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Ghost Story VI: John Williams Meets Paul Samuelson and Milton Friedman

M. Scott Niederjohn, Mark C. Schug, and William C. Wood

Authors' Note: This article is the sixth installment of a "ghost story" series by the same authors that has appeared in earlier issues of *Social Education*. In the first installment in 2010, former Federal Reserve Chairman Ben Bernanke was "visited" by the ghosts of Adam Smith and John Maynard Keynes. In later installments, Bernanke received visits from the ghosts of Keynes and of Milton Friedman (2012) and Keynes and Friedman again (2013). In 2015, Bernanke's successor at the Fed, Janet Yellen, was visited by two famous economists with opposing views—John Kenneth Galbraith and Friedrich A. Hayek—for a lively discussion regarding the direction of American monetary policy. In a 2017 special section on international economics, Mario Draghi, president of the European Central Bank ("Super Mario"), was visited by the ghost of an early member of the Austrian school of economic thought, Ludwig von Mises, and the always-relevant ghost of Keynes. In our latest story, the new president of the Federal Reserve Bank of New York, John Williams, is visited by two Nobel Prize winning economists, Paul Samuelson and Milton Friedman.

[The dialogues in each of these articles provide teachers with a ready-made reader's theater script for classroom use and a summary of the economic concepts involved.]

Jerome Powell is the chair of the Federal Reserve Board of Governors (his essay appears elsewhere in this special section)—but who is John D. Williams? As the president and chief executive officer of the Federal Reserve Bank of New York, he plays a critical role in the operation of the nation's monetary policy. Since 1936, the Federal Open Market Committee (FOMC) has annually selected the Federal Reserve Bank of New York to execute transactions using its Open Market Trading Desk ("the Desk") to influence interest rates. Thus, the FOMC decides what action to take regarding interest rates, but it is the New York Fed that has to make it happen.

How does it do that? If the FOMC decides it wishes to increase interest rates, it authorizes the Desk to sell Treasury securities to banks. In accepting banks' payments, the Federal Reserve ends up drawing down the banks' reserves and reducing their ability to make loans. Therefore, the FOMC's sales of Treasury securities tightens up the money supply and raises interest rates. If the FOMC decides instead to reduce interest rates, the Desk purchases Treasury securities to provide banks with more reserves, enhancing their ability to make loans, and loosening the money supply. The Desk continues its buying or selling of securities to maintain the FOMC's target interest rate.

Williams and Powell are serving the Fed in challenging times. President Trump has seriously questioned the actions of the Fed, an action nicknamed "Fed-bashing," for following a multi-year policy of increasing interest rates. But Williams has more on his mind than presidential criticism. The U.S. economy is hot. When the final GDP growth statistics for 2018 come in, the growth rate is expected to be about 3 percent—almost double the growth rate since former President Barack Obama's last year in office. The unemployment rate remains low at 4 percent while more people enter the work force and the economy continues to add jobs.

Even with all this heat, the inflation rate remains low at 1.9 percent, very near the Fed's 2 percent target. Reports from the Bureau of Labor Statistics provide evidence of a slow but steady rise in wage growth of around 3 percent, following years of wage stagnation. Powell and the overall economy are in a sweet spot which is the envy of the world. What could possibly go wrong?

Setting the Stage: Challenges for Williams and the Fed

The Federal Reserve now faces two key questions: What action should the Fed take on interest rates? The Fed has been keeping interest rates extremely low in reaction to the 2008 financial crisis. The Fed always assumed that after the crisis had passed, at some point interest rates would need to return to a "neutral interest rate." In "Fed speak," that neutral rate doesn't fuel inflation nor does it slow economic growth. Returning to neutral after a long period of stimulative low rates runs the risk of slowing the economy too much. Adding to the case for caution are worries about a softening domestic housing market, slower economic growth in Europe and China, uncertainty regarding international trade policies, and a late 2018 slide in the stock markets.

