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- Hello, this is William Clark, financial editor of the Chicago Tribune, welcoming you again on behalf of Instructional Dynamics to this weekly series of commentaries on current economic developments. Reporting to you again this week will be one of the nation's leading economists, Professor Milton Friedman of the University of Chicago. Dr. Friedman, some economists argue that a new Bretton Woods Conference is an essential thing, and others say that no new international arrangement could offset the lack of financial self-discipline within individual countries, and therefore that a new Bretton Woods Conference might not accomplish very much. I wonder what your views are on this question.

- I believe that a new Bretton Woods Conference at this stage would be a disaster. I cannot say what it can accomplish except to promote a wave of speculation, a wave of uneasiness and no decision. The reason why that's so, is because we do have at the moment existing institutions for international cooperation, the International Monetary Fund, the Group of Ten central bankers, the Bank for International Settlement. There has been no shortage of forums of institutional arrangements within which you could get monetary reform, but there hasn't been any significant monetary reform. The most recent of these episodes was the Bonn conference last fall, and again there wasn't any agreement there. There's little point, it seems to me, to having any kind of an international conference unless there has in advance been a wide measure of agreement among the participants as to the kind of changes in the institutional arrangements they would like to bring about. Short of that, you will have an interminable discussion and very little consequence. But if you had that kind of an agreement, if you were anywhere close to that kind of an agreement, it could be affected through IMF, or through one of these other institutions, and would not require another conference. So far as the United States is concerned, I think we ought to be willing to continue to cooperate fully with all of the other countries, to deal with them, to go back and forth with them, but I do not believe that we have anything to gain by submitting ourselves to the kind of a farce that at this stage would be involved in a Bretton Woods Conference.

- Doctor, do you think the meetings of the so called Ten, out of which came the Special Drawing Rights plan, were constructive affairs?

- I do not myself think so in terms of the outcome, I am in a small minority of those who have very little hope or faith in the SDRs. The SDRs are an attempt to postpone matters, they are an attempt to provide some kind of a paper-gold substitute, they have not yet come into effect. I venture to predict that while they may come into effect, they will never come into effect in more than a rather token fashion. Now why is this so? You have widespread agreement on it. But unfortunately what you have agreement on is the idea, the general idea, the general principle. You do not have an agreement upon the exact details, in particular on when it should come into effect, and on the amount that should be produced. Now each country separately, will be delighted to join in an arrangement under which it can use as much SDRs as possible, provided at the same time that it need accept as little as possible. So while every country separately will be in favor of SDRs, under the right arrangements, these arrangements are ones that it will be very difficult mutually to agree upon. People are talking about the SDRs being better than gold and therefore why shouldn't people want 'em? But if they were better than gold, it is hard to see why they would have to be hedged around with all the requirements that they are in fact hedged around with, about redeemability in gold, about how many you have to take, how little you have to take and so on. And all of these things lead me to believe that when and if SDRs come into effect, they will be in a rather token fashion. Of course I should explain that partly part of my underlying uneasiness about it is that I think it is not desirable from the point of view of either our country, or more important the world, to give a group of central bankers from ten countries enormous powers to run the world. We have had experience with this kind of thing before. One of the episodes that has most strongly impressed itself on me, was the experience of the western world from about 1925 to 1933 or 4. At that time, you had a smaller number of major central bankers. You really only had four that counted. You had Montagu Norman who was a head of the Bank of England, you had Emile Moreau whom I mentioned in one of these earlier talks in connection with his standing up firmly against Poincare. You had Emile Moreau of the Bank of France, you had Benjamin Strong in the United States, until he died in 1928, and then after that George Harrison. They were both the heads of the Federal Reserve Bank of New York. You had Hjalmar Schacht in Germany, the man of notorious Nazi fame, who was a Nazi finance minister, the man who invented one of the few modern inventions in the economic sphere, namely exchange controls of the modern type.

- Oh.

