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- Good morning. This is Rose Freedman inviting you on behalf of Instructional Dynamics to another conversation with Milton Freedman, Professor of Economics at the University of Chicago. We are taping this conversation in mid-June. For our last take, we started with the British pound. Maybe since that is still in the news or was not too long ago we should start this tape again with the British pound. In the meantime, an international consortium of countries including the US has been formed to shore up the pound. Do you think that this will succeed?

- I am very dubious that it will. We have had this experience over and over again, that central banks repeatedly try to shore up their currencies one way or the other, try to prevent market forces from having their affect. They sometimes succeed for a brief period but not for very long. If we look at the character of the funds made available to Britain, they are very large but they are for a very short term period. The funds that have been made available are for a three to six months on a three to six months basis. Presumably Britain is supposed to replace any funds that she uses between now and then. What I mean by uses is of course what Britain has been given is a lot of credit or drawing power. She will actually draw upon it only insofar as the British buy net sterling as a way of holding up it's price. Insofar as it does that it will accumulate a debt in dollars or in Swiss franks or in whatever other currency it draws on. And the question is how will it pay that back three to six months from that? The whole operation makes sense on one assumption and one assumption only. Which is that the present rate of the pound is below the equilibrium rate and below the rate that will be prevailing three to six months from now. Presumably the British were willing to go along with this and the other countries were as well because the central backers of the world reached the judgment that that was the case. They reached the judgment that speculative influences of one kind and another had driven the British pound below its level that you could not explain the deterioration of the British pound adequately on the grounds of the excess inflation in Britain compared to other countries or on the ground of capital outflow from Britain. And that therefore you had an opportunity to make a killing on the market. In short, the whole operation makes sense only on the assumption that the central bankers of the world believe that they had an opportunity to make a killing against the speculators of the world. That may be right. It can happen from time to time. But it's very hard for me to see that it's a good bet over any long period of time. One thing that the British are doubtless counting on is the success of their wage agreement policy. They expect to have a massive vote from the trade unions to accept limitation of 4.5% on wage rises. But as I repeatedly stressed here, I believe that that's a side show, that the real question with respect to British inflation and therefore with respect to the British pound is whether in fact the British will be able over next year or two to curtail British government spending to the extent by which the British government has to borrow and create money in order to meet it's current expenditures and the extent to which Britain as a nation borrows from abroad. In these respects it's very hard to see any fundamental change. To get a better perspective it's worth looking at the other side of the picture. Here are the British desperately trying to keep the pound from depreciating any farther. On the other side of the picture you have the Swiss government, the Swiss bank, and then the Swiss bankers desperately trying to keep the Swiss frank from appreciating. Now if you look at the attempts on part of the Swiss government you will see that over the last year or two they have taken one measure after another trying to prevent the Swiss frank from becoming too attractive a currency and rising too high in price. Of course the reason they have done so is because they fear that the rise in the price of the Swiss frank tends to be unfavorable to their own export industry, particularly tourism but also the export of manufactured products. In their attempt to shore up, down not shore up to keep down the price of the frank, the Swiss have imposed charges on foreign funds held in Switzerland, negative interest rates. They have prohibited the purchase of real property in Switzerland by outsiders and they have done one thing after another. Now one of the reasons why I cite this is because interestingly enough as a purely technical matter the Swiss are in a position where they can always succeed. They only thing they have to do in order to be able to keep the Swiss frank from rising too high is to sell Swiss franks to all comers. Now they have a monopoly on the printing press that turns out Swiss franks. There is no limit whatsoever to the volume of Swiss franks they can create.

- So won't this come back to haunt them in way of inflation?