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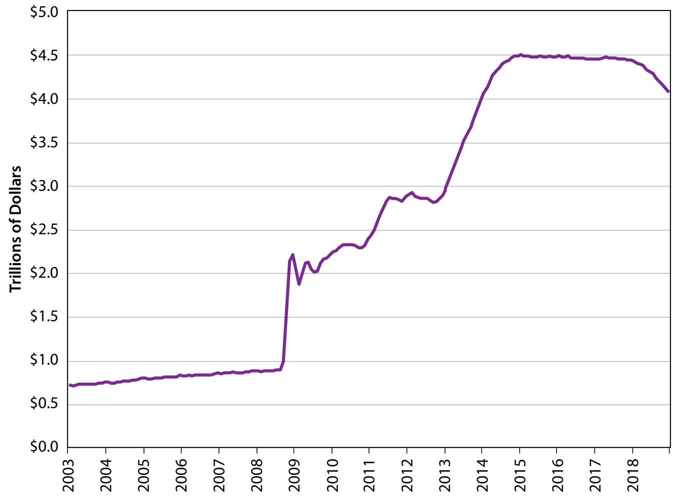
How can the Fed reduce the large amounts of financial assets that it owns? This concern centers on the Fed's enormous balance sheet, its listing of what it owns ("assets") and owes ("liabilities"). Right after pushing interest rates well below the neutral rate, the Fed bought large quantities of securities in a program referred to as Quantitative Easing (QE). In this effort to push more dollars to financial institutions to stimulate more lending, the Fed bought Treasury securities and mortgage-backed securities from banks and tucked them away on its balance sheet. While some economists worried that the Fed's bond-buying campaign would risk higher inflation and a depressed dollar, these did not materialize. Thus, Fed leaders take credit for QE being an important part of the remedy that brought an end to the Great Recession that hit in 2008.

But if QE contributed positively to the recovery, won't reversing that policy come with some negative consequences? Quantitative Tightening (QT) refers to the Fed's current draw-down of the securities in its balance sheet. The Fed wants to shrink its balance sheet with QT gradually and without disrupting financial markets. The Fed's balance sheet reached a peak of $4.5 trillion. Figure 1 shows what a large departure that amount was from past practices.

Under QT, the Fed is not aggressively getting rid of its securities. But it is letting as much as $50 billion of holdings mature every month. The Fed now has cash each month that it does not spend on buying U.S. bonds, and its balance sheet shrinks. Figure 1 shows that the Fed began reducing its balance sheet in October 2017. Since then, it has trimmed its bond portfolio by around $365 billion to $4.14 trillion.

How will it all turn out? No one knows for sure. "Normal" for the Fed would be higher interest rates and a smaller balance sheet. But how fast should the Fed proceed, and what will be the "new normal"? This is uncharted territory.

Figure 1. All Federal Reserve Banks: Total Assets

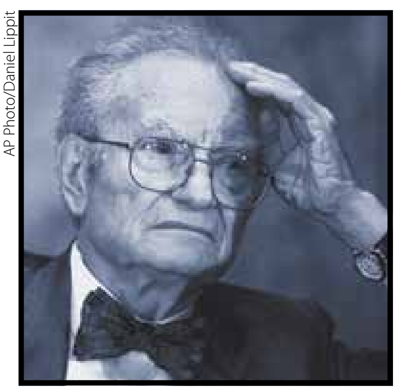


The Players

AP Photo/Manuel Balce Ceneta

John C. Williams, as mentioned previously, is the president and chief executive officer of the Federal Reserve Bank of New York. From 2011 through mid–June 2018, Williams was the president and chief executive officer of the Federal Reserve Bank of San Francisco, succeeding Janet Yellen, who later served as chair of the Federal Reserve Board in Washington.

