
- Hello, this is William Clark of the Chicago Tribune, saying welcome once again on behalf of Instructional Dynamics Incorporated to a visit with the distinguished economist Professor Milton Friedman of the University of Chicago. As we record this visit, March is almost upon us. It's getting close. And Milton, we always seem to run out of time before we get to the letters from your subscribers. Suppose we start today's visit by taking up a couple of those letters. The first one I have is from Mr. Vaughan E. Taylor, vice president of the Reuben H. Donnelley Corporation, and Mr. Taylor writes as follows. "In February's Fortune, Mr. Roy O. Little, "former chairman of Textron, likened our present recession "to the recession of 1920 and '21. "For your convenience, I am enclosing a copy of the article. "Based on his analysis, Mr. Little predicts "a sharp reduction in consumer and business demand "with a resultant drop in raw material costs "and interest rates, as well as the virtual disappearance "of inflation by year end 1975. "To offset the forthcoming reduction in demand, "Mr. Little recommends cutting inventories, overhead, "and operating costs, paying off current bank debts, "and reducing or eliminating long-term commitments "for raw materials at fixed prices. "How would you agree or disagree "with Mr. Little's analysis and conclusions?"

- There's much to be said for his basic analogy. There is a good deal of similarity between the present recession and the recession of 1920-21. Both are extremely sharp. Both follow a period of rapid inflation. But there are also important differences. I think the major differences are two, one in magnitude, another in quality. So far as magnitude is concerned, the inflation that preceded the 1920 recession was considerably sharper than the inflation that has preceded this one. Prices in the United States doubled during World War I, and half of that increase, roughly, came after the war. So from the end of World War I in 1918 to early 1920, prices rose, if I remember rightly, by about a third, from 150 to 220 or 160 to 220 in terms of index numbers. That was a very much sharper price rise than we experienced in the past year. The second thing about the price rise is that unlike the price rise we've been experiencing, that one was widely regarded by everyone as temporary. It did not really get built into people's expectations. It was interpreted as an effect of World War I, which it was, and the post-war rise as an aftermath of the war, rather than as a element of a new era. With respect to the present or more recent price rise, I think the situation is different. Almost everyone interprets it as part of a longer-term phenomenon, and therefore a good deal more of it has been built into people's expectations. With respect to the recession, in January 1920, the key step toward the ending of the recession was a decision by the Federal Reserve Board to raise its discount rate. In the prior year, it had been accommodating the Treasury in floating securities, and had been essentially holding down the interest rates. As a result, it had been pouring out a great volume of credit, interestingly enough, to private sources, because the government itself was running a balanced budget. It was refinancing bonds rather than floating more. The wartime taxes that had been imposed in 1918 were just beginning to bring in their full revenue potential. Expenditures had gone down sharply with the dismantling of the armed forces, so that interestingly enough, the government was having a surplus during 1919, early '20. But nonetheless, the Fed had been increasing the money supply very rapidly by holding down its discount rate and by stimulating private credit. The discount rate at that time was of vastly more importance than it is now because in January 1920, total borrowings at commercial banks exceeded the whole of their required reserves. They had essentially negative owned reserves. That sum today, I'm not sure what the exact magnitude would be, but it would be, oh, a very large multiple of any volume of borrowings that we now have. Under those circumstances, when in 1920 the Fed suddenly raised its discount rate, this put enormous pressure on banks to contract, and you had a very sharp, and this is the second difference of that period from now, you had a very sharp contraction in the quantity of money from early 1920 to the middle and later 1920, and this produced a very sharp decline, not only in economic activity, but in the price level. If I remember rightly, the decline in prices in 1920-21 was at the fastest rate of any decline in prices that we've ever experienced. What it was, was a puncturing of a bubble, and when the bubble broke, it really collapsed, so that by the summer of 1921, as Mr. Little properly said, you had falling prices instead of rising prices. You had essentially a zero rate of price increase. And then for the rest of that decade, well, you had some recovery in prices to '23. From '23 to '29, prices, if anything, fell. Now, that's the second difference. While the Fed has been following a very restrained monetary policy so that the M1 has grown only at the rate of 1% per year over the past seven months and M2 at the rate of 5%, there is essentially no chance that it is really going to reduce the quantity of money, that you're going to get a positive fall. And indeed, I believe the outlook is that the Fed is in the process of shifting, and it's trying and will succeed in getting a very rapid increase in the quantity of money, so that while up to now you might say there are some similarities, I think from here on out, the danger on the monetary side is of stimulating a new inflation, not of forcing a further decline. On the other hand, based on what has already happened, there is every reason to expect that this recession will be the most serious of the post-war period, that it will extend to late in the year. The question is what about the advice that Mr. Little gives? That advice is premised not merely on a tapering off of inflation, but on a positive decline in prices. Raw material prices, of course, are very variable, and they already have declined much. But if we take the price level as a whole, it is almost inconceivable to me that it will really decline absolutely over the next few years. I think we will be very lucky if, on the contrary, we don't have a renewal of inflation. It may well be that by year end '75, the rate of inflation may be in the range of 5%, 6%. It might be a little lower. Obviously, just as we overshot on the way up, we might overshoot on the way down. And so just as we went up to 12% on the basic built-in inflation of 6% or 7%, we might go down to 4% when the basic rate of inflation is 6%. But looking forward for more than a few months, I think it would be very unwise to anticipate a decline in prices. Moreover, so far as interest rates are concerned, again, they are coming down, but again, that's going to be a temporary phenomenon as the economy turns around, and as we have an increase in quantity of money, interest rates will go up. Obviously, so far as individual business is concerned, it may well be sensible to cut inventories, overhead, and so on. It seems to me all of that has to do with how you manage a particular business and enterprise. But I find it hard to believe that a business would be well advised, if they can do so, to eliminate or reduce long-term commitments for raw materials at fixed prices. On the contrary, if they can get them at today's prices, which it can't, it probably should apprehend such commitments.

