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REMEMBERING MILTON FRIEDMAN
A EULOGY

John Greenwood

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Remembering Milton Friedman - A Eulogy

By John Greenwood

About the Series

The *Studies in Applied Economics* series is under the general direction of Professor Steve H. Hanke, Founder and Co-Director of the Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise (hanke@jhu.edu). This working paper is one in a series on currency boards and monetary systems. The working papers will fill gaps in the history, statistics, and scholarship of the subject. The authors are mainly students at the Johns Hopkins University in Baltimore.

About the Author

John Greenwood is the Chief Economist at Invesco Ltd., a global asset management company. As editor of the *Asian Monetary Monitor* over the period 1977-96, he is widely credited as the designer of the restored currency board system in Hong Kong at the time of the currency crisis in 1983, a model for numerous subsequent currency board systems. Holding an MA and Honorary Doctorate from the University of Edinburgh, he is the author of "Hong Kong's Link to the US Dollar – Origins and Evolution" (Hong Kong University Press, 2007). He has been a Fellow at the Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise since June 2016.

Abstract

Milton Friedman is widely known as a brilliant teacher and theoretical economist, but he was also intensely interested in the practical application of his theoretical analysis. In this eulogy, given at the Institute of Economic Affairs (I.E.A.) in London soon after Friedman's death, I recall two striking examples of these aptitudes. First, anticipating the breakdown of the Bretton Woods system of fixed exchange rates, he advocated the introduction of currency futures by the Chicago Mercantile Exchange. These instruments have subsequently become indispensable for portfolio managers and currency traders around the world. Second, although Friedman was renowned for his advocacy of floating exchange rates, he was also at the same time an

advocate of fixed exchange rate systems, or currency boards, for small open economies. This idea led to his direct involvement with the stabilization of the Hong Kong dollar after its collapse in 1983. Friedman's mastery of academic economic analysis no doubt reinforced his confidence in the implementation of those ideas.

REMEMBERING MILTON FRIEDMAN

John Greenwood[1]
A Talk Given at the Institute of Economic Affairs, London
December 14, 2006

I was privileged to meet Milton Friedman when I was a student in Japan in 1969. The lecture that he gave that August afternoon in the Nihon Keizai Shimbun Hall in Tokyo on “Monetary versus Fiscal Policy” had a profound impact on my thinking. He inspired me to undertake economic research in Japan, and this decision set the course for my career. He remained an unfailingly loyal friend and supporter for the next 37 years.

Tonight, I want to discuss two related topics in economic analysis that will illustrate Friedman’s extraordinary ability to combine the most rigorous of academic arguments with the practical application of those ideas in the real world – currency futures and exchange rates. Many academics are happy to develop a theory, but when it comes to implementation they often step back and leave that to others. Not Milton Friedman.

Friedman became well known from the early 1950s onwards for his advocacy of flexible exchange rates. By the late 1960s and early 1970s his academic advocacy had become a one-man campaign to end the Bretton Woods system of fixed but adjustable exchange rates (and the periodic crises they created), and to replace them with floating exchange rates. Much to the consternation of central bankers he predicted not only that the shift to floating exchange rates was inevitable, but also that this eventuality would be highly desirable. Variable (but relatively stable) exchange rates had after all been the subject of his famous article, “The Case for Flexible Exchange Rates,” twenty years earlier in 1953.[2]

Perhaps less well known is that this advocacy positioned him to become the intellectual godfather of financial derivatives. This came about because he clearly foresaw – ahead of other economists of the day – the imminent demise of the Bretton Woods system. But he did not stop there. He also foresaw that to deal with some of the practical consequences of exchange rates that were free to vary on a day-to-day basis, traders, bankers, businessmen and investors would need wide and deep markets in currency futures, which until then had not existed. (Forward contracts arranged by banks already existed, but this was essentially an OTC market limited to substantial bank clients with approved trade transaction requirements, not a market based on a formal exchange where anyone could hedge or speculate at will.)