Williams began his career in 1994 as an economist at the Board of Governors before moving on to the San Francisco Fed. Additionally, he has served as a senior economist at the White House Council of Economic Advisers and as a lecturer at Stanford University's Graduate School of Business. Williams has a PhD in economics from Stanford University, an MSc from the London School of Economics, and an A.B. from the University of California at Berkeley.

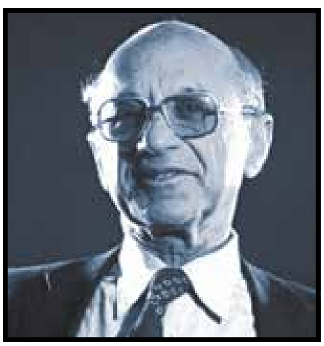


AP Photo/Daniel Lippit

Paul Samuelson was a highly renowned economist who spent most of his career teaching at the Massachusetts Institute of Technology beginning in 1940 at age 26. His popular textbook, simply titled *Economics*,[1] was for decades the most widely used economics textbook in the nation, beginning with its 1948 first edition. While primarily a college text on the principles of economics, it was also used in many high schools. Samuelson had a popular column in *Newsweek* from 1966 to 1981, where he debated Milton Friedman. He served as an economic advisor to President Lyndon B. Johnson and then to President John F. Kennedy, whom he advised to cut taxes to promote economic growth.

Samuelson was highly respected among economists for raising the level of mathematical analysis in the field. He also referred to himself as one of the few remaining economic generalists. His writing crossed many subfields of economics, from consumer theory and international trade to overall macroeconomic theory. In 1970, he became the first American economist to receive the Nobel Prize.

Samuelson is perhaps most famous for merging a classical belief in the powers of the free market with an argument for increasing government intervention in economic downturns. Samuelson's "neoclassical synthesis" thus combined ideas of Adam Smith dating back to 1776 with the 1936 ideas of British economist John Maynard Keynes. Samuelson reasoned that free markets worked well during periods of economic stability. However, he suggested the government should take action, including increasing spending or cutting taxes, when the economy was operating well below full employment. Samuelson's neoclassical synthesis on macroeconomics would have favored increased government stimulus spending such as occurred during the Great Recession of 2008.



AP Photo/Eddie Adams

Milton Friedman, along with his friend Samuelson, was one of the most influential economists of the twentieth century. Friedman spent most of his career teaching at the University of Chicago beginning in 1946. He was credited with bringing the Chicago school of economics to prominence. This group of Chicago-based thinkers produced numerous Nobel Prize winning economists, including Gary Becker, Robert Lucas, Jr., Robert Fogel and Ronald Coase. Friedman himself won the Nobel Prize in economics in 1976.

Friedman was widely known as the author of the bestselling book *Capitalism and Freedom*, in 1962. Although Friedman was highly respected for his mathematical and technical skills, in this book he used non-mathematical models to explore the role of government in a free society, with applications as varied as education and poverty relief. In retirement, Friedman was asked to create a television program presenting his economic thinking. Friedman and his wife, Rose, developed the series called *Free to Choose*, which aired on the Public Broadcasting Service beginning in 1980. The program became the basis of a bestselling book with the same title and has since been translated into 14 languages. He also served as an economic advisor to President Ronald Reagan and Prime Minister Margaret Thatcher.

Friedman was best known in economic circles for the 1963 publication of a book co-authored with Anna Schwartz, *A Monetary History of the United States, 1867–1960*.[2] Up until that time, most economists believed that the Great Depression was caused by some combination of the stock market crash of 1929, excessive borrowing to purchase stocks and consumer goods, excessive competition, overproduction of goods and services, and low farm prices and wages leading to an uneven distribution of income.

Friedman and Schwartz contended that the Great Depression was the result of the Federal Reserve's failed monetary policies. They argued that the Fed increased interest rates at the beginning of a mild recession when it should have been doing the exact opposite. Matters were made dire when the Fed failed to act as a lender of last resort as thousands of banks across the nation failed and the money supply plummeted. With impressive historical evidence, Friedman and Schwartz persuaded the skeptics and caused great consternation at the Federal Reserve.

