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A Monetary and Fiscal Framework for Economic Stability: A Friedmanian Approach to Restoring Growth

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A Monetary and Fiscal Framework for Economic Stability: A Friedmanian Approach to Restoring Growth

by
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The title of this chapter is drawn from Milton Friedman's 1948 article, "A Monetary and Fiscal Framework for Economic Stability". (Friedman 1948) In that piece, he put forward what he thought was a new proposal according to which the government would run a balanced budget only at full employment, with deficits in recession and surpluses in economic booms. There was nothing too controversial about that—indeed, this view of the proper fiscal stance was incorporated into just about all post-war orthodox thought. In recent years, however, at least some economists have been supporting persistent budget surpluses. Indeed, in America over the past decade, the Democrats (led by President Clinton) decided to become fiscally responsible and have advocated permanent budget surpluses come what may.

But what was unusual was Friedman's "proposal" to finance budget deficits through money creation. Surpluses would destroy money. He thus proposed to combine monetary policy and fiscal policy, using the budget to control monetary emission in a countercyclical manner. He also would have eliminated private money creation by banks through a 100% reserve requirement, something that he had picked up from Fisher and Simons, hence, there would be no "net" money creation by private banks—they would expand the supply of bank money only as they accumulated reserves of government-issued money.

This proposal results in strong counter-cyclical forces to help stabilize the economy. However, Friedman could still be a good quantity theorist, because he could argue that it would be fluctuation of money, not government spending, that stabilized the economy. Further, his plan for countercyclical stimulus is rules-based, not based on discretionary policy.

In principle, there is nothing wrong with his article, except that at bottom it is not a proposal—it is just a description of what really happens (so long as we drop the 100% reserves idea). Abba Lerner called it the "functional finance" and "money as a creature of the state" approach. (Lerner 1943, 1947) When I first studied money and banking, Lerner's approach was still there, at least in an appendix. When government spends, it does so by creating "high powered money" (HPM)—that is, by crediting bank reserves. When it taxes, it destroys HPM, debiting bank reserves. A deficit necessarily leads to a net injection of reserves, that is, to what Friedman called money creation. Stephanie Bell and I have been trying to explain this in a series of articles, but have been making little progress because few can follow balance sheets any more. (Bell 2000; Wray 1998) Most have come to believe that government finances its spending through taxes, and that deficits force the government to borrow back its own money so that it can spend. However, any close analysis of the balance sheet effects of fiscal operations shows that Friedman (and Lerner) had it right.

Note that Friedman would have had government deficits and, thus, net money emission so long as the economy operated below full employment. Again, that is Abba Lerner's functional finance view, and I suppose it was adopted by just about everyone after WWII. But almost no respectable economist or politician will today go along with that on the

belief it would be inflationary and/or would bust the budget. Such is the sorry state of economics education today.

A Budget Stance for Long Term Growth

In Friedman's proposal, the size of government would be determined by what the population wanted government to provide. Tax rates would then be set in such a way so as to balance the budget only at full employment. To build in sufficient countercyclical swings to move the economy back to full employment requires two conditions. First, government spending and tax revenues must be strongly cyclical—spending needs to be countercyclical, and taxes pro-cyclical. This implies a strong social safety net so that transfer spending increases sharply in a downturn. Alternatively, or additionally, tax revenues also need to be tied to economic performance—progressive income or sales taxes could do the job.

Second, government needs to be big. Hyman Minsky (1986) used to say that government needs to be about the same size as overall investment spending—or at least, swings of the budget imbalance have got to be as big as investment swings. According to Minsky, government was far too small in the 1930s to stabilize the economy--even during the height of the New Deal, the federal government was only 10% of GDP. Today, all major OECD nations probably have a government that is big enough. I'll say more about state and local government in a minute because that complicates things. Based on current realities, it looks like the national government can range from the US low of less than 20% of GDP to a high of 50% in France. The countries at the low end of the range need more automatic fluctuation built into the budget.

