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**Friedman Would Be Roiled as Chicago Disciples Rue Repudiation**

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Professor John Cochrane



Professor Eugene Fama

Dec. 23 (Bloomberg) -- [John Cochrane](http://search.bloomberg.com/search?q=John+Cochrane&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) was steaming as word of U.S. Treasury Secretary [Henry Paulson](http://search.bloomberg.com/search?q=Henry+Paulson&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1)’s plan to buy $700 billion in troubled mortgage assets rippled across the [University of Chicago](http://www.uchicago.edu/) in September.

Cochrane had been teaching at the bastion of free-market economics for 14 years and this struck at everything that he -- and the school -- stood for.

“We all wandered the hallway thinking, How could this possibly make sense?” says Cochrane, 51, recalling his incredulity at Paulson’s attempt to prop up the mortgage industry and the banks that had precipitated the housing market’s boom and bust.

During a lunch held on a balcony with a view of Rockefeller Memorial Chapel, Cochrane, son-in-law of Chicago efficient-market theorist [Eugene Fama](http://search.bloomberg.com/search?q=Eugene+Fama&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), and some colleagues made their stand.

They wrote a petition attacking Paulson’s proposal, sent it to economists nationwide and collected 230 signatures. Republican Senator Richard Shelby of Alabama waved the [document](http://faculty.chicagogsb.edu/john.cochrane/research/Papers/mortgage_protest.htm)as he scorned the rescue. When Congress rejected it on Sept. 29, Cochrane fired off congratulatory e-mails.

The victory was short-lived. Lawmakers approved the plan four days later, swayed by what Cochrane calls a pinata of pork-barrel amendments.

“We should have a recession,” Cochrane said in November, speaking to students and investors in a conference room that looks out on Lake Michigan. “People who spend their lives pounding nails in Nevada need something else to do.”

Unusual Role

At the University of Chicago, once ascendant free-market acolytes are finding themselves in an unusual role: They’re battling a wave of government intervention more sweeping than any since the Great Depression as the U.S. struggles with the worst recession in seven decades.

By the end of November, the government had committed $8.5 trillion, or more than half the value of everything produced in the country in 2007, to save the financial system.

The European Union had ponied up more than $3 trillion to guarantee bank loans and provide capital to lenders. And China had unveiled a $586 billion stimulus plan and its biggest interest-rate cut in 11 years.

The intrusion is anathema to the so-called Chicago School of economics and its patriarch, the late [Milton Friedman](http://search.bloomberg.com/search?q=Milton+Friedman&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1).

Nobel Dominance

For half a century, Chicago’s hands-off principles have permeated financial thinking and shaped global markets, earning the university 10 Nobel Memorial Prizes in Economic Sciences starting in 1969, more than double the four each won by Columbia University, Harvard University, Princeton University and the University of California, Berkeley.

Chicago’s laissez-faire imprint underpins everything from U.S. President [Ronald Reagan](http://search.bloomberg.com/search?q=Ronald+Reagan&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1)’s 1981 tax cuts and the fall of communism that decade to quantitative investment strategies.

In 1972, Friedman helped persuade U.S. Treasury Secretary [George Shultz](http://search.bloomberg.com/search?q=George+Shultz&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), former dean of Chicago’s business school, to approve the first financial futures contracts in foreign currencies.

Such derivatives grew more complex after Chicago economists created the mathematical formulas to price them, helping spawn a $683 trillion market that’s proved to be a root of today’s financial system breakdown.

On Dec. 16, the U.S. Federal Reserve cut its target lending rate to as low as zero for the first time and said it will buy mortgage-backed securities.

Free Market

Friedman, who died in 2006 at age 94, defined the Chicago School in 1974 as he spoke to a board of trustees dinner.

“‘Chicago’ stands for a belief in the efficacy of the free market as a means of organizing resources, for skepticism about government intervention into economic affairs,” he said.

Friedman was explaining a movement that had taken hold in the U.S. and was percolating in Europe and South America.