Samuelson and Friedman were highly influential economists of their generation who shared a strong interest in economic education. Paul Samuelson died in 2009 and Milton Friedman in 2006. No contemporary economist has been as dominant in the public arena as they were.

The Scene: The Evening Before the Federal Open Market Committee Meeting

On a cool evening in March of 2019, John Williams sat at the desk in his Washington hotel room making final preparations for his report to the FOMC. At its meeting in January of 2019, the FOMC decided to place its plans for rate increases on hold. The members of the Committee continued to question and debate their interest rate moves at every meeting afterward.

Williams was confident in the policies the Fed had followed so far but he had always been a cautious man. The economy seemed hot but economic growth was slowing in China and Europe. The stimulus effect of the tax cuts passed in 2017 might be fading. And there were fears of tariff wars.

Williams shut down his computer, rubbed his eyes, and headed to bed. He fell asleep as soon as his head hit the pillow and dropped into a deep dream. In it, he wondered what actions other prominent economists would favor under these circumstances. He remembered studying the writings of Paul Samuelson, the founder of the macroeconomic neoclassical synthesis

Tossing over, he thought of a very different man—Milton Friedman. Williams knew that Friedman had been a severe critic of the Fed. For decades, the Fed had resisted Friedman's conclusion that placed the blame for the Great Depression on the Fed's mishandling of monetary policy. A smile crossed his face when Williams recalled what Ben Bernanke said at Friedman's 90th birthday party: "I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."

The Script: Dreaming about Money

Williams's dream that night may have gone something like this:

Williams: I think I may be seeing things. Professor Milton Friedman, is that really you?

Friedman: John Williams, I am honored to make your acquaintance. Call me "Milton." And congratulations on being appointed president of the Federal Reserve Bank of New York. You now have a lot of new responsibility for conducting the nation's monetary policy.

Williams: Wait, Milton. I believe that we are being joined by a second spirit. Paul Samuelson, is that you? What an honor it is to be in your presence.

Samuelson: Yes, here I am. Like Milton, I have followed your career carefully. And Milton, after all of these years, it is a pleasure to be in the same dream with you.

Williams: Gentlemen, thank you for showing up. While you are here, maybe you could give me some advice. You'd think people today would greet our low unemployment rate, low inflation rate, and healthy economic growth with good cheer. Some call it the Goldilocks economy, not too hot or too cold. I should be sitting on top of the world. Instead, from the president on down, the Fed seems to face criticisms from all quarters.

Friedman: I think you're on the right track with interest rates. Interest rates needed to be reset to more normal market rates after being held artificially low for so long. Producers and consumers needed to be nudged away from breathlessly following the Fed's every move. Fed interest rate policies should strive to be neutral. That is good for the economy in the long term.

Samuelson: I agree with Milton. The interest rate set by the Fed, the federal funds rate, should be neither so low that it overheats the economy nor so high that it slows economic growth. I think the FOMC took action at the right time, following the cautious leadership established by Janet Yellen.

Friedman: Of course, there could always be second-guessing, and I will indulge in a little of that myself. I was never a fan of bold interest-rate intervention by the Fed, and I think you should have moved back toward normal interest rates sooner than you did. Producers and consumers should base decisions on their own prospects and costs in the real economy, not on what the Fed may or may not be doing. But I know you at the Fed were in a tough place in 2008—that was the worst crisis we had faced since World War II. At least now the economy is healthy, unemployment is low, and prices are stable.

Williams: Yes, but there is another unintended consequence of higher interest rates that is not often discussed. My colleagues over at Treasury are worrying a lot these days. At the moment, I think they are pleased that we have hit the pause button on interest rates for now, at least.