Looking to the decade of the 1960s in the US, one sees that it was more-or-less consistent with Friedman's proposal, that is, the 1960s were Friedmanin. I know those are always called the Keynesian years, but actually they were more consistent with Friedman's proposal than with Keynes's policy prescriptions. (See Kregel 1994-5 and Wray 1994-5.) Federal government spending averaged around 18-20% of GDP, and deficits ran $4 or $5 billion a year, except for 1968 when they temporarily increased to $25 billion—but for the decade, deficits ran well under 1% of GDP on average. Yes, we could quibble about whether the US was at full employment in the 1960s; I would argue we weren't very close, but I'm in a small minority. On Friedman's 1968 ("natural rate" or even the Bastard Keynesian "nonaccelerating inflation rate of unemployment") definition, we must have been close. And, yes, one could object that it took a war on two fronts (Viet Nam and Poverty) to get spending up to 20% of GDP, so that might sound a bit more like military Keynesianism than rules-based Friedmanianism. However, the US almost always has at least one war going, so one could counter that the 1960s were not a major deviation from the rule because we tend to carve off a fairly large part of GDP to support wars.

In fact, military spending was much higher during the 1950s—peaking at 14% of GDP during the Korean War, and it was still at 10% in 1959. Over the 1960s, total defense spending remained a constant 8-9% of GDP, even with the Viet Nam war escalation. At best, we might say that the Viet Nam war build-up only postponed the fall of military

spending, which fell by half over the 1970s. At the end of the Reagan presidency defense spending got back up to 6%, but it fell by half again, to 3% by the end of Clinton's term. So compared with the Military Friedmanian 1960s, we lost up to 6% of GDP by cutting military spending in the post 1970 period and that is not likely to come back, even with the war against terrorism. However, while defense spending fell from 1970, total federal government spending remained fairly constant at close to 20% of GDP, with some cyclical fluctuation, until the late 1990s—so cuts of defense spending were matched by rising social spending.

The Post-1970 Period: Slow Growth and Rising Instability

We encountered three major problems over the course of the post-1970 period. Let me deal with each in turn.

The first is that the budget was not sufficiently countercyclical, and I suspect changes made over the 1970s and 1980s, and even into the 1990s made matters worse. While government spending did swing, typically by about 1-2% of GDP over the cycle, that was not enough to result in a sufficient stabilizing influence. As government became increasingly mean-spirited about the safety net, the problem was compounded. Looking at Bush senior's expansion and recession, the total swing of government spending as a percent of GDP was only 1%. By contrast, the swing during the recession of 1974-5 had been 1.5%. Over the period, federal tax revenue was never very cyclical, and became less pro-cyclical as we reduced progressivity. During the Reagan recession, federal receipts fell by about 1.5% of GDP; during the Bush recession, receipts fell very slowly, and by a total of only 0.8% of GDP. Still, it is true that deficits grew in the right direction, and remained fairly large as unemployment remained high. Just what Friedman wanted, although not of sufficient size.

What Friedman had not counted on was the growing and persistent trade deficit, reducing the impact of the government's deficit on unemployment. (No particular line of causation is implied, although it seems likely that the foreign desire to accumulate dollar-denominated assets is the underlying cause of the US trade deficit.) Recall that Friedman had wanted a balanced budget at full employment, which is fine so long as a nation has balanced trade (and no desire to net save domestically—as we'll see). At the aggregate level, the private sector's balance must equal the government's budget balance plus the trade balance—a budget deficit adds to a trade surplus to generate a private sector surplus. On the other hand, with a trade deficit, the budget deficit has got to offset it to avoid a domestic private sector deficit. If full employment coincides with a trade deficit of 5% of GDP (which seems to be the case in the US), then the appropriate budget stance is a minimum government deficit of 5% at full employment (ignoring the private sector's desire to run surpluses). Otherwise, full employment is unsustainable—for both flow and stock reasons. Let me leave state and local government to the side for a second. If the federal government has a balanced budget, and the trade deficit is 5% of GDP, then the private sector must have a deficit of 5% and the outstanding stock of private sector debt will also grow.