- Of course, that's why they're not going to talk. But go slowly, yes and no. Insofar as they simply, if they were right about the long run view about the price of the Swiss frank, then they could perfectly well afford to create all the Swiss franks they want, provided they were being held by speculators idle as a horn not being transferred into the hands of Swiss citizens to spend at home. But of course the problem is it's very hard to keep that distinction. It's very hard to print Swiss franks like mad for speculative purposes and not have some of them leak out. And of course the point you cite is the exact reason they have been unwilling to do it. And of course that shows up in what's been happening to Swiss prices. The price level in Switzerland over the past year has risen at the annual rate of something like 2.5%, about the lowest rate of any country in the world. Well if we go back to the mainline of this, here are the Swiss in a technical position where there's no limit to what they could do. You see the situation of the British is different. They have to buy pounds which they create the pounds, they can produce more pounds, but in order to get the foreign exchange to buy pounds they have to borrow from abroad. So there is a definite limit to what they can do. Well the Swiss have been unable and unsuccessful in their attempt. The Swiss frank has gone up despite their every effort and will continue to do so. It has cost them money to try to do this. Is there any reason to suppose that the British will be any more successful? Now clearly the Bank of England understands all of this as well as I do. And I find hard to believe that they will be willing to throw any very large sums of money into this pot. But maybe that's wrong. The short time perspective is tremendous. I am rather inclined to believe that what'll happen is that the Bank of England will be able to stem the tide without spending a great deal of money, but because of the psychological effect and influence on other speculators who will pull back for a while and hold off trying to see what happens. And that some time down the road, maybe it will be two months, maybe it'll be three months, maybe it'll be sooner or later, the whole thing will collapse again. Now whether that's true or not depends of course on whether inflation heats up again in Britain. If indeed my evaluation of the situation on that score is wrong, if the British should be able to reduce government spending, should it hold down their borrowing requirement and should be able to keep inflation down well then the whole story would be very different. Other the other hand if sometime in the next few months inflation seems to be heating up again, or even five or six months down the line, I think we will discover that this has been another one in a dreary, lengthy catalog of futile efforts by central banks to prevent the fundamental underlying forces in the market from working themselves out. I just had occasion to look at one calculation from a very, very long time period, which is kind of interesting from this point of view. In connection with the long period study we have been making, from 1870 to 1973, that's 103 years. British prices rose on the average 8/10 of one percent per year more than American price. On the basis of that 103 year period, the British exchange rate decline relative to the American exchange rate by what do you suppose? 8/10 of one percent per year. These basic underlying forces manifest themselves of course. A 103 years is a long time. There's a lot of room for error and deviation and staying away from the straight and narrow path in the course of a century but yet it brings out again how fundamental are these basic economic relations connecting different currencies.

- Is there anything to add to what you said last time about the domestic, our own domestic policy in general and monetary policy in particular?

- Very little. We seem to be going very much along the path that we then described. The Fed is continuing, it's apparently continuing it's efforts to bring down the rate of monetary growth but so far with no success. The rate of growth of the money stock for the past two months has been at the annual rate of 11%. For the past three months, 9.8. The past four months , 9.1. Very little sign of improvement there. Although if you look at the graph with if you look at the chart with a magnify glass you can see some slight tapering off of the rate of monetary increase over the past four or five weeks. It's hard even to see that if you look at the M2 definition. On M2 over the past two months at 12.8, past three 11.7, past four 12.4, past five months 12.4 and so on down the line. That seems pretty steady, there's little sign of any tapering off. The one change that might be worth noting is that the very sharp rise in short term interest rates that accompanied the Feds boosting their temporary federal funds target as they sought to get monetary growth under control, has temporarily halted for a week or so. There hasn't been any further increase in the short term rate. I suspect that this is a temporary phenomenon and the markets seem to agree with that. If you look at the international money markets treasury bill series, the futures market there is predicting a treasury bill rate of about 7% at the end of the year by comparison with about 5.5% now. So I think we will shortly see a resumption in the rise in the short term rates.

- I suspect that most if not all of your subscribers have seen the article in Business Week of June 7th, the critics ask is monetarism dead. And I suspect that they are eager to hear your defense, in particular the article says the fact that the equation linking money and national income has gone down the drain at least temporarily is undeniable.