“By the mid-1970s, there was a whole generation in government and academia who’d trained at Chicago or places influenced by it,” says [Ross Emmett](https://www.msu.edu/~emmettr/), a [Michigan State](http://www.msu.edu/) University professor who’s written three books on the school.

Today, 10 percent of Chicago undergraduates study economics. Alumni of Chicago’s graduate business school, now called the Booth [School](http://www.chicagogsb.edu/) of Business, run states and companies.

[Jon Corzine](http://search.bloomberg.com/search?q=Jon+Corzine&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), the former chief executive officer of [Goldman, Sachs & Co](http://www.bloomberg.com/apps/quote?ticker=GS:US). who earned his MBA in 1973, is governor of New Jersey. [Peter Peterson](http://search.bloomberg.com/search?q=Peter%0APeterson&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), who graduated with an MBA in 1951, co-founded [Blackstone Group LP](http://www.bloomberg.com/apps/quote?ticker=BX:US), the world’s largest private equity firm.

[David Booth](http://search.bloomberg.com/search?q=David+Booth&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), a 1971 MBA graduate for whom the school is now named, donated $300 million in November, the largest endowment given to the university.

Booth School

Booth, who founded Dimensional Fund Advisors Inc., bases his funds on Fama’s theory that a market digests information affecting prices so well that even professional investors can’t outsmart it for long. Even with his U.S. Micro Cap Portfolio fund down 40 percent in 2008 through Dec. 22, Booth says quantitative investing is less vulnerable during a slump than stock picking that relies on human judgment.

“This supports our theory in that predicting the market is even more difficult than we expected,” he says.

Unlike Booth, 62, much of the academic world is reassessing Chicago School hallmarks. That’s true even in the limestone buildings on the 211-acre (85-hectare) [Hyde Park](http://www.chicago.com/neighborhoods/Hyde_Park/) campus in which professors teach Friedman’s theories.

‘Systemic Orgy’

On Oct. 14, about 250 students and professors debated an administration-backed plan for a $200 million research [center](http://mfi.uchicago.edu/faq.mfi.shtml) to be named for Friedman. The protesters argued that the institute would enshrine policies that have brought economies near collapse.

“When Friedman’s Platonic ideas of free-market virtues are put into practice, they have too often generated a systemic orgy of competitive greed -- whose remedies, ironically, entail countermeasures of nationalization,” [Marshall Sahlins](http://anthropology.uchicago.edu/faculty/faculty_sahlins.shtml), an emeritus professor of anthropology, said during the debate, speaking in a room adorned with murals of female students parading through the campus in medieval gowns.

Sahlins, 77, noted a few weeks later socialist and capitalist countries alike are regulating or nationalizing financial institutions in a rebuff to Friedman.

Off campus, the global meltdown is stirring anti-Chicago economists, who were voices in the wilderness during decades of lax government oversight of markets.

[Joseph Stiglitz](http://search.bloomberg.com/search?q=Joseph+Stiglitz&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), who won one of Columbia’s economics Nobels, says the approach of Friedman and his followers helped cause today’s turmoil.

‘Bears the Blame’

“The Chicago School bears the blame for providing a seeming intellectual foundation for the idea that markets are self-adjusting and the best role for government is to do nothing,” says Stiglitz, 65, who received his Nobel in 2001.

[University of Texas](http://www.utexas.edu/) economist [James Galbraith](http://search.bloomberg.com/search?q=James+Galbraith&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) says Friedman’s ideology has run its course. He says hands-off policies were convenient for American capitalists after World War II as they vied with government-favored labor unions at home and Soviet expansion overseas.

“The inability of Friedman’s successors to say anything useful about what’s happening in financial markets today means their influence is finished,” he says.

Instead, Galbraith, 56, says policy-makers are rediscovering the ideas of his father, Harvard professor [John Kenneth Galbraith](http://search.bloomberg.com/search?q=John+Kenneth+Galbraith&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), and economist [John Maynard Keynes](http://search.bloomberg.com/search?q=John+Maynard+Keynes&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) of the University of Cambridge.