Without getting into more details, we can't say for sure whether the private sector's deficit will have to grow faster than its income, or whether the debt-to-income ratio will grow, both of which would make it obvious that this is not sustainable for long. But it is simpler than that. It just isn't conceivable that in the real world, as opposed to a modeled world in which just about anything can happen, that the private sector will spend more than its income year after year. Even if it is willing to deficit spend for some time, it will eventually want to reverse that so that it can accumulate savings and net wealth. (All the tax advantages bestowed upon savings, as well as loss of faith in Social Security and unbridled optimism about stock returns together enhance the inducement to save.) As the private sector tries to adjust its spending in line with income, the economy drops below full employment and a budget deficit will result (and the trade deficit might fall as income and demand fall). This means that a federal budget that is set to balance at full employment in an economy that runs trade deficits at full employment guarantees that full employment can only be rarely achieved, and only when the private sector runs sustained deficits.

The 1990s and Goldilocks Growth

In recent years, the US seemed to enjoy Goldilocks growth—neither too hot to cause inflation nor too cold to generate unemployment. Goldilocks growth appears to have been anti-Friedmanian. In spite of a huge and growing budget surplus in combination with a rising trade deficit, the economy boomed. As Wynne Godley has shown and as I've argued elsewhere, the US private sector ran increasingly large deficits during the last half the 1990s—which is just the other side of the aggregate balance sheet. If the government budget is in surplus and the trade balance is negative, then the private sector must run deficits. The Clinton expansion was, by no coincidence, the first time the US private sector balance ever went negative; and by the end of 2000, the private sector deficit actually reached over 6% of GDP. (Godley 2002; Wray 2000) By no coincidence, the private sector's debt-to-income ratio also reached an all-time record (the private debt stock reached almost twice disposable income by 2002). These results were guaranteed because of the tendency to run trade deficits whenever the economy grew, as well as by the government budget surplus that grew over the expansion. Things were made worse because the Clinton budget was actually biased to run large surpluses at full employment—rather than achieving a balance at full employment as Friedman had recommended.

Note that even if trade is balanced, we cannot have a private sector surplus unless the government has a deficit. Hence, Friedman's original specification requires no net or "outside" saving or net wealth accumulation by the private sector. All this means that our expectation would be that at full employment, the federal budget ought to be in deficit, and equal to the sum of the private sector's desired net saving (or surplus) plus the trade deficit. Since the mid-1980s the private sector's desired net saving has averaged something like 2-3% of GDP (with strong countercyclical swings, rising sharply in recession and falling in expansion). The balance of payments deficit has averaged some 1-2%, but with a rising trend, especially since 1995. This means that a "normal" or

structural government budget deficit of some 3-5% is required to keep the economy near to a full employment growth path.

However, the various budget agreements passed (mostly under Clinton) resulted in a budget that would run surpluses at even moderate rates of GDP growth. This is highly unstable and unsustainable because of impacts on the private sector's balance sheet. It is helpful to add Hyman Minsky's insights to Friedman's model to explain why Goldilocks was doomed. As is well known, Minsky analyzed each economic unit as a "money-in, money-out" entity. As he wrote in 1963, "each liability emitter attempts to arrange his receipts and spending so as to be able to meet his commitments." (Minsky 1963, p. 412) Minsky emphasized the important role played by margins of safety--that is, by the maintenance of a gap between money inflows and outflows, as well as a gap between assets and liabilities, and a reserve of liquid assets to be called upon should money inflows fall short of committed money outflows. In an expansion fueled by the private sector, these margins of safety would be (intentionally) reduced as an ever-increasing proportion of prospective income flows would be committed to servicing liabilities, and as the ratios of debt to net worth and of debt to liquid assets would increase. However, Minsky contrasted this with a government-spending-led expansion: "During a protracted expansion dominated by household and business deficits the ratio of household and business financial commitments to income rises, whereas in an expansion dominated by government deficits the ratio of private commitments to income decreases." (Minsky 1963, p. 412) Hence, not all expansions are created equal--an expansion that is led by private sector deficits is inherently unstable and unsustainable because "the greater the payment commitments relative to expected receipts the greater the reluctance and the smaller the ability of a private unit to finance its operations by deficits." (Minsky 1963, p. 412) When the prospective gain is outweighed by the reluctance and inability to undertake additional deficits, the private sector-led expansion must come to an end.

