

- Hello, this is William Clark, financial editor of the Chicago Tribune, welcoming you, once again, on behalf of Instructional Dynamics to this weekly series of commentaries on current economic development. Once again, we are visiting with one of the nation's leading economists Professor Milton Freedman of the University of Chicago. Dr. Freedman, some of the financial writers are saying that money is very tight and that the Federal Reserve people are stepping on the brakes pretty hard. And others are saying just the opposite. And I find this quite confusing. I wonder if you could help me out of this confused state.

- Well, the funny thing is, that probably all of them are right. The situation is confusing and not really the commentaries. In all the period that I have been watching these monetary totals, which is a considerable time, I do not know of any other period in which it is so hard to read the monetary figures and see exactly what they are saying. The most interesting thing, the way to show what the problem is, I think, is to explain how different indicators are saying different things. In general, there are three indicators that are worth watching from this point of view from the point of view of monetary supply. First, there's the broad monetary total of currency, plus all commercial bank deposits. This is both demand and time. This is a total that has special importance because we've had evidence on it for a very long period of time, but also, because it comes closest to corresponding to the total assets of the Viking system, (indistinct) which the Federal Reserve pays attention to. And so, it has a great deal of relation, as I mentioned in an earlier take, they've been putting emphasis on bank credit proxy, so called, which is very close to this concept.

- Yes.

- So, there's first of all there's broad total, which for convenience in referring to, I'll call M2, which is a jargon, Capital M sub 2, which is what the economists working on this has come to adopt for it. Second, there's a narrower total, which is currency plus adjusted demand deposits, which the Federal Reserve used to always refer to as money supply and still uses the term money supply to refer to. We'll call that M sub 1, M1. And the third, there is something which, in the Federal Reserve jargon, is called High Power Money. Which now tends to be called more nearly the Monetary Base. Which is currency in circulation, the green stuff plus deposits of the Federal Reserve. That is it's really currency plus bank reserves. It's high powered because it's the stuff such that banks get more of it. For each dollar they get, they can issue the banking system, as a whole, four or five dollars of deposits, so it has a multiplier. That's why it's called High Power. It's called the Monetary Base, for the same argument. Because the argument is that this is a base on which the quantity of money is erected.

- I see.

- Now look at these three things. Here's M2, here's M1, here's the base. And what are the facts on them? As between, for M2, the total quantity has been falling very, very sharply. In fact, if you compare the level of M2 now with the level of the, say on the average of December or mid-December, it's been falling since then at

the rate of 5% a year. Before that period, for the six months before the middle of December, it had been rising at the rate of 12% a year. So you've gone in M2 from a rise of 12% to a fall of 5%. Which if you look at M2, you must say we've got enormously tight.

- I can see that's a very sharp turnaround.

- So I think it's about as sharp as any I know on the record. Second, however, suppose you look at M1. Now, M1 prior to December, was rising at a fairly rapid rate. I think the figure was around six, or seven, or eight percent, somewhere in that neighborhood. For some reason, I don't have that figure exactly in mind. But since, the beginning of December, M1 has been horizontal, on the average. That is the level of M1 now is roughly the same as it was in early December. In the meantime, there was a big spurt up and down, an erratic movement, but on the average, if you say, "where are you now?" You'll have to say that for about six weeks now, you've had, essentially, a rate of growth of one percent, uh, zero percent per year in M1. Well, that again is very tight looking at it, as you go from eight percent, or seven percent, six or seven percent, to zero percent. It's not as sharp a swing as M2, but it's still tight. So, if you look at those two, you have to say money is, in that sense, tight. But now, I go and look at the Monetary Base. The Monetary Base, which is this additional High Power money, they total that stuff is currently go up at the rate of eight percent a year, which is faster than it was before December. Before December, it was going up at something like six or seven, now it's going up at about eight percent a year. And so you have these three basic totals that are each telling a different story. And the real thing you have to do at the moment, is to try to understand the differences among them.

- What is the reason for this seeming discrepancy?

- Well, suppose we start with M2, 'cause that's kind of the bay place to start at, I think.

- Alright.

- And there, the explanation is very, very simple. The explanation there has to do with regulation Q. As you know, regulation Q is a regulation whereby the Federal Reserve system sets a maximum rate on the interest, a maximum level on the rate of interest, that member banks may pay for time deposits. Now this rate of interest is a complicated structure of maximum rates because it applies to household safety deposits, and what's more important for our present purpose, large certificates of deposits. That is, certificates of \$100,000 and over, which are new market instrument developed over the last six or seven years, but now very large in scope, amounting to over 20 billion dollars in volume,

- Hmm...

- Issued by the large banks in denominations of \$100,000 and over for periods of time ranging from one month to six months and over. The maximum rate, which, at the moment, the banks are permitted to pay on this, and this is a rate which has prevailed since April of last year. It hasn't been changed for almost or close to a year. That maximum rate is 6.25% on the very longest certificates. Those that have a maturity of 180

days or more. The rate is 5.75% for maturities of, 90 day maturities. Now, before December, of the past year, those rates were very attractive compared to market rates that were available to the corporations that are the main investors in these certificates of deposit. The alternative rates they could get on treasury bills, on open market commercial paper, and so on. One of the main, less than the rate they could get on the CDs.

- I see.

- Of course, the next question you ask is "How come the banks were able to pay such rates?"

