- Hello, Instructional Dynamics Incorporated welcomes you to this weekly series of commentaries on the current economic scene. Reporting to you will be one of the nation's leading economists, Professor Milton Friedman of the University of Chicago. What you are about to hear was recorded just a few days ago by Doctor Friedman for subscribers to this exclusive IDI informational service. The views expressed are Doctor Friedman's of course, and we invite you to talk back, if you have a question, or a criticism, or a subject you would like to hear discussed, write to Doctor Friedman, care of Instructional Dynamics Incorporated 166 East Superior Street, Chicago 60611. If for some reason the playback unit given as part of this service does not perform satisfactorily please bring it to the nearest Norelco service outlet. The cassettes and tapes in this series may be played by subscribers as often as they like, but this material may not be reproduced or duplicated without the written consent of IDI. Now Doctor Friedman, I'd like to welcome you to this information service on behalf of IDI and our subscribers.

- Thank you, I am delighted to join in this venture, it's a new venture for me as it is for you, I hope it will prove mutually satisfactory, both to me and to our subscribers.

- Doctor Friedman let's start with Wall Street. What do you think of its long term prospects?

- The long term prospects for the stock market seem to me to be excellent. Over the long past period of the past century or so, equities have yielded a much higher rate of return to people who have held them than have bonds. In the past 10 years, this has been reinforced by the growing awareness of the likelihood of substantial price inflation. When prices rise, interest returns on bonds are worth less to the person who holds the bond if the interest rate is 7% and prices are rising at the rate of 4% a year, the holder of a bond is really only getting a 3% return. This fact has led many purchasers of assets to shift from holding bonds to trying to acquire equities. There has been an enormous spread in recent years on the part of pension funds to change their portfolio, there has been a great development of mutual funds involving the participation by holders in a diversified collection of equity, all of these factors have tended greatly to strengthen the equity market. These factors are not of an end, at an end. They're still is a tendency to move toward equities and away from bonds, and so long as this happens you will have a very strong stock market. Of course that has to do with its long term prospects, it doesn't mean that the market is gonna go up every day or every week obviously, what you're going to have are all sorts of ups and downs in the course of time. It's because of these ups and downs that the market has, on the average over a long period, had so much higher a yield than the bond market.

- But look what's happening to interest on bonds, they're going up like mad, isn't that going to reverse the process?

- They've been going up precisely because of the forces I mentioned, it's precisely the attempt by people to get into the, into equities and out of bonds that has been driving down the prices of bonds, that has been forcing new issuers to offer high yields. In any event, in considering the yield you must, as I mentioned earlier, look at not only the nominal yield, but also the yield after allowing for inflation. 7% seems like a very high yield, it is if you think of a world in which prices are stable. But if prices are going up at 4% a year, that means that the net yield, the yield after allowing for price inflation is only 3% and that certainly is a very low yield. It's precisely because that's such a low yield, that if inflation should continue at anything like the rate that we have been experiencing over the past few years, there is every reason to expect that interest rates will continue to rise.

- There is another special problem confronting the market these days that relates to the SEC investigation of commission charges, what's your reaction to the charge that stock market commissions are too high?

- Commissions on the stock market are too high. They are too high because you have a monopoly to all intents and purposes, fixing the commission rates there is an implicit or explicit agreement among the firms operating on the New York Stock Exchange and forced through the stock exchange that leads to identical commissions on the part of all participants. Unaccustomed as I am to agreeing with my colleague Paul Samuelson on this particular issue, I find the comments he made in testifying before the SEC the other day to be entirely valid. The country would be better off if we had competitive setting of commission rates. I should add to that, that I am strongly opposed to having the SEC fix commissions and decide what they should be. Governmental price fixing is no improvement over private price fixing. What we need is less regulation by the SEC and more competition.

- Most everyone has been surprised that the stock market has done so well the past few weeks. Most people expected the surtax to cool off the economy. What's your explanation?