Friedman: Let me guess why. Your Treasury friends are worried because the budgets adopted by Congress and the president call for spending much more than the Treasury receives in taxes. Those budgets can only mean increasing federal deficits and a rapidly growing national debt.

Williams: Yes, you hit the nail on the head. Higher interest rates mean that federal spending on interest payments on the debt will increase substantially. Because federal borrowing reduces the total savings in the economy over time, I worry that the private sector will have less money to invest. That, in turn, would result in slower economic growth, lower productivity, and lower wages.

Samuelson: I never worried that much about borrowing and spending in a crisis. At that point, you just want to get the economy going again. Even today, I think worries about federal spending and the hot economy are overblown. Look, inflation rates are still low, even a little below the FOMC's expectations. It seems that the economy might be able to handle lower unemployment than many current economists suspect. It doesn't make sense to worry about an overheating labor market when there is little sign of inflation. John, does that help you feel more confident with your policies?

Friedman: If I might chime in here, I would like to add a slightly different take on inflation. It seems to me the Fed has been overly reliant on the Philips curve—the view that inflation rises as unemployment declines below a level estimated to be consistent with stable prices. It seems to me that recent data are less supportive of this framework. Perhaps unemployment can decline a bit more without worry about overheating the economy.

Williams: Regarding inflation, you both make excellent points. We have had a long period of low inflation which has been helped lately by technological innovations and low oil prices. But as a member of the central banking community, I never stop thinking about price stability. That is always our focus, though we do have to keep an eye on maintaining low unemployment.

Friedman: Is it the Fed's extraordinary balance sheet that keeps you awake at night? Could that be the inflation time bomb?

Williams: Maybe. That is why we need to move cautiously. I agreed with the actions taken by Ben Bernanke pushing Quantitative Easing. At the time, we were faced with a real financial crisis that, to our embarrassment, neither the Fed nor economists in general saw coming. It was the worst financial collapse since the Great Depression of the 1930s.

Samuelson: I understand your need to react quickly at that point. As a Keynesian, I support the general notion that the government needs to take action in the time of crisis. And while stimulus spending may be appropriate on the fiscal side, the Fed also needed to take steps to avert a financial collapse.

Friedman: While I do not share Paul's enthusiasm for stimulus spending, at least the Fed under Ben Bernanke acted swiftly to reduce interest rates and to act as a lender of last resort to prevent bank failures. It is somewhat satisfying to see that some lessons were learned from the mishandling of the economy by the Fed back in the 1930s.

Williams: Thanks for your understanding. We have begun the process of reducing our balance sheet but this is new territory. Our models suggest that we can do this successfully over time. Still, they are only models. No one has ever done this before because such a situation has never existed before.

Samuelson: I see. You do not have a road map. Caution seems to be the word for the day.

Williams: Gentlemen, I value your advice and your wisdom. Thank you for visiting me in this unusual and confidential way. The media will never get a hold of this story.

Conclusions

Williams awoke the next day feeling better about the day's report. He was becoming surer that the FOMC could hold off interest rate increases for the time being. He was less sure what the exact neutral interest rate was or how long to extend QT. But there was time. Williams felt increasingly confident in a cautious step-by-step approach. Fortified by his visits from two of the all-time best thinkers in economics, he was ready to face his FOMC colleagues.

Notes

1. Paul A. Samuelson, *Economics*. (New York, N.Y.: McGraw-Hill Companies, 1948).
2. Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States 1867–1960* (Princeton, N.J.: Princeton University Press, 1963)

M. Scott Niederjohn *is Dean of the School of Business and Entrepreneurship and Charlotte and Walter Kohler Professor of Economics at Lakeland University, Sheboygan, Wisconsin, where he is also Director of the Center for Economic Education.* **Mark C. Schug** *is Professor Emeritus at the University of Wisconsin-Milwaukee.* **William C. Wood** *is Professor of Economics at the Director of the Center for Economic Education at James Madison University.*