- This is a separate issue. You know one of the extraordinary things is how people take things for granted, because they're familiar with them. We take the status quo for granted. And everybody thinks well, if you ask people, What about exchange controls, the limitations and how much you would pay and so on? Everybody takes it for granted that that's something of very, very long standing. But it's one of the few things whose invention you can date with precision. It was on a--I've forgotten the exact day, but there is a day in 1934 when Schacht introduced these in Germany. Prior to that date you have various minor forms of exchange control, but you never have had the extensive kind of sweeping control of what a man may do with his money, the kind of sweeping prohibition of converting marks as it was then into other currencies that you had then. And of course what people don't realize, is that Schacht's controls were not solely for balance and payments purpose, indeed not predominantly. A major function of Schacht's controls, exchange control, was to make it difficult or impossible for the Jews to get their capital out of Germany. And it was a very, very successful measure from that point of view. But the modern imitators, the India's, Brazil's, and others who are imitating it, are not using it for that purpose. Well let me go back. I was saying at that time you had the consortium of Montagu, Norman, Emile Moreau, Hajalmar Schacht in Germany, Benjamin Strong in the United States. And here were the four men who did have an enormous amount of power, and who were cooperating. Montagu Norman is a key figure in this. He was the Englishman. And this is why I bring it up in this connection. He was absolutely clear and explicit about what their role was to be. Said Montagu Norman in so many words, essentially in private conversations that were recorded, "The world needs some sensible people and strong people "to run it properly. "We can't depend," said he, "on either the vulgar mobs or vulgar democracy "that controls Britain and the United States, "nor would it be desirable to depend "on the plutocracy that controls wealth. "We need these well-intentioned public civil servants "who have the good of the world at heart, "namely I and these fellow men, "to control the world. "If the four of us," he said, "really work together and cooperate, "we can run the economic destinies of the world, "in the right way." A benevolent dictatorship. Not called that but that's what it was to be. Well now if you stop and think about it, suppose you gave the government, the central bankers, a group of ten, enormous powers over the way in which the international financial machinery was to be run? They would have enormous power. That power would be granted to whom? Not to people who have been selected through any democratic process. Not to people who have any responsibility to an electorate. To ten people who happen to be at the heads of their central banks or their governing boards. And this has two things about it. It seems to me a politically intolerable arrangement. We may many of us hope that we will have a greater form of international cooperation, but it must take arrangements which provide for political representation and democracy. So it's undesirable politically. But also it's unworkable economically. Because for the very reason that these men have no political basis, if they try to do something that is very unpopular, or that would go much against the grain of national policies, they will be discarded. This is the second lesson that you learn from the episode of 1925 to 1935. As soon as the central bankers were engaged in an activity which ran into great difficulties for the rest of the world, in our case as soon as the U.S. central bank was forcing a deflation on the rest of the world, well then the central bankers lost their position of power. They weren't able to do what they wanted. And similarly now. It seems to me that to try to have a group of ten central banks have large political and economic powers would be a terrible mistake, from their point of view as well as from ours.

- That's an interesting appraisal. Doctor, there've been a number of recent, well articles, commentaries on whether the Federal Reserve Bank is keeping money typed or making it typed or not. One of the popular newsletters starts out, "There's a new policy on money. "The policy is to keep money typed "for the foreseeable future." On top of that, a recent article in a newspaper under a Washington dateline says that the so-called monetary in-groups are looking dubiously at the nation's central bank operations. People are criticizing, sort of laughing at the Fed, according to this piece. What would be your reaction to all these different kinds of opinions on what the Fed is doing, and whether it really knows what it's doing, and what the effect of what it's doing is going to be.

- Well what one is observing now I think, Bill, is a very interesting situation of a great deal of discussion and dispute because you are in a transitional phase, in which one conception of monetary operations and policy is in fact taking the place of another conception. And the time when you get the most crossed currents, people misunderstanding one another, confusion, is always at a time when you're shifting direction in this sense. One doctrine which has been dominant is declining and another doctrine is taking its place. Well that's really what you're having now. In grossly oversimplified terms, what we're seeing now is the decline of the credit doctrines, which have in fact ruled the Federal Reserve System, and other central banks as well, for many, many years, and the emergence of the money supply doctrines, which have been gaining increasing adherents among economists and others. Now this shows up in everything. Let me illustrate in a number of ways. First, what are the actual facts about whether money is tight or not? If you're a credit man, if you have been taking that view all along, by the traditional Federal Reserve approach, or credit approach, money has been tight for a long time. Money has been tight because why? Because from that point of view, the measure of tightness is interest rates. If interest rates are high, money is tight. Well interest rates have surely been high for quite a long time, and in particular, they rose very rapidly during the second half of

1968.