- Good enough, and thanks to Mr. Taylor for his letter. Now, Mr. Thomas E. Keistecker of Winnetka, Illinois writes as follows. "Dear Dr. Friedman, you have made a recent reference "to an autonomous velocity increase "without a prior increase in the quantity of money "that occurred at the time of the Korean War. "Would you point out examples in the past, if they do exist, "of autonomous decreases in the velocity "without prior decreases in the quantity of money? "In view of the University of Michigan's "Survey Research Center's Index of Consumer Sentiment "being most pessimistic, what are your estimates "of such an autonomous decrease "occurring in the immediate future, "and with what near-term and longer-term effect?"

- That's, again, also a very penetrating question. The Korean War autonomous velocity increase was easy to understand at that time. It was just shortly after the end of World War II after the price-controlled experience of World War II and the jump in prices immediately afterwards. And you could thus understand that fearful of further price controls, fearful of further price increases, and fearful of the unavailability of goods, people wanted to get out of money into goods. Now the other kind of move, autonomous decrease in velocity, I cannot think of any example that is as dramatic and as long-continued as the Korean velocity increase. However, you have had almost invariably an autonomous velocity decrease whenever uncertainty increases by a large amount. The most dramatic examples of that are the outbreaks of war. In 1914 when World War I broke out, and again in 1939 when World War II broke out, most people would anticipate, looking back, you'd say, "Well everybody knows "that wartime is gonna be a period of inflation. "The stock market price rises and so on." And yet the outstanding feature of the first couple of months of both of those wars was that stock prices fell, that the prices of commodities fell. And the explanation that has generally been given for that is that the increased uncertainty at that time, raised by the war - nobody could know exactly what was going to happen, what goods were gonna be available, how they were gonna be available, and so on - led people to want to be more liquid, to have their cash balances higher. And this was an autonomous decrease in velocity. Again, exactly the same thing happened in 1971 when Mr. Nixon imposed price and wage controls. All of a sudden, people- That case, prices and wages were frozen, you will recall, for a 60 or a 90-day period, I've forgotten which. And people at that time were very uncertain about what would happen. And as a result, if you look at the statistics, you will find there was an autonomous velocity decrease. It was not very large. I once estimated it at that time as being about 2%. But it was very obvious. The later price control moves, when a second round of price controls was imposed, did not have the same effect because by that time, people had come to recognize that price control was going to be followed by inflation rather than deflation, rather than to table prices. And so you had two offsetting forces, one of which was uncertainty, which would decrease velocity, the other of which was fear of higher prices, which would increase velocity. As of the present time, it's not clear that pessimism, per se, will decrease velocity. What will decrease velocity is uncertainty, which leads you to want to be more liquid and to hold a larger amount of cash. And to some extent, that always happens during a recession. I am distinguishing at the moment these autonomous velocity decreases and increases, which come out of some unexpected event, from the typical cyclical pattern of velocity. As a standard matter, during an expansion, velocity tends to increase. During a contraction, velocity tends to decrease, and that decrease tends to reflect this kind of pessimism and uncertainty that always goes along with recession. And to some extent, that is happening now, and velocity is decreasing somewhat now. However, only to a very small extent if you look at M2 velocity. That's been extraordinarily stable.

