Keynesians and the Friedman critique in the 1970s

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« What is important for policy purposes is that even the [natural rate of unemployment hypothesis – NRH] is not inconsistent with the existence of a short-run trade-off between unemployment and inflation and hence with the view that an active stabilization policy can contribute to speeding the return of the economy towards equilibrium when it is subject to a variety of demand and supply shocks.” (Modigliani and Papademos, 1978)

The Keynesian economists of the late 1960s reacted in different ways to Milton Friedman’s critique of the Phillips curve. Whereas Robert Solow launched a crusade against the accelerationist approach and the conception of the natural rate of unemployment, Franco Modigliani or Robert Gordon seem to have rapidly incorporated part of Friedman’s analysis. This appears clearly in Modigliani and Papedemos’s (1978) paper on “Optimal demand policies against stagflation” or Robert Gordon textbook Macroeconomics (1978). These economists accepted the idea of an economy adjusting automatically to the natural rate of unemployment in the long run but argued that stabilization policies were still necessary to speed up the process. The process leading to the incorporation of Friedmanite ingredients in the Keynesian apparatus will be the subject of our inquiry. How did Gordon, Modigliani, James Tobin or Stanley Fisher consider Friedman’s conception of the adjustment towards a natural rate of unemployment? To what extent did they accept the idea? Did they already share part of this approach before 1968? Don Patinkin for instance assumed a self-adjusting economy as soon as 1956. And Samuelson and Solow (1960) mentioned the existence of a structural rate of unemployment in their seminal paper on the Phillips curve. We will follow the debates surrounding Friedman’s contribution until 1978 with a focus on the Keynesians that accepted at least part of Friedman’s reasoning. In so doing, we hope to shed new light on the history of macroeconomics during the revolutionary 1970s. The standard history presents the collapse of Keynesianism in the 1970s in the following sequence of events: Milton Friedman criticized the Keynesian understanding of the Phillips curve, this critique was rationalized by the New Classical economists and it led to the birth of a new form of Keynesianism in the 1980’s, “New Keynesianism”, adopting the methodological standard put forth by Robert Lucas. In this story, New Keynesianism was mainly a reaction to the New Classical claims about the ineffectiveness of monetary policy. As shown by Stanley Fisher and John Taylor, rational expectations were compatible with policy effectiveness if long term contracts hence price rigidities were taken into account. The problem with this story, according to us, is that it is totally silent about Keynesianism in the 1970s, that is between 1968 and the first “New Keynesian” contributions. In particular, the potted history does not allow to understand why in many textbooks still in use today and written by Keynesian economists, in particular the one by Olivier Blanchard, the natural rate hypothesis has become the core of the aggregate supply-aggregate demand model. We conjecture that New Keynesianism in the 1980s or the views of Keynesians trained at the MIT was as much the result of the process of absorption of the Friedman critique as a reaction to the policy effectiveness claims of the New Classical around Robert Lucas. In the work of Robert Gordon, for instance, adaptive expectations are put forward as an alternative to the rational
expectation approach of New Classical (see Gordon, 2011). In a way, Friedman is used to counter the New Classical.