- They surely did.

- They reached, I guess the most dramatic of these was the prime rate of 7%. And I gather there's talk about a still further hike in the prime rate, isn't there?

- Yes there is. You do hear this.

- Well from that point of view, money has been tight. And from that point of view, money will surely remain tight. The interest rates are going to remain high. But that's the credit approach. Now comes along the monetary school and says, But now look, interest rates can be high, not because money is scarce in any relevant sense, but for other reasons, because demand is rising for other reasons. Look, we would say to the credit school, interest rates rose and were very high during the last half of 1968, but at the same time the quantity of money, defined as currency plus all commercial bank deposits, rose at a rate of nearly 12% a year, via what the Federal Reserve calls a bank credit proxy, which is simply member bank deposits. And in fact I may say, that very terminology exemplifies this switch from one doctrine to another. They are using the old words to refer to one of the new concepts. We can go back to that if you'd like in a moment 'cause I think it's an interesting phenomenon. But what they call a bank credit proxy has been rising at the rate of about 13% a year during the last six months of 1968. By any standards of quantity, that is extraordinary ease, not tightness. So from the new approach, from the monetary supply approach, you would say we've had very easy money for the last half of 1968. Alright now what about this month? Well now for the month of January, both approaches as it happens will say the same thing. Interest rates have remained high, in that sense money is tight, but there has also been a dramatic shift in the rate of monetary expansion. Now as yet we only have evidence for about three weeks, and I would hesitate to make any very firm or long-range prediction on the basis of three weeks. There is a great deal of an erratic element in the monetary supply series. But if you look at that month, money defined as currency plus all commercial bank deposits, which is close to what they call the bank credit proxy, money defined that way has in this month stopped rising and actually declined absolutely. A very rare event. Money defined more narrowly to include only demand deposits, currency and demand deposits, has continued to grow but at what appears to be, in that three week basis, a sharply reduced rate, so that looking at those figures, you would have to say that that first month of 1969 looks very much like the first month of the credit crunch in 1966. I no longer remember whether that was March or April, but it's either March or April which showed a sharp tapering off. If indeed this is continued, then you will have had a very drastic shift to tightness, if when you were referring to the letter which referred to the money as being tight, when they said it'll be tight for months to come, if from this point of view, from the monetary point of view, if the change in the behavior of the money aggregates continues, you will have extraordinarily tight money for the next few months, and you will produce something like the credit crunch of 1966.

- Is this shift probably the reflection of a shift in the Fed's Open Market Operations?

- Oh it undoubtedly reflects a change in the Federal Open Market Operations, but in the present instance it also reflects something else. It reflects the coming into serious operation of Regulation Q. Now what Regulation Q means is that time deposits are allowed to run off, 'cause certificates of deposits are not renewed. That in itself would lead to a shift, if that were all that happened, the only real effect would end up by being that demand deposits would increase and replace the time deposits. But demand deposits require higher reserves than time deposits. As a result a run-off of time deposits means that for the same amount of Federal Reserve Open Market Operations, for the same reserves fed into the system, the banking community can have a smaller total of money more broadly defined. And consequently, the major reason at the moment why currency plus all commercial bank deposits is turned around, is because of this shift out of time deposits, rather than because of a drastic change in Federal Reserve Open Market Operations.

- I see.

- But any continuation of this trend, any continuation of such a sharp break, will certainly reflect what the Federal Reserve Board does in buying and selling bonds. Now as I say, if you look at this current situation and ask, Is money tight? you have to say, it seems to me, by whatever measure, for the month of January, yes. Prior to January, yes, if you're continuing the old style, looking at interest rates. No, if you're looking at money supply. What will happen for the rest of the year? Well now that's where you get into this thing that in that article you were quoting, of Ed Dales in the New York Times, there's no use not to give him full acknowledgment for--

- It's an interesting piece.