- Thank you very much. That also was a good letter. We haven't discussed the oil situation on these tapes for a while, Milton. Thinking back to some of our comments of a year or so ago, the oil cartel has been remarkably durable, and some people have been surprised at its durability. Recently we have been reading some articles suggesting that maybe there's going to be a crack showing up in the cartel. I wonder what your observations are at this point.

- Well, it's a funny thing about the way in which these reports that you're referring to go. There seems to be a tendency for the media to swing wholly one way or wholly the other way. Somehow or other, you never have just one paper bringing out a story. They all bring them out. As a veteran of the newspaper business, you know about that better than I do, though. But in this case, for about a year, the only thing you could read in the newspapers was that the oil cartel was here and with us forever and that the higher prices of oil were inevitably going to last and that the newfound cohesion of the OPEC countries was a permanent thing, and so on. Now as you quite properly say, when the oil embargo occurred in October of 1973, I expressed the view, both in these tapes and also in print, that the cartel would break down. And that was based on the experience of similar cartels in the past, the coffee cartel, tin cartel, rubber cartel. We have no end of past experiences of cartels. And I could see no reason why this cartel was fundamentally and basically different from others. The reasons why cartels tend to break down are very simple. They really have to do with the elementary proposition that people can adjust better to unexpected change the more time they have to adjust to it. That's a very simple proposition, yet it's a very fundamental proposition. Let the price of something like oil be raised sharply, let the production of it be curtailed somewhat, and immediately it's very hard for people to adjust to it. It takes a very high increase in price to get people to conserve enough to meet the reduction in the quantity produced. But give them time, and all sorts of changes happen. People can shift the kind of cars they drive. They can shift their habits. They can shift where they live. They can move to different fuels, different energy sources. And on the other side of the picture, there is a great incentive for people to find alternative sources, substitutes for oil, whether it be- or rather for OPEC oil, whether it be oil produced elsewhere or whether it be alternative sources of energy or what. And in my opinion, that was the reason why, in my opinion, the cartel was doomed to break, because as these longer-term adjustments take form, they inevitably produce friction within the cartel. They require that to maintain the price, you have to have a reduction in production. So long as most of the cartel members can sell all they produce at these high prices, everybody is happy. But as soon as you have to start reducing it, the question is, who should reduce it? But having said that, I must go on and say that I was wrong in my estimate of the length of time it would take. As of October 1973, I would've predicted and did predict that by this time, close to a year and a half later, the cartel would not only be showing signs of cracking. It would've cracked. And so I have been puzzled as to why the cartel has been as successful as it has. Most cartels have not been able to last that long. I think there are several factors that explain the relative success of the cartel. First, the cartel did consist of two groups. The one outer group, Iran, Venezuela, Nigeria, etc., countries that did take advantage of the cartel and the higher price to produce all-out and get the higher prices. Then the inner group of Saudi Arabia, Kuwait, Abu Dhabi. These are fundamentally- Algeria, to some extent. These are fundamentally the countries which took the bulk of the pressure to reduce output. And they were in a peculiarly favorable position to do so compared to most cartels in the past, for several reasons, one of which was that none of these are democracies. They all are in the hands of a small number of oligarchs who are really running the thing. The second is, they have relatively small populations, so that the enormous increase in their incomes left them simply with funds to invest. It was not used for current needs, unlike the case of some of the others. As a result, they were in a position where they could sustain fairly large declines in output. The most recent issue of Newsweek has an interesting chart which documents the kind of statement I have been making. That chart shows output in relation to potential. And if you look at that, you will see that the biggest cuts in that have been the cuts by Saudi Arabia, Kuwait, Libya, and Abu Dhabi, the countries that I have been referring to as being in this position. And in some of those cases, the cuts are