There is no fine rule governing willingness and ability to deficit spend. Prospective income flows, expected capital gains, interest rates and debt service ratios, confidence and euphoria, custom and attitudes toward risk and uncertainty, and expected continued access to credit on reasonable terms are all important determinants. Minsky devised a well-known classification scheme--hedge, speculative, and Ponzi--to describe three types of balance sheet positions. (Papadimitriou and Wray 1998) He argued that over the course of an expansion, economic units would take increasingly fragile positions, especially if the expansion were led by private sector spending. This would be reflected both at the micro level as income and outgo flows became more closely articulated, and at the macro level as the weight shifted from mostly hedge to largely speculative finance. Empirically, we could look at overall debt service ratios, at the ratio of private sector deficit spending to income, and at aggregate debt-to-disposable income ratios to obtain an idea of the fragility of the Goldilocks economy.

The Federal Reserve publishes data on the debt service burden, which includes only payments on consumer debt and home mortgages--but it is a reasonable proxy for the overall private sector burden. The debt service burden is determined by three factors: average interest rate paid, the debt stock, and income flows. In the US, a clear pattern

emerges: the debt service burden tends to rise over the course of an expansion, peaking at just above 14% before falling in recession. Note also that with only one major exception (the business cycle that included the Bush, senior, recession), monetary policy (as measured by the fed funds rate) has little impact on the debt service burden. Swings of the debt service burden are not normally correlated with swings of the fed funds rate. In other words, rising debt service burden is not (primarily) due to rising interest rates but rather can be attributed to growth of debt at a pace faster than income flows. The debt service burden in the US reached above 14% by the end of the Goldilocks expansion—as is normal.

As mentioned, another important measure of aggregate fragility would be the ratio of private sector debt to disposable income. In the US, we experienced rather rapid growth of the debt ratio over the Goldilocks years, reaching an all time high by 1998, and then continuted growth to higher and higher record peaks. The outstanding debt stock grows when the private sector deficit-spends. The debt ratio increases when the rate of growth of private sector spending exceeds the rate of growth of its disposable income. In other words, if the private sector's deficit rises as a percent of its income, then the debt to income ratio will grow. While the Fed began to lower the fed funds rate sharply as the economy slowed, this has not succeeded in lowering the debt service burden because debt has continued to grow.

Hence, Goldilocks growth was an extreme example of Minsky's case of an expansion led by private sector deficits with public sector surpluses--implying deteriorating private sector balance sheets. Clearly, the expansion was unsustainable, but it could have gone on for an indeterminate period so long as borrowers and lenders allowed it to do so. While the dating of her demise could not be predicted with anything approaching accuracy, it was inevitable. If the expansion had instead been based on expansion of public sector spending relative to its income--that is by public sector deficits--Goldilocks could have been sustained for some time. Of course, Minsky always argued that stability is itself destabilizing--a sustained expansion fueled by public sector deficits would eventually change expectations in such a way as to encourage destabilizing behavior. In other words, Minsky never believed in fine-tuning, however, he emphasized that a growth path requiring ever rising private sector deficits would exhibit greater endogenous fragility than one fueled by public sector deficits that generated private sector surpluses (as in the 1960s).