- That's right. (chuckles)

- And the answer is, the banks were not using the funds they got in this way to invest in treasury bills or not very much. Because that wouldn't have paid them. They could pay more in receiving that, they were using it to make loans, to make it a higher rate of 7% or more, business loan. Or they were using it for investments or mortgages or other paper, which had a higher rate. The bank was engaging in what we like to call an intermediary function. The commercial bank was borrowing from the corporations. And using it for these various investments and the commercial banks are very efficient and a sensitive mechanism for doing this, so that they, this is a very efficient market system to do. But now, beginning about December, the short term interest rates, long term interest rates, all interest rates in the market, rose quite a bit. They rose, well, December, late November, but from the end of November through December, they rose. They've remained high since. They have not recently been rising as rapidly as they did in December. December they rose a good bit and since, through January, February, they have been relatively stable. They've shown some rise, but they stayed at a high level. But the regulation Q rates have not been changed. This means that right now, the rate of interest that you can get on a three month treasury bill is higher than the maximum rate commercial banks are permitted to pay on a three month CD. The rate you can get on commercial paper is probably also higher, and these rates are indeed very close to the rates, the maximum rates, the commercial banks are permitted to pay on six months paper. Well, the result of this is, to use this other very long word that has become customary, disintermediation, it's an awful word.

- Yes, it is.

- But, what does that mean? That means that here's a corporation, that before this was buying a CD and it now, the bank was using these funds for its investments. Now, the corporation says, "Well, this is silly. Instead of my buying the CD, I'll go to the market and buy a treasury bill or commercial paper directly for myself." Now, the reason it's called disintermediation is simple. Consider what isn't the fact, but it's sort of a hypothetical case, which will make it first. Let's suppose that the commercial banks themselves had been buying precisely those things that corporations are now buying. Let's suppose that the commercial bank had been borrowing through the CD of the corporation, and using those funds to buy treasury bills or commercial paper. Now, suppose the corporation simply buys the treasury bill directly. That is, the bank is now no longer used as an intermediary. But then, from an economic point of view, almost nothing has happened. We just wiped out some book entries. Before, we had asset for corporation, a CD, liability for the bank, a deposit in the form of a CD, asset for the bank, a treasury bill. Now, by this process that I've just

described, we've wiped out two of those book entries. We have asset for the corporation, a treasure bill, the bank has neither an asset nor a liability, corresponding to it. That's why it's called disintermediation, because you've gotten rid of the intermediary. Well, the question, then.. Well, now as I say, that isn't what's literally happened, because the assets which the bank acquired with the funds they got from CDs are not precisely and identically the same as the assets which the corporation will acquire. But you can see, that it's a very close parallel to it, in the sense, that you have a very fluid capital market that funds can flow back and forth from commercial paper to other kinds of asset. And so, in affect, what you've done is to reduce the role of the banks in borrowing from some and lending from the others. And instead, you've increased the role of the corporations in doing the direct lending. Now, the question is, "Is this contractionary?" If we look at this kind of a run off, of the time deposits as a result of the CDs, is this contractionary or expansionary? If you look only at the money supply you'll say, well this is contractionary. If you look through this process at the disintermediation, it's very hard to know if it's contractionary at all. What you can then say, is only, one aspect of it is, that the banks, if anything, have greater free funds because they now have released the reserves which formerly had to be held against the CDs. On the other side of the picture, you could say, so far as the corporations are concerned, they're just as well off as they were before. That's one way of looking at it. It's not the whole way, and it's not necessarily the right way; it's much more complicated. Presumably, the reason corporations held CDs before rather than these other instruments, is because they regarded the CD as a superior instrument. They regarded it as more liquid, otherwise they wouldn't have held it before. And therefore, when they have to go directly into the business of the loans, as it were, the treasury bills, they are making themselves a little bit less liquid. And they will, as a result, want to have higher demand deposits. This is why people will talk about the fact that you've had a shift from time deposits into demand deposits. Well, in a sense, that's right. In part, you have. The right way to look at it is, disintermediation has led to an increased demand on the part of the business enterprises for demand deposits and therefore, an increase in demand deposits would not be expansionary, but would not really satisfy their desires. On the whole, because of the fact that CDs are a recent phenomenon. We only have five or six years of experience with them, we really have no empirical evidence, unfortunately, to know how big is the secondary effect. Whether it's big enough, so that, really, you have to regard this run off in CDs as deflationary or whether it is small enough so you can say, "Well, we really ought to look, not at the total M2 in total but an M2 minus CD." I should say on this going, all the empirical studies in the past, which has led me to regard M2 as a superior indicator of economic policy than M1, those have all been for periods when you didn't have any CDs. So, that evidence isn't relative to the handling of these large CDs, which is a new innovation. And my own personal feeling, at the moment, is that there is a very strong APRI reason to believe, that this disintermediation is not a very important factor. That it doesn't really matter if it is the banks or the corporations that hold treasury bills and commercial paper. And then, consequently, in some ways, you would get a better bit of evidence on the behavior of money, if you look, not at current M2, but at M2 minus these CDs. Now, if you do that, you get back to the M1. Because M2 minus the CDs has been behaving just like M1. It's been roughly horizontal.

- I see. You've been telling us to watch the money supply and I was wondering, as you were talking, if this different behavior of different types of money supply, different types of money, constituted a challenge of any sort of what you've been telling us to do.

- Oh, of course, it does, and it would. My answer, to that particular question, is that these differences in behavior reflect entirely, regulation Q and government intervention world has no business intervening. In fifty years of data, before the past few years, you, at no time, have such wide discrepancies between the movements of different monetary totals as you have in the last five years. Why? Because, while regulation Q, or its equivalent, was introduced in the middle '30s. I've forgotten exactly which banking act. It never was effective. The limits were so high that it made no difference. As a result, you didn't have this regulation Q effect. Now, since the regulation Q has been