- As it happens, I was one of the few economists who was opposed to the surtax all along, and who still believes it was a mistake to have put on the surtax. I did not myself expect that the surtax would have any significant effect in cooling off the economy. The difficulty is, that the common discussion of the surtax looked at only half of its effect. Everybody talked about how increased taxes would lead tax payers to spend less. That is certainly true, increased taxes do have some effect in that direction, but there's another side to the picture, increased taxes means that the government has to borrow less in order to finance its expenditures, if it borrows less, the people who would have loaned it the money have that money available, to lend to somebody else to use to pay their taxes, or to spend themselves. Consequently there is no obvious reason why increasing taxes should in any way cool off the economy. The one thing you could really expect it to do, would be to lower interest rates. The reason you can expect it to that is because the higher taxes do mean that the government has to borrow less, the government's borrowing less means that there is lower pressure on the market for loanable funds, this reduction in demand for loanable funds will lower interest rates, and in my opinion that is the main reason why you had a substantial fall in interest rates in the middle of this year. As far as economic activity as a whole is concerned, it seems to me that that depends very much less on the level of taxes and government expenditures than it does on what has been happening to the quantity of money. This is a little bit complex to discuss, because one of the most important things about the effect of money on economic activity is that it takes some time for changes in the quantity of money to have their impact on the economy. Sometimes it takes six months sometimes even longer. As a result, in order to understand the behavior of the economy now, we have to go back and look at what the Federal Reserve system was doing, some six or nine months ago. Similarly, in order to analyze the effect of what the Federal Reserve system is doing now, we wanna ask what will be the conditions maybe some six or nine or 12 months from now. That is one of the reasons why there has been so much misunderstanding about the relations between the quantity of money and the economy, there is a widespread tendency to look at them as if any changes in the quantity of money would have their effect instantly, rather than with a substantial lag. If we do look back, we will find that between about November of 1967, and April or May of this year, the Federal Reserve had moved to a somewhat tighter monetary policy. The economy itself was moving up very rapidly, but that was because the Federal Reserve had, prior to November 1967 been following an extraordinarily easy monetary policy. That tight monetary policy between November and April or May of this year started to have some impact on the economy along about April or May or June, and it accounted, in my opinion for some of the signs of weakness that were widely seen and widely interpreted as heralding a slowdown in the economy. These were intensified by the fact that the surtax came into effect early in July. The interesting thing however is, that when the surtax was passed the Federal Reserve apparently came to the conclusion that it could stop worrying about inflation, that the surtax was going to do the job for it. Accordingly along about March or April, the Federal Reserve started easing money very, very sharply, and in the six months since then, the quantity of money has been growing at an excessively rapid pace. This rapid expansion of the money stock in my opinion, has offset by now, the earlier dampening effect. It has also accounted for the growing appearances that the economy will continue to boom. So we have a combination of two factors, on the one hand there is no reason why the surtax should have slowed down the economy. All you could reasonably expect it to do was to produce lower interest rates which it did do. On the other hand, you have had the Federal Reserve engaged in booming the economy and that's showing up in the very sizeable rate of growth during the third quarter and continuing during the fourth.

- Doctor Friedman, you've been talking about tightness and ease, what do you mean?

- That's a very good question because the terms are used very loosely. Frequently what people mean by tightness or ease of money is whether interest rates are high or low, but that's a very bad index of tightness or ease, because what happens to interest rates depends not only on what the Federal Reserve System does, it depends also on how much demand there is for loanable funds, whether there's a strong capital market or not. I mean something different by tightness and ease. When I refer to the Federal Reserve System as being easy, I mean that it has been permitting the quantity of money, the amount of currency people carry around in their pockets, the amount of deposits they have to their credit, it has been permitting this total to go up at a very slow rate. On the other hand when I talk about the Federal Reserve as being easy, I mean that it has been permitting the quantity of money to grow at a very rapid pace.

- Monetary policy right now, easy or tight in your view?

- Turns out that right now that is an extremely difficult question to answer. The reason is because there is no single necessarily best measure of the quantity of money. The measurement that is widely used is currency plus demand deposits, however commercial banks also have a very large volume of time deposits and many individuals and businesses hold time deposits. For the past few weeks time deposits and demand deposits have been going in opposite directions. Demand deposits have been showing a very distinct slowing down and if you look at the money stock defined narrowly as currency plus demand deposits alone, you will have to say that in the last month or two months the Federal Reserve has tightened up very sharply indeed. On the other hand, time deposits have been going up at a fabulous rate and if you look at the quantity of money including time deposits then you will say that the Federal Reserve has continued to be easy, that there was a shift from tightness to ease in April or May and there has been no reversal since. The reason for this differential behavior of time and demand deposits is, the existence of regulation Q. Regulation Q as you know is the regulation which sets a maximum rate on the interest that banks may pay on time deposits. Before the surtax was passed market interest rates were sufficiently high, so that banks were up against the ceiling. Being up against the ceiling they were unable to attract time deposits and time deposits were going up slowly, after the passage of the surtax market interest rates fell sufficiently so that the ceiling no longer became a factor. The interest rates being paid by banks on time deposits and certificates of deposits was attractive and as a result you had a very rapid expansion in time deposits. There have been a number of instances over the past, when regulation Q has added into the picture in this way, and every time that has happened it has been extremely difficult to judge whether monetary policy has been easy or tight.