Finally, since 1960, state and local governments have grown relative to GDP and relative to the federal government. In 1960, state and local government spending totaled about 40% of federal spending; that is now well over 60%. State and local governments taken as a whole almost always run surpluses. Only in the recession years of 1982, 1991, and 1992 did they run deficits, which isn't surprising, as most states are prohibited from running deficits by both their constitutions and by financial markets that downgrade their debt when they run current account deficits. As a result, during a slowdown, they must raise taxes and/or slash discretionary spending. In fact, they have mostly raised taxes because there isn't much spending that is discretionary.

For example, over the Bush, senior, recession years, from 1990-92 federal receipts rose by 6%, while state and local government receipts rose by 15%. While state and local government spending rose slightly more than 15%, they were able to keep total deficits to less than $10 billion per year. In contrast the federal budget deficit rose from $173 billion to almost $300 billion annually as spending growth outpaced revenue growth. Because state and local governments raise taxes as much as they increase spending in recession, and because state and local governments have regressive tax systems, they do not help to maintain demand in a countercyclical manner. In fact, they do the opposite. In expansion, they run up surpluses--$50 billion a year by 1999—which makes it even harder to achieve and maintain full employment because private sector deficits (and/or federal budget deficits) have to be that much greater. And then even in recession state and local governments try to maintain surpluses, or at least balanced budgets. In other words, because of the different financing situation faced by state and local government, to prevent large deficits from rising, they must raise taxes and/or cut spending precisely when fiscal stimulus is required. Prior to Clinton's welfare reform, they relied mainly on tax hikes so that they could cover needed social spending. This time around, they seem to be mostly cutting spending to avoid deficits.

Restoring Stable Growth

A lot has changed since Clinton took office—mostly for the worst, so far as Friedman's proposal goes. First, Democrats became "fiscally responsible" and gave the Republicans what they thought they wanted—a budget that would run huge surpluses at anything approaching full employment. Under Clinton, federal government receipts rose above 20% for the first time since WWII, indeed, receipts nearly reached the 1944 wartime peak. At the same time, federal government spending fell to about 17% of GDP—the lowest since the start of the Viet Nam build-up. Of course, federal budget surpluses were supposed to run as far as the eye could see, enabling the government to retire all debt and then to accumulate trillions of dollars of claims on the private sector. This gave candidate Gore his main campaign issue: a proposal to lock away surpluses, to be consumed later by retiring babyboomers. Ironically, this freed Republicans, who quickly disowned fiscal responsibility when they realized it amounted to a peaceful socialist revolution that would result in the government owning everything. So with Greenspan's blessing, they advocated tax relief for the rich as a counter-revolutionary measure to restore budget deficits and rightful ownership to the wealthy.

What can we do to halt the recession and to put the budget on sound, Friedmanian, footing?

First, we need tax relief. The Republicans were mostly right, but didn't carry tax relief far enough—the rich got just about the right amount of tax relief, but the Republican tax cut should have been supplemented with a permanent reduction of the payroll tax by at least a third, and up to a half. (Wray and Tcherneva 2001) I'd also increase the Earned Income Tax Credit (a sort of negative income tax for the working poor), and I support James Galbraith's proposal to increase Grants-in-Aid to states on the

condition that they reduce regressive taxes on a dollar-for-dollar basis. The total tax reduction should be in the $200-300 billion per year range.

Let us turn to spending.

When Clinton ended welfare "as we know it", and substituted lifetime limits in TANF (Temporary Assistance for Needy Families—the "welfare" program that replaced Aid to Families with Dependent Children), he virtually guaranteed that Federal spending cannot provide a big enough response to a recession. "Lifetime limits" is bad economics and bad social policy. It will shift more of the burden to state and local budgets for the simple reason that communities are not going to stand by and watch families kicked off the TANF roles. In addition to federally subsidized tax relief for state and local government, I'd provide additional federal aid to encourage state spending. I would make this a permanent program—maybe along the lines of an infrastructure bill I've been working on that would provide nearly $400 billion of interest free loans for state and local infrastructure projects. (Wray 2001) The bill would build up to that figure, adding $80 billion over each of the next 5 years. The timing of the spending could be made somewhat counter-cyclical. If local unemployment rates are below 1 or 2%, spending would be postponed.