- Well you know whenever anybody makes a statement like that you usually have strong adjectives that are usually a substitute for strong arguments. It's not only undeniable, it's simply not true. Nothing has gone down the drain. This is a very, very curious article. I really am puzzled by it because I may say I spent 3/4 of an hour or so the telephone from Business Week before they produced this article. They ended up using absolutely no quotations whatsoever from my comments in the article and not taking into account the comments which I made in any way. If you look at the source for their belief and their equation linking money and national income has gone down the drain, it's based entirely on a prediction by one economist, Dudley Johnson, who's at Citibank, and as they go on to say based on his money model Johnson projected a first quarter real GNP growth rate of 0.69%. The actual increase was 12 times as great. Clearly the monetarists blew it. Now that's a most curious paragraph. In the first place, I would hope that the monetarists are a more varied, diverse, independent group of people than Dudley Johnson. Dudley Johnson's a fine fellow. He is an able man. He has done some good work, but I would hardly be willing to have him stand as the stuff and symbol of the whole monetarist movement. I feel that especially strongly because the so-called money model that Dudley Johnson uses is one that most monetarists reject out of hand, including myself as I have in the past. The essence of Dudley Johnson's model is that he relies on the real money supply. The basic essence of the whole monetarist approach is that it has insisted on the need for keeping separate nominal magnitudes from real magnitudes. And so to say that the monetarists blew it on the basis of Johnson's particular prediction for one quarter, seems to me to be resting a very tall structure on a very, very narrow base. If you look at the predictions which various other monetarists myself included have made, there is no such, there is no great difference between our predictions and the results. On the contrary, on the whole, we've been pretty much on the right track. The one point you can make validly is that a considerable number of us were afraid in the fall of 1975 that the very slow rate of monetary growth over the last six months of '75 would seriously dent the current recovery. Now I trust some of you have seen the Newsweek column which I published in last week's Newsweek, entitled, "Are these monetary swings necessary?" One of the main reasons I published that piece was as an indirect way of replying to this Business Week article. I included in that piece a chart, which showed two-- the rate of change of two concepts of money, M1 and M2. And also the rate of change of personal income. Now it's precisely that relationship that the monetarists have relied on over a long period. That relationship was maintained, very clearly and strongly in the period. There was no breakdown. The one respect in which you might say it didn't conform to past experience was that the reduction in the rate of personal income growth that followed the very slow pace of monetary growth in the last half of 1965

- '75.

- 1975, 1975 that reduction was rather smaller than you might have expected on the basis of the reduction of the rate of monetary growth. That is to say that you did have a slowing down in the expansion but the slowing down was rather small. Now this kind of a deviation is to be expected. No monetarist I know of, certainly not myself, has ever claimed that there is anything like a perfect relationship, perfectly rigid, a perfectly precise relationship between changes in money and changes in income. On the contrary. A major reason why I have consistently for many years been opposed to discretionary monetary policy and in favor of a fixed rate of monetary growth is precisely because there is this kind of a deviation. And therefore you cannot ever be sure of the exact consequence of leaning against a wind or moving in a different direction or another direction. So I have always argued that the least costly procedure is to avoid introducing erratic elements into the picture. Let the monetary authorities simply increase the money supply at a steady rate. Well if I go back in this sense it's very hard to see any respect in which the equation linking money and national income has gone down the drain. It's just about as good as it ever was. There was a quarter or two, last quarter of '75, the first quarter of '76 which particularly for the M1 relationship shows a particularly significant deviation from the typical pattern. But to make a case to make a case out of one swallow is carrying a good thing pretty far. Now the other point in this direction is a great emphasis on M1 versus M2, which is as you people know I have consistently denigrated. So long as the Federal Reserve is going to be messing around with the conditions on which people can hold timed deposits or cannot hold time deposits, with a maximum interest rate that can be paid on various category of time deposits and the like, there are going to be erratic movements between M1 and M2. But again, if you look at that chart which I published in Newsweek, the major purpose of it was to present both M1 and M2 and to show that clearly in their broader movements they tell the same story, that there is no fundamental incompatibility between them.

- Now then they go on to the mystery. Aside from the difficulties they say in choosing the precise measure of the money supply, the monetarists explanation of the channels through which money growth causes nominal GNP to increase, remains shrouded in mystery. And now we're back to the Freemainian process which is indeed a fiction of black box.