In the words of the Chicago-based lawyer and founder of the Chicago International Money Market, Leo Melamed: “I asked him [Friedman] whether he would endorse – when Bretton Woods collapsed – the concept of futures contracts in foreign exchange. Without hesitation, Dr. Friedman embraced the concept and authored a study in December 1971 which became the intellectual foundation for the birth of currency futures. It was not a major treatise, hundreds of pages long with footnotes and a bibliography. The world-renowned economist stated all he

[1] Mr. Greenwood is Chief Economist of Invesco. Between 1977 and 1996 he was the publisher and editor of the *Asian Monetary Monitor* in Hong Kong.
[2] Friedman M. (1953), *Essays in Positive Economics*, University of Chicago Press, Chicago, U.S.

needed in just 11 pages. His paper, entitled 'The Need for Futures Markets in Currencies,' provided us with academic authenticity of the highest magnitude to prove that our theory was a viable necessity. As I have often stated, Professor Friedman gave my idea the credibility without which the concept might never have become a reality. For with Dr. Friedman's paper in hand, I was able to convince government officials, bank presidents and the brokerage community of the Chicago Mercantile Exchange that the idea had merit."

In effect Friedman created the intellectual framework for the extension of futures markets from their agricultural base (wheat, pork bellies, and the like) to financial instruments. Five months later, in May 1972, the Chicago International Money Market opened. Futures in gold, interest rates, Treasuries and stock indices followed, and in time the modern world of derivatives and risk management was born.

To give some of the flavour of that paper it is worthwhile to quote Friedman's concluding paragraph: "To summarize this analysis: changes in the international financial structure will create a great expansion in the demand for foreign cover. It is highly desirable that this demand be met by as broad, deep, as resilient a futures market in foreign currencies as possible in order to facilitate foreign trade and investment. Such a wider market is almost certain to develop in response to the demand. The major open question is where. The U.S. is the natural place, and it is very much in the interests of the U.S. that it should develop here. Its development here will encourage the growth of other financial activities in this country, providing both additional income in the form of services, and easing the problem of executing monetary policy." Most of these predictions have proven correct.

The other topic that I want to focus on this evening is Milton Friedman's position in the debate on fixed versus floating exchange rates. In particular I want to illustrate Friedman's versatility and his intense interest in real-world problems by telling you about his involvement with the fixing of the Hong Kong dollar in October 1983. As many of you will know, after a decade of floating between November 1974 and mid 1983, Hong Kong faced a currency crisis that caused the Hong Kong dollar to plunge 40% in the space of a couple of months. Living in Hong Kong at the time I had studied the problem extensively and published several papers on the topic in *Asian Monetary Monitor*, a bi-monthly journal. Among other solutions I had proposed a restoration of the old currency board mechanism that had been used in British colonies and elsewhere – essentially a fixed exchange rate system with 100% foreign exchange reserves as cover for the local banknote issue.

I had made little headway with the currency board proposal in the preceding year or two, so when the crisis came in September of 1983, like Leo Melamed, I sought out the strongest academic backing for my proposal that I could muster. Among others I consulted Alan Walters and Maxwell Fry, but I also consulted Milton Friedman. In his autobiography with Rose Friedman, *Two Lucky People,* he recounts his role: "John was on the phone almost nightly conferring […] with me on the details of the proposed reform" (p.326). Milton was pleased to have what he called a ringside seat, and had numerous helpful suggestions, especially on the detailed mechanics of the proposal.

So here we have the best-known academic advocate of floating or flexible exchange rates consulting with me on, and promoting, a fixed exchange rate system for Hong Kong in 1983, barely a decade after the demise of Bretton Woods whose collapse he had cheered on from the sidelines. Moreover, as we know he later became a strong opponent of the single currency for the European region. How to explain these apparently contradictory positions?

Simple really! Circumstances alter cases. One clue was in the words he used to describe the Hong Kong episode in *Two Lucky People*: "The monetary reform," he wrote, "led to the Hong Kong dollar being ***unified*** with the US dollar." In effect he was willing to back a thorough-going monetary union between a small territory and a far larger economy, and particularly a small economy like Hong Kong where there was a high degree of flexibility in prices, wages and so on. But the case for a monetary union between two or more larger economies with a range of rigidities in pricing and institutional practice was by no means so clear-cut.

Valuing personal and economic freedom above all, Friedman could see that the benefits to a small, *highly externally oriented* market economy like Hong Kong would bring benefits far outweighing the costs of any alternative system. By contrast, for much larger, well-established and more rigid (one might even say sclerotic) economies in Europe he could see that adherence to a single currency would eventually imply surrender of economic and possibly even political freedom and sovereignty to the much larger entity of the currency union.

I have argued that Friedman's ability to combine powerful, academic theories with contributions to the practicalities of markets (such as currency futures and exchange rate mechanisms) was rare in economists. I will miss him as a friend, as a supporter, mentor and teacher. We will all miss his exceptional ability to convey a complicated analysis in simple, layman's terms.

Thank you.