To make the overall budget more countercyclical, and to ensure that jobs will be available when they are needed most, we need an employer of last resort (ELR) program—or, what has been variously called a public service employment program, or a job guarantee. (Forstater 2001; Wray 1998) Enough has been written about this that there is no need to go into the details, but if we look at typical swings of unemployment over the business cycle, we can get some idea of the countercyclical forces of an ELR program. The number of officially unemployed workers swung by about 4 million during the Reagan recession, and by about 3 million during the Bush recession. If we presume that additional federal spending on employing a worker in ELR above average spending on an unemployed worker is about $20,000 each (direct wage costs, benefits, and program costs, less unemployment compensation paid to the small percent of the unemployed that qualify for benefits), we come up with budget swings of $60 to 80 billion in recession.

The actual swing will probably be larger because most people who lose their jobs go out of the labor force rather than into the category called unemployed. If one looks at the Bush, senior, recession, and takes into account trend growth of the labor force, we were probably short at least 5 million jobs strictly due to the cycle, so ELR countercyclical spending might be as much as $100 billion a year. That is slightly larger than the size of cyclical fluctuations of private fixed investment, so by Minsky's measure, ELR might provide enough of an automatic stabilizer to offset investment fluctuations. I think we need to build more into the budget because what we used to call autonomous consumption (not geared to income and hence more subject to fluctuation) has become more important. A strengthened social safety net, with some of that taking the form of grants to States, would help. I'd like to see a more progessive tax structure, but the reduction of payroll taxes that I mentioned earlier might be enough.

Implications for Mexico

Many might wonder whether such a Friedmanian stabilization policy is possible for countries other than the US. In particular, I have heard many arguments to the effect that the US is unique because its currency is the (or one of the) world's reserve currency. Hence, the US might be able to run budget deficits as needed to stabilize its economy, but other nations are subject to "market discipline" and will not be able to run deficits as needed. This is presumably because the government might find itself unable to "borrow" to finance deficits. However, this is not correct for any sovereign nation that issues a sovereign currency—which cannot face such "market discipline", although it might impose on itself "discipline" that it believes to be coming from markets.

Mexico is a sovereign nation with the ability to issue a sovereign currency. When the federal government spends, it injects peso-denominated high powered money into the economy; most of this flows into the banking system and results in a reserve credit. Taxes drain banking system reserves. Hence, as Friedman argued, it is deficit spending by the government that leads to "money creation", that is, to net reserve credits. Government (treasury and central bank) sales of government bonds then drain excess peso reserves from the banking system. If this were not done, the Bank of Mexico would not be able to hit its overnight interest rate target because the excess reserves in the system would push the overnight rate toward zero. While the Treasury and Bank of Mexico may not realize it, the "government borrowing rate" can be set anywhere the government likes—it need not be (indeed, cannot really be) a market determined rate. While the Treasury and the Bank of Mexico might try to set the overnight rate in line with what they believe to be a market rate, this is really a case of the dog chasing its tail. Market rates necessarily are set relatively to the government's overnight rate (which is the base rate).

The budget stance together with Mexico's balance of payments position determine the private sector's balance. If the government were to run a budget surplus, there is naturally pressure on the private sector's balance—Mexico must run a larger balance of payments surplus in order to allow the private sector to run a surplus (to "save"). Minskian-type private sector fragility increases if the balance of payments surplus deteriorates to a deficit, especially in the presence of a budget surplus. A 1930s-style debt deflation is not out of the question, unless the government's budget surplus can be turned very quickly toward very large budget deficits. The problem is that the government is not likely to allow this to occur, for reasons to be discussed in a moment.

