At a celebration of Milton Friedman’s 90th birthday in 2002, Ben Bernanke, then a newly appointed member of the Federal Reserve Board of Governors, [said](http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021108/default.htm) “You’re right, we did it. We’re very sorry. But thanks to you, we won’t do it again”

Ben thought Milton had been right about the Great Depression. Until the early 1960s the common interpretation of the Depression was the Keynesian one, such as [that put forward by Peter Temin](http://fraser.stlouisfed.org/docs/meltzer/gandid77.pdf), where a switch in “animal spirits” had caused aggregate demand to collapse. Then, in 1963,   
Friedman and his colleague Anna Schwartz produced a radical new interpretation in ‘*A Monetary History of the United States, 1867 to 1960*’.

In this mammoth, exhaustively researched book, Friedman and Schwartz argued that far from money being ‘neutral’, as was thought at the time, fluctuations in the money supply were closely linked to fluctuations in output. So, if you wanted to stabilise output you had to stabilise the money supply. Monetarism was born.

But the books centrepiece, so much so that [it was released separately as a book](http://press.princeton.edu/titles/8754.html) in itself, was that covering the onset of the Depression, ‘The Great Contraction’. Here, Friedman and Schwartz claimed that a common or garden down turn (brought on by the tightening of monetary policy from 1928 which, they said, had triggered the Wall Street Crash) was turned into a Depression by the Federal Reserve allowing the money supply to shrink by a third between 1929 and 1933.

This, it was argued, had increased the real debt burden of businesses and individuals. As the money supply fell so did prices, this was deflation. Anyone who had debt to service had to service debts of fixed nominal amounts which had grown in real terms as the deflation set in, with money which had shrunk in value at the same time.

Though Friedman subsequently became linked with the fight against inflation he was also concerned about deflation. Friedman argued that a money supply which neither shrank nor grew too fast was needed to bring about the monetary stability which he saw a necessary precondition for economic stability. So while, in the 1970s, Friedman advocated slowing the increase in the money supply to tame inflation, in the early stages of the Depression, he and Schwartz argued, the Federal Reserve should have fought deflation by expanding the money supply.

That the Federal Reserve didn’t do this was, to Friedman, the cause of the Depression. It was the supposed truth of this insight that Bernanke was acknowledging in 2002.

Ben Bernanke spent his academic career studying the Depression from a Friedmanite perspective, producing [a dull but worthy book](http://press.princeton.edu/titles/6817.html) on the subject. When he took over from Alan Greenspan at the Federal Reserve in February 2006 the Great Moderation was still in full swing but when the downturn came in 2008 it would have been hard to find a more qualified man to have at the helm. It was a case of cometh the man cometh the hour.

In September 2008 Lehman Brothers collapsed, banks everywhere looked vulnerable and began hoarding cash. [The US broad money supply collapsed](http://www.shadowstats.com/alternate_data/money-supply-charts). Bernanke acted quickly to apply the lessons of the Depression he had learned from Friedman. As one reviewer of his book put it “He is practicing today what he preached in his book: Flood the system with money to avoid a depression”

The Fed Funds rate, which had already been reduced from 5.25% in early 2007 to 2% when Lehman tanked, was cut further [to a range between 0% and 0.25%](http://www.federalreserve.gov/monetarypolicy/openmarket.htm) by the end of 2008 where it remains today. Still, the money supply contracted.

In November 2008 Bernanke launched [QE1](http://www.bankrate.com/finance/federal-reserve/qe1-financial-crisis-timeline.aspx). Changes in the Fed Funds rate are facilitated by the buying and selling of short term dated securities to alter short term interest rates. Quantitative Easing works the same way except via the purchase of long term dated securities so as to bring down longer term interest rates.

QE1 was an unprecedented attempt to infuse tottering banks with liquidity and shore up the money supply. By the time it came to an end in March 2010 the Federal Reserve had bought $1.75 trillion of mortgage backed securities.

But still the money supply kept falling so in November 2010 Bernanke initiated QE2 which involved the purchase of $600 billion of Treasury securities. By the time QE2 docked in June 2011 the money supply had stopped shrinking. Indeed, it had returned to fairly brisk growth. Bernanke had made the moves straight out of Friedman’s playbook and staved off deflation.

But, apart from the Federal debt, the money supply was all that was experiencing brisk growth. GDP was slowing and unemployment remained stuck over 8%. Bernanke, with a theory of fighting inflation, was now coming under pressure to boost growth and employment.

He took over a year to arrive at his decision but last week Bernanke rolled the dice on QE3, an open ended commitment to spend 40 billion newly created dollars a month on mortgage backed assets until, well, until something turns up.

If you are going to do a job you need the appropriate tools. QE and the mass monetary intervention executed so far by Bernanke was designed to stop the money supply contracting. Eventually it did. But the money supply is not now contracting, [it is growing](http://www.federalreserve.gov/RELEASES/h6/Current/), QE is totally inappropriate now even on Monetarist grounds.

In desperation, with the economy stagnating and fiscal policy at its capacity, Bernanke, to the great relief of the Obama administration, is deploying a policy tool conceived and designed to achieve stability of the money stock, to boost the real variables of output and employment. Increasingly Bernanke resembles a golfer with one club. He’s stuck in a bunker and all he has is a driver.

<http://www.thefreemanonline.org/features/the-great-depression-according-to-milton-friedman/>