- Does the current monetary policy relate also to determining short term outlooks?

- Not fully, as I mentioned earlier the effect of monetary change operates only with a lag. What is happening today in the economy is reflecting not today's behavior of the quantity of money, but what was happening to the quantity of money maybe four or five or six or seven or eight months ago. As of that time by whichever measure of money you took money was expanding, the quantity of money was expanding very rapidly. This leads me to believe that the current ebullient state of the economy will continue, at least for some months. The difficulty of judging the present state of monetary policy makes for uncertainty about the course of the economy some months from now. If within the next month or so the narrowly defined money stock starts moving up very rapidly and at a pace more nearly parallel to what's been happening to the money stock broadly defined, the implication will be that you will continue to have expansionary and inflationary pressure in the economy in the early part of 1969. On the other hand, if it turns out that the broader definition of the money stock starts behaving like the narrower one, that is if the fed does tighten up and slow down the rate of growth of the money stock however defined, then that will spell the possibility of a slowdown sometime in the early part of next year. The main effect of the ambiguous dance of current monetary policy therefore is that it makes it extremely difficult to look more than a very few months ahead.

- Friedman could you be more specific in your assessment of the current outlook?

- One thing about the current outlook that can be take for granted is that whatever happens to the growth of GNP, or national income, or the stock of money, one thing is very clear, prices will continue to rise. One of the things that is clearest from the historical record is that there is a great deal of inertia in the movement of prices, once starter prices start going up it is very hard to turn them around. The reason for that is obvious, it's because people widely expect prices to rise and thus incorporate rising prices in various contracts. Workers are led to demand higher wages, and these wages are incorporated in contracts running over the next six months or a year. Business men in bidding on plans for the future take into account the fact that prices will rise, thus you have a great inertia effect which means that prices keep on rising even though there may be a slowdown in total demand in the economy. This is of course why it is so difficult to stop inflations, it is also of course, in my opinion why it's a terrible mistake to let an inflation get started, because once you let it get started the only way you can stop it is by producing a fairly substantial amount of unemployment in order to break peoples expectations and get them to the position where they no longer anticipate continuously rising prices. One of the great tragedies of the past decade is that after the Eisenhower administration paid that price from 1956 to 60, after they had adopted fairly tight policies which had the effect of having unduly high levels of unemployment but did cause a widespread disappearance of inflationary expectations, caused people to consider that stable prices were possible. After you had that then unfortunately in the next six or seven years that gain purchased at a high price was thrown away. We embarked on a policy of undue expansion which led to rising prices so that in the past year prices have risen at a rate of 4% per year the highest rate for many, many years in peace time, and it has instilled on the part of consumers, workers, businessmen almost everybody in the economy, a widespread belief that prices will continue to rise at that rate. In order to break that expectation we shall again, have to pay a significant price.

- So much for prices, what about some of the other indicators?

- So far as aggregate demand or GNP, or indicators of that sort are concerned, we're only now beginning to experience the expansionary effects of the easy money policy which the fed began in late spring, early summer. As a result there's every reason to expect that these magnitudes will continue to expand at a relatively rapid pace, certainly for the rest of this year, perhaps for the early months of next year. This means that we should continue to experience a high level of employment, that there should be no appreciable increase in unemployment and perhaps even a decrease. It means also of course there will continue to be strong pressure on prices, that inflationary movement will not be damped down but if anything will be intensified. To go beyond the rest of this year is much more difficult because of the uncertainties which I discussed earlier about the present stance of monetary policy. In addition of course there are many other factors that can enter into the picture, among the most important of these will be the consequences of the election, who is president, and the consequences of the change in the tempo of the Vietnam War, as a result of the aftermath of the present peace moves which are underway. These are matters that I will discuss further next week, at which time we will know who is president and can speak more confidently about the likely results of the election, This is Milton Friedman.

- Thank you sir, if you have questions or comments or suggestions for topics you would like discussed in this series please send them to Instructional Dynamics Incorporated, 166 East Superior Street, Chicago, 60611.