- Yes is it. He has his tongue in his cheek (chuckling) and he's having some fun. But as always, nothing is good fun unless there's a real element of truth to it.

- Right. Well, that's a much more complicated question, because what's happened is that when old habits change, they don't change all at once. When people change one part of their behavior, some of the other parts of their behavior lags behind. There's what the anthropologists call a cultural lag. Well in my opinion what's been happening in central bank circles, and particularly in the United States and the Federal Reserve, is that unquestionably they have been starting to give more and more attention to these monetary aggregates, to these totals. Currency plus demand deposits, currency plus all commercial bank deposits, bank credit proxy. They've been very resistant on that. And I mentioned before that the titling of bank credit proxy is--

- Yes I wanted to come back that and I'm glad you have. So using for an old terminology in connection with new concepts, is that how you put it?

- Yes. You see what they've really done, what is a bank credit proxy? Why is it called that? Well what it actually is numerically, is total member bank deposits. But why not call it member bank deposits?

- Why not?

- Because member bank deposits is one of the elements in the money supply totals, and I and others have been urging should be used as a criterion of policy. Now, every bank has a balance sheet. It has a total of liabilities and it has a total of assets. The two, short of an embezzler, always balance, they always agree. That's accounting. The liabilities of a bank are almost entirely deposits. There are a few other liabilities such as capital and net worth, but mostly it's deposits. The assets of the member bank are currency in the vault, deposits with the Federal Reserve System, and then the rest of it is what you might properly call bank credit, namely loans and investments. Alright now, therefore, total member bank deposits are a very close measure of total member bank credit. And so it taketh, while they measure member bank deposits, they call it the bank credit proxy. What does a proxy mean? That instead of measuring credit directly, you measure it indirectly through the means of member bank deposits. Why use that terminology? For the reasons that I'm saying, that that produces a greater continuity in terms of their behavior. They've been accustomed to looking at credit measures, and whether credit is tight or easy, whether interest rates are high, whether funds are available and so on. So by using this terminology and calling it credit proxy, they seem to themselves to be departing less from the earlier approach.

- I see.

- Well that's one sign, their adoption. They're placing emphasis on that bank credit proxy, on member bank deposits, on one component of the money supply broadly defined. I should say that's another reason for this language. You see, the Federal Reserve has always used the word money supply to refer to currency plus demand deposits. And that's a perfectly good usage. I'm not going to argue strenuously. This is a question of terminology. But it so happens that I and those who have worked with me on monetary studies, have found it more useful to use money supply to refer to currency plus total deposits of commercial banks. A major reason why we have found that more useful, there's lots of reasons and lots of evidence, but a major reason is because if you go back before 1914, the distinction between time and demand deposits did not have the significance it had today, and there are no reliable figures on that break-down before 1914. And since we've tried to do a lot of long historical studies covering the period from about 1867 on, and indeed we've had some people doing it earlier than that, it has been very useful to have a concept that we could keep the same all along. But that being the case, we have used money supply to mean that. The use by the Federal Reserve System of member bank deposits is partly a move in that broader direction. And that has also made it a little more difficult. But now coming back to the change. As I say, this use of my bank credit proxy and other indications, make it absolutely clear that the central bank, the Federal Reserve System, has given increasing attention in recent years, and more particularly in recent months, and this month, to what is happening to the monetary aggregates. But that has to do with their objective, with what they would like to do. On the other hand, their operating procedures, the way the people in New York operate, the instruments through which they carry out their policy, are still the instruments which carry over from the earlier approach, which carry over from the approach of trying to have interest rates behave in a smooth fashion, trying to hold down interest rates, trying to determine credit conditions. Well, now that means that there's a kind of a schizophrenic situation in terms of our monetary authority. While they've changed to a limited extent, to a substantial extent, their objectives of policy, they have not as yet adjusted their instruments of policy to enable them to achieve their objectives. And if you look at Dale's piece on that, you will see, I believe, that this distinction between the objectives and the instruments of policy goes a long way to explain almost all of the humorous puzzles that he mentions in his piece.

- Thank you very much, Dr. Friedman. 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. This is William Clark. Dr. Friedman and I will be talking to you again next week.