Keynes, who died in 1946, argued that governments should spend to combat the unemployment that free markets tolerate. Galbraith, who died in 2006, rejected mathematical models and technical analyses as divorced from reality.

Obama’s Role

[Barack Obama,](http://search.bloomberg.com/search?q=Barack+Obama%2C&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) who will referee the laissez-faire versus free-market debate as U.S. president, has pledged the largest spending on infrastructure since the 1950s to save or create 3 million jobs.

Obama, 47, has deep roots on the university’s campus in Hyde Park, a middle-class enclave 7 miles south of downtown Chicago. His Victorian house is a five-minute walk from the school’s northern edge. He taught constitutional law there for 12 years, stepping down when he was elected to the U.S. Senate in 2004.

Obama tapped fellow Chicago professor [Austan Goolsbee](http://search.bloomberg.com/search?q=Austan+Goolsbee&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) as staff director of his President’s Economic Recovery Advisory Board, which will propose ways to revive growth.

Goolsbee, 39, who was Obama’s chief economist during the campaign, has taught at the business school since 1995. Goolsbee says Obama’s top priority is to prevent the crisis from spiraling into a depression. Yet he insists Obama won’t overregulate.

‘Chicago School’ Democrat

“If the president-elect were not a ‘University of Chicago Democrat,’ then the natural response would be to just try to turn back the clock to what was there before,” he says.

“Because Obama comes out of a framework where the market is not the enemy, there’s a possibility we can create new institutions to guard against excess without going back to what was wrong in the old regime.”

Goolsbee supports bigger capital requirements for banks and other institutions that can borrow from the Federal Reserve, and wants expanded monitoring of hedge fund firms and ratings companies. Derivatives may need to be traded through clearinghouses, like those used in Chicago wheat pits, which act as counterparties for each trade and can suspend traders with insufficient collateral.

“Getting us out of the hole we’re in, promoting oversight and making investments so the economy can grow doesn’t make you anti-market,” Goolsbee says. “It’s totally pro-market.”

Already, some of the university’s top economists have abandoned hard-line Friedmanism for the middle ground.

[Douglas Diamond,](http://www.chicagogsb.edu/faculty/bio.aspx?person_id=158119) a finance professor at Chicago since 1979, declined to sign Cochrane’s petition damning Paulson’s bailout. Diamond says he knew the Sept. 29 vote against the rescue would spur investors to pull assets from banks. He says governments have no choice but to provide safety nets for banks and tougher oversight.

‘Crazy Stuff’

“The vote was the beginning of people believing crazy stuff, like the U.S. might find it politically expedient to let its financial system go,” Diamond, 55, says.

[Robert Lucas](http://search.bloomberg.com/search?q=Robert+Lucas&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), a Chicago economist who won a Nobel in 1995 for a theory that argued against governments trying to fine-tune consumer demand, says deregulation may have gone too far.

Depression-era laws that separated commercial and investment banks helped depositors decide if they wanted secure accounts or riskier investments. Today, without these distinctions, people can’t be sure if their investments, or those of their customers, are safe.

“I’m changing my views on bank regulation every week,” Lucas, 71, says. “It was an area I saw as under control. Now I don’t believe that.”

Lucas says he voted for Obama, the only Democrat besides [Bill Clinton](http://search.bloomberg.com/search?q=Bill%0AClinton&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) he’d supported in 44 years. He concluded the candidate was comfortable talking with professional economists. He describes Goolsbee, whom he has met in faculty workshops, as a serious scholar.

‘Survival of Fittest’

Chicago students seem less concerned about the debate swirling through their campus than with finding -- or keeping -- a job.

Milos Dedovic, an emigre from Serbia, is studying for his MBA at night. He works for[Continental AG](http://www.bloomberg.com/apps/quote?ticker=CON:GR), Europe’s second-largest auto parts maker, managing sales of transmission control modules to [General Motors Corp.](http://www.bloomberg.com/apps/quote?ticker=GM:US) Dedovic, 38, says his MBA will help make him secure even if he loses his job.