really dramatic. For Libya, they're down to less than a third of their potential. For Kuwait, it's roughly a half. For Abu Dhabi, it's less than a half. For Saudi Arabia, it's about three-quarters. Now, those are very substantial cuts in production. On the other hand, if you look at Iran, its output has been cut only about 10%. Venezuela about 10%, Nigeria about the same, Algerian hardly at all. Those outer countries have sort of been getting the gravy while the inner countries have been bearing the burden. A second factor, I think, which contributed to the long period during which the cartel was successful was our own foolish policies. The United States, instead of following the sensible policy of letting market rates rise to whatever they would and giving incentive for domestic production, has followed the policy of letting the price rise to a considerable extent, but at the same time discouraging domestic production by having a price ceiling of $5.50 on old oil and a price ceiling of 25 cents on old gas, 50 cents on new natural gas. The result of this has been that there has been an actual decline in the production of oil in the United States. We are now importing a million barrels a day more from abroad than we were before, so that we have really been acting as if we were paid agents of the OPEC cartel. And I believe that has contributed a fair amount to the maintenance of demand for Arab oil. As an aside on this, it is an example, one of these examples of terrible economics, the way in which people react to these kinds of things. There's a egressions law that cheap money drives out dear money, and there's also what I think is a law of economic journalism that bad economics drives out good economics.
(laughs) Your own paper, the Chicago Tribune, had a headline the other day about Plan to Raise Oil Prices. And what it consisted of was Ford's proposal to eliminate the ceiling on the price of old oil.

- I noticed that.

- Now, eliminating that ceiling would surely lower the price to you and me. It wouldn't raise it. If you eliminate the ceiling on old oil, that's surely going to make for a larger amount of oil produced, not a smaller. How are you going to have a larger amount of oil sold at a higher price? Where is anybody gonna buy it? Right now you don't have any rationing. Markets are clearing. There are no lines at the gas stations. And therefore, the effect of removing the ceiling on the price old oil would be to raise the price of old oil, but what it would do would be to eliminate the wedge between the $5.50 for old oil and the $10 or $11 for new oil, which some middleman somewhere or other is being able to rake in. He's the one who would be hurt. The producers of old oil would have an incentive to exploit their wealth more fully and to get more old oil. The consumers like you and me, we would have more oil to buy and therefore the price would go down. And you would have a further continuation of the pressure which you now have on all gasoline stations to sell off. Well, going back to the general situation, while I was wrong about the timing and it has taken longer than I expected, it now has really begun to bear. And now you've had all the news media suddenly switch to the other side, and not only the Wall Street Journal, but also the Newsweek and everybody else has been having stories about the cartel is showing signs of breaking. One thing about that, that we should learn from past experience, is that once a cartel starts to break, it often happens very, very fast. And the reason for that is straightforward. As time goes on, these adjustments become larger and larger on the part of other people, and you have the- both in demand and supply. In addition to which, the more the countries cut, the further cut that is required for a given decline in world demand. If I'm producing 100 units and world demand goes down by 10, I have to cut my output by 10%. But if I'm producing 50 units and world ouput goes down by 10, I have to cut by 20%. And therefore it's always much harder to achieve the further cuts in production that

are needed to maintain the price of oil. Another factor, as I mentioned, is the increasing effect of further discoveries. I'm told that in the year and a half since the embargo, the amount of new oil discovered in the world, in Mexico and Indonesia, off the China Sea, in the North Sea, and so on, discovered outside OPEC countries and outside of the US continental, United States, that that new oil discovered amounts, in reserves, to the same amount as total US continental reserves. So in one year, we've added that much to the world's known reserves. And consequently that's going to come on stream. It takes time before it dissolves, so that I think we can look forward confidently to a real break and a real destruction of that oil cartel. In view of my past experience, I hesitate to stick my neck out
(laughing) by giving a time span. But yet, it's inconceivable to me that by this time next year (laughs), that won't be a thing of the past.

- Thank you very much, Dr. Friedman. May I remind you, subscribers, if you would like to suggest questions for Dr. Friedman to answer or subjects for him to discuss on future tapes, please write your suggestions to Instructional Dynamics Incorporated, 450 East Ohio Street, Chicago, Illinois 60611. We'll be talking with Dr. Friedman again two weeks hence.

- All right, we've gone up a thousand.