do not wish to do so, for a payment, or to repair the automobiles of those who are unable to do so, for a fee, why should be so when it comes to the shifting of risk? Fourth, puts and calls, short selling and other speculative actions via financial intermediaries help set proper prices not only for tractors, but far more important, for actual firms, via the stock market (Murphy, 2006A, 2006C). Fifth, according to Murphy (2006B), "Just as varying inter-*regional* prices serve to efficiently allocate goods and services over space, so too do varying inter-*temporal* prices allocate them over time." Yet, without future and forward markets, also aspects of financial derivatives, generation of these latter prices would be rendered far more difficult. In a world where futures markets were prohibited by law, this sort of allocation would be faced with the difficulties that Mises (1922) pointed out would afflict central planners of the economy. Consider one last example, the credit default swap. Here, people arrange insurance with each other, to allay the risk of a bankruptcy. Why this should end up creating a depression, as opposed to entrepreneurs attempting to protect themselves from one, is not easy to see (Murphy, 2009, *Wall Street Journal*, 2010). Contrary to the critics of financial derivatives, they tend to bring about economic efficiency, not mayhem.

CONCLUSION

At the time of this writing, there is a brou-ha-ha at the University of Chicago[16] over the issue of whether or not a new institute named after Milton Friedman ought to be inaugurated. The campus lefties are up in arms in opposition, blaming this Nobel Prize Winner in Economics for many, many things. Well, one thing they cannot blame him for

[16] http://www.chicagotribune.com/business/chi-tue-friedman-protest-oct21,0,1125996.story

is this: if the Fed had followed his 3-5% annual increase in money advice, we would likely not be in as severe an economic recession as we are now suffering from.

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