“If the economy is spiraling down, you get survival of the fittest, where skills and accreditation matter even more,” he says.

The university got its start in 1892 as a haven for researchers, not would-be managers.

[William Rainey Harper](http://www.lib.uchicago.edu/e/spcl/centcat/pres/presch01_01.html), a Bible scholar who taught at Yale, attracted oil magnate John D. Rockefeller as his benefactor. Harper broke with then prevailing Ivy League practices by hiring Jews, finance professor Fama says. By 1946, Chicago was luring stars such as [Enrico Fermi,](http://nobelprize.org/nobel_prizes/physics/laureates/1938/fermi-bio.html)father of the self-sustaining nuclear reaction.

Keynesian Orthodoxy

Friedman’s parents were Jews who emigrated from what’s now Ukraine. When he joined the faculty in 1946, he allied with [Friedrich Haye](http://www.hayekcenter.org/)k, a London School of Economics professor who later transferred to Chicago. They sought to discredit Keynes, who argued that deficits in government budgets could revive demand in recessions. They viewed rising government power as a step toward left-wing totalitarianism and wanted to stop it, says [Philip Mirowski](http://www.nd.edu/~pmirowsk/), a University of Notre Dame economist.

Friedman challenged Keynesian orthodoxy with work that culminated in a [Nobel Prize](http://chronicle.uchicago.edu/061207/miltonobit.shtml) in 1976. He argued that consumers decide how much to save based on earnings prospects throughout their lifetimes, not on short-term government efforts to manipulate demand. Friedman demonstrated that inflation and unemployment may rise in tandem and that governments cause inflation by printing too much money.

‘Change My Mind’

Lucas, the 1995 Nobel laureate, recalls Friedman convincing him in a 90-minute undergraduate class in 1960 that labor was subject to the same economic laws as other commodities. Friedman argued that [minimum wage](http://www.dol.gov/esa/whd/flsa/) laws, which Lucas saw as humanitarian, harm workers by reducing demand for their services.

“I never thought I could change my mind like that,” Lucas says.

[Deirdre McCloskey](http://www.deirdremccloskey.com/), now an economist at the University of Illinois, Chicago, remembers laughing with fellow Harvard undergraduates in 1963 at Friedman’s claim that free markets allocate resources better than governments. She says Harvard-trained bureaucrats enjoyed prestige following World War II. She switched her support to Friedman after the Vietnam War destroyed her faith that such bureaucrats knew what they were doing.

Friedman, who stood 5 feet 3 inches (160 centimeters), was a fierce debater, McCloskey recalls.

“He always asks, persistently, ‘How do you know?’” McCloskey, now 66, wrote in the Eastern Economic Review in 2003. “It’s a terrifying question, because most of the time we can’t say.”

‘Shock Therapy’

Friedman was chief economic adviser to Republican presidential candidate [Barry Goldwater](http://search.bloomberg.com/search?q=Barry+Goldwater&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) in 1964. He began attracting nonacademic audiences with a Newsweek magazine column that ran from 1966 to ’84. When Reagan was governor of California, Friedman campaigned with him in 1973 for limits to property taxes that had fueled government growth in the state.

In 1975, Friedman traveled to Chile and met dictator [Augusto Pinochet](http://search.bloomberg.com/search?q=Augusto%0APinochet&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), who’d seized power two years earlier in a coup in which thousands died, including Socialist President [Salvador Allende](http://search.bloomberg.com/search?q=Salvador+Allende&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1). Pinochet practiced “shock therapy,” including monetary controls, to tame inflation.

Friedman’s friend [Alan Walters](http://en.wikipedia.org/wiki/Alan_Walters), later an adviser to British Prime Minister [Margaret Thatcher](http://search.bloomberg.com/search?q=Margaret+Thatcher&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), went to Chile to monitor what he viewed as laboratory-like conditions for shock therapy, says Andy Beckett in “Pinochet in Piccadilly” (Faber & Faber, 2002).