All of this should by now sound familiar after the analysis of the US case provided above. The only important difference between the US and Mexico on this score concerns exchange rate policy. The US allows the dollar to float more-or-less freely. This allows the US to pursue—if it chooses to do so—independent fiscal and monetary policy in accordance with the principles laid out by Friedman. The US does not need to accumulate large reserves of foreign currency to protect its exchange rate, hence, its budget need not be constrained by fear that economic growth will cause the trade deficit to rise. Nor does it need to keep interest rates high in order to keep the exchange rate

overvalued. And its government is not burdened by debt that is denominated in a foreign currency. The US government only issues debt denominated in dollars, and, as discussed above, only issues debt in an amount required to drain excess banking system reserves in order to hit overnight interest rate targets. In other words, government debt issues are not really a borrowing operation at all—no sovereign government needs to "borrow" its own currency in order to spend. Rather, deficit spending leads to net reserve injections; excess reserves are then drained through sales of dollar-denominated treasury securities. It would make no sense for the treasury to issue foreign-currency-denominated securities since the purpose of the security sales is to drain dollar reserves.

All of this applies to sovereign nations issuing sovereign currencies on a floating exchange rate. However, Friedman's proposal really cannot work in a nation that tries to peg its exchange rate, or which issues government debt denominated in a foreign currency. Such a nation would always fear that "net money creation" by the government would endanger the exchange rate peg and/or its ability to service the foreign-currency-denominated debt. Further, the overnight interest rate in a country with a currency peg is not ultimately exogenous because it must be set at a level that is believed to protect the exchange rate.

Unfortunately, Mexico finds itself in a self-imposed trap that prevents it from pursuing Friedman's proposal. It wants to keep a strong currency through fiscal and monetary constraint—that is through balanced government budgets and high overnight rates. Worse, its government has issued foreign-currency denominated debt, perhaps because it did not understand the purpose of treasury security sales. Ironically, the overvalued peso makes it difficult for Mexico to achieve the trade surpluses that would generate private sector surpluses, and that would make it possible to service the dollar-denominated debt the government and private sector firms issued. This increases pressure on the government to run fiscal surpluses and to privatize assets to generate peso and dollar revenues to service its debt. At the same time, "fiscal discipline" depresses economic growth, hinders investment that could make Mexico more competitive in the world economy, raises unemployment, depresses domestic demand (increases attempts by the private sector to run surpluses), and increases poverty. Because Mexico is committed to maintaining its exchange rate, national sovereignty is sacrificed.

It is ironic that both Monetarism and Market Liberalism are celebrated around the world today, and Milton Friedman is given credit for the role he has played over the past half century in winning the fight against Keynesianism. And yet, his plan for creating the monetary and fiscal framework that is necessary to achieve economic stability has been largely ignored. Without this framework, Market Liberalism cannot succeed because the "free market" requires stable economic growth at full employment before market forces can achieve allocative efficiency. Because his followers have ignored the required fiscal and monetary framework, they undercut the "free market forces" with "fiscal discipline", excessively high interest rates, foreign-currency-denominated debt, and pegged exchange rates.

Friedman was on the right track in 1948. In a sovereign nation with a sovereign currency, government deficits do inject HPM into the economy, some of which is drained through Treasury sales of interest-earning government bonds. This allows the private sector to run surpluses—or, net save. Because there are all sorts of reasons to expect the private sector to normally run surpluses, the long term budget stance of government should be biased to run deficits at full employment (except in modern mercantilist nations like Taiwan or Singapore that run perpetual and large trade surpluses). If we add to Friedman's insight the recognition that the US will run trade deficits at anything approaching full employment, the case for a "permanent" budget deficit is strengthened. It appears likely that Mexico will not run balance of payment surpluses in the near future. This means that its government will need to run budget deficits at full employment to allow the private sector to net save. By the same token, the notion that the federal government in either the US or Mexico ought to aim for persistent surpluses is exposed as a huge backward step in thinking. However, before Mexico can move forward, it must recognize the tremendous sacrifice of its sovereign power that it is making in the name of maintaining a "strong currency".

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