- This argument is one I must confess I have very little patience with and have had very little patience with for years. It was probably the one that I spent most time talking to the Business Week reporter about. It's utter nonsense. There is no respect in which the monetarists have in any way relied on a black box. The claim that we have derived simply from the fact that our interpretation of the channels is different from the Keynesian interpretation. From the Keynesian point of view it's a black box because they don't accept our explanation of how money enters into the economy. But there is probably no subject on which monetarists, myself included have written more and more explicitly than in analyzing the channels through which money growth causes nominal GNP to increase. What is true is that it is an essential part of our analysis to say that there is no rigid connection between any particular channel and the particular result. It is an essential part of our analysis to say that we interpret experiences showing that the apportionment of the influence among different channels may be one thing at one time, and another thing at another time. Let me see if I can put that in context. Our argument has always been that when the quantity of money increases it's effect is to leave people with a disproportion in their portfolios. That they end up somebody or other depending on exactly where the extra money is spent and into whose hands it falls and so on. Somewhere or other somebody finds that he has more money relative to his other assets. And this means that there is a discrepancy between different components of his balance sheet and also between his balance sheet and his income account. The wealth holders, whoever is in this position will try to adjust, as he will not do this instantaneously. In the first instance, for very short periods, money balances serve as a shock absorber and so he'll let it pile up. But when it becomes beyond that shock absorbed amount, and it's of course initial shock absorber thing that is the first contribution to the lag between monetary change and income change, when it goes beyond that he will seek to adjust his portfolio. Now and here is where the variability enters in. There is no reason why the adjustment that he makes should be the same every time. That will certainly depend on the accident of the particular hands into which it falls. It will depend on the accident of the structure of his assets and so on. One time it may well be that the first impact of an excessive quantity of money relative to other assets will be an attempt to buy utility bonds and it will drive up the price of utility bonds. And another time maybe it'll drive up the price of equity stock. And another time maybe the people in who's extra hands it falls will see that this is a good time to buy their new automobile or their refrigerator or some other consumer durable good. What we have stressed is that there are that the portfolio, the assets which are held contain a great many items, of which interest bearing securities traded on organized markets are only a small part. That there is no reason why the major effect should be through those interest bearing securities. This is where we differ most sharply from the Keynesian view. Because the Keynesian view is that the effect is wholly concentrated in the first instance on that narrow class of interest bearing assets that are traded in organized markets. And it is only insofar as the prices of such assets are bid of, the interest rates on such assets reduced that you have in turn an impact on other spending. And that then the initial impact is on investment spending and only as it goes through the multiplier process that it affects income as a whole. Well our argument has been, if you go back, that's a very particular channel. It conceivably could be true but we don't believe the evidence is consistent with the view that it's true. And then a much more intelligible and plausible interpretation of all of the evidence is that the disproportion in the balance sheet may take anyone of a large number of different forms and generally will take many such forms. So that it will show up part in perhaps the prices of utilities or treasuries and so on. But in part also in purchases of durable consumer goods. In part maybe in restocking of clothing. Who knows what? And that therefore there will be a widespread pervasive influence of excessive monetary balances on a large number of spending streams and through them a nominal income. Now I don't see that there's any mystery about or any black box about that. What there is is a recognition that you cannot specify in advance particular ways in which the excess money growth will be channeled.

- I guess we've--

- Indeed it is this very difficulty of specifying the precise channels or of assuming that they are any particular occasion, that is assuming that the channels are identical on any particular occasion, that we deduce to explain why it is that there is variability in the relation between changes in money and changes in income. Why the strength of the relation is sometimes somewhat greater at one time, somewhat less at another. Why the lag is sometimes briefer, sometimes longer. So that the picture as a whole as I see it fits together. Now of course the other part of the picture which there isn't time to go into here has to do not with the relation with nominal income but with the relation with real income, with the breakdown between nominal and real income. And here again is a place whereas the article does point out there is a big difference between the Keynesian and ourselves, particularly in the role which we will attribute in that process to the anticipated rate of price change as opposed to the level of utilization of capacity.

- Our tape is just about over but before we finish let me add my explanation for the whole article which I think appears in the later half of last paragraph. If the recovery in the next few quarters is robust then the monetarists may suffer the same skepticism that befell the Keynesian in the late 1960's. The Keynesian have never recovered from what happened to them in the late 1960's. Remember subscribers--

- Now before you go on to that, let's note just one thing about that. That certainly I and other monetarists on the basis of the recent monetary explosion have been saying that the recovery is going to be robust in the new few quarters. So this is a complete non sequitur.

- Okay, remember subscribers if you have any questions or comments please send them to Instructional Dynamics Incorporated 450 East Ohio Street, Chicago, Illinois 60611. We should be visiting with you again in about two weeks.