India and China

Walters, 82, taught at the London School of Economics and at Johns Hopkins University in Baltimore, later serving as vice chairman of AIG Trading Group Inc. He was fascinated by “the Chicago boys” who trained in Hyde Park and became advisers to post-Soviet governments in Eastern Europe after serving in Chile.

Students reacted differently. After the coup, a generation of Latin Americans refused to study at Chicago, says [James Heckman](http://nobelprize.org/nobel_prizes/economics/laureates/2000/heckman-autobio.html), 64, an economist at the university who won a Nobel in 2000.

McCloskey, who taught in the Chicago economics department for 12 years starting in 1968, says several professors played bigger roles than Friedman in Chile. His opposition to training economists for [Shah Mohammed Reza Pahlavi](http://search.bloomberg.com/search?q=Shah+Mohammed+Reza+Pahlavi&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) of Iran shows he didn’t coddle dictators, she says. McCloskey still trusts Friedman’s teachings.

“The big event of the last 20 years is the success of free markets in India and China,” says McCloskey via telephone from South Africa, where she’s a visiting professor at the University of the Free State in Bloemfontein.

“This is more important than any financial crisis and makes it really hard to argue for a return to central planning.”

In 1977, Friedman reached the then mandatory retirement age of 65 and left for the [Hoover Institution](http://www.hoover.org/) at Stanford University.

Black-Scholes

While wrapping up his Hyde Park career, he reviewed the early research of professors [Fischer Black](http://search.bloomberg.com/search?q=Fischer+Black&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) and [Myron Scholes,](http://search.bloomberg.com/search?q=Myron+Scholes%2C&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) who gave Chicago theories a bigger and more direct role in financial markets.

The pair provided a foundation for trading call options on stocks by creating a formula to link the value of the options to share price and volatility, time remaining on the option and interest rates.

The Black-Scholes model helped spark the global derivatives market.

At the time, Fama was positing that securities prices reflect the collective wisdom of all participants. This “efficient market” theory helped make him the No. 1 scholarly business writer, with 250,828 downloads of academic papers as of Dec. 22, according to [Social Science Research Network](http://www.ssrn.com/).

Fama’s theory helped pave the way for the recent economic crisis by sanctioning limited government, Notre Dame’s Mirowski says.

“Fama taught that no human being knows enough to understand how resources should be allocated,” he says. “All you can do is let the market have greater and greater ability to repackage information and risk. The result is, people bought mortgage-backed securities with no idea whether borrowers could repay.”

AIG’s Long Position

Fama, 69, who favors casual shirts and chinos on campus, joined the Chicago faculty in 1963. When he opened his financial theory class on Sept. 29, the day Congress voted down Paulson’s bailout, he placed efficient-market equations from his 1976 textbook on an overhead projector.

Fama says he never denied the possibility of unexpected events even though he’d spent a lifetime showing that markets effectively digest information. He was stunned that [American International Group Inc.](http://www.bloomberg.com/apps/quote?ticker=AIG:US), once the world’s largest insurer, sold $441 billion in unhedged and undercapitalized insurance on securitized debt, much of it tied to mortgage values.

“No one expected a player like AIG to take a long position and not hedge themselves,” Fama says. He says the government may have been able to stabilize the U.S. financial system at a lower cost by letting AIG collapse.

Bailout Mania

Bailing out Detroit automakers will simply postpone their demise as they reel from expenses promised for employee retirement plans, he says.

Cochrane, who circulated the anti-rescue petition, says a rash of bailouts will expand government and kill entrepreneurship.

“People don’t notice businesses that didn’t start,” he says. Cochrane says he was encouraged by the Fed’s Dec. 16 rate cut and its plan to buy mortgage-backed securities, saying these moves will help unfreeze capital markets.

“This is exactly the right thing for a central bank to be doing in the midst of a credit crunch,” he says.

Fama and Cochrane have more in common than their outlooks. Cochrane is married to Fama’s daughter Elizabeth, a finance Ph.D. who writes [fiction](http://www.babybeebooks.com/Elizabeth%20Fama%20Book%20Page.htm) for young adults. Their families have dinner together twice a week; on campus, their offices adjoin.

Cochrane’s Vindication

Cochrane’s has a [photo](http://faculty.chicagogsb.edu/john.cochrane/research/Papers/) of himself in a glider in which he competes. He says he felt vindicated in November when Paulson abandoned the idea of buying mortgage assets. He advocates patience as markets rebuild themselves.

In the future, people who originate securities will retain a higher percentage of the debt, understand risks better and earn smaller profits, he says.

For now, he says, when a U.S. bank fails, a hedge fund in Denmark may bear the brunt, which is an improvement from the Depression era, when neighborhoods surrounding a bank were devastated.

“That’s risk being spread all around the world,” he says.

Cochrane says he now represents a minority viewpoint among Chicago’s business faculty. He says Diamond, who declined to sign the petition, holds a majority view, which posits financial institutions must be rescued and regulated.

Bank Failures

Diamond began studying bank failures when he was a doctoral student at Yale in the 1970s. The 1963 book that Friedman wrote with [Anna Schwartz](http://search.bloomberg.com/search?q=Anna+Schwartz&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), “A Monetary History of the United States, 1867-1960,” provided the foundation. A copy, held together by Scotch tape, sits on Diamond’s desk, even though he concluded at Yale that a main premise was wrong.

Diamond rejects Friedman’s view that banks failed in the 1930s because the U.S. money supply contracted as panicky Americans started hoarding cash and the Fed reacted too slowly. Diamond sees the money supply as less significant than Friedman did.

Banks failed, he says, because their assets weren’t readily converted into the cash that depositors were demanding.

During the 1980s, Diamond’s research was similar to that of Fed Chairman [Ben S. Bernanke](http://search.bloomberg.com/search?q=Ben+S.+Bernanke&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), 55, whom he calls a good friend. The two postulated that because bankers accumulate experience in assessing risk, they play a key role in the economy.

In the past decade, bankers failed to properly grasp risk because of a “witch’s brew” of mistakes, Diamond says.

Real-Life Experiment

Former Fed Chairman [Alan Greenspan’s](http://search.bloomberg.com/search?q=Alan+Greenspan%3Fs&site=wnews&client=wnews&proxystylesheet=wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) 1 percent interest rate in 2003 -- a 45-year low -- flooded Wall Street with so much cash that banks could increase profits with short-term borrowing to service long-term liabilities, Diamond says. The mismatch grew more dangerous as Greenspan resisted regulation of off-balance-sheet structured investment vehicles, which banks used to circumvent capital requirements.

Reagan’s $4.5 billion rescue of [Continental Illinois](http://www.fdic.gov/bank/historical/history/235_258.pdf) National Bank & Trust Co. in 1984 convinced bankers that bailouts would come if things turned bad, Diamond says.

By 2007, a quarter of assets held by big U.S. investment banks came from short-term borrowing, up from 12 percent three years earlier.

Goolsbee describes the plan Obama is formulating -- tax relief for workers, investment in technology and infrastructure and more oversight of financial markets -- as pragmatic and data-driven. He says Friedman would approve of Obama’s determination to keep policy making rooted in the economic methodologies developed at Chicago.

The University of Texas’s Galbraith compares Obama to pragmatic philosopher [John Dewey](http://www.bgsu.edu/departments/acs/1890s/dewey/dewey.html), whose ideas sparked educational reform in the 20th century. While on the Chicago faculty in 1896, Dewey started the [school](http://www.ucls.uchicago.edu/) that the Obama and Goolsbee children attend.

With his inauguration on Jan. 20, Obama faces a real-life experiment in organizing financial markets amid turmoil few presidents have navigated.

His success will be measured partly by how he uses the University of Chicago as an intellectual anchor -- and whether he can meld its free-market heritage with today’s nonstop intervention to bring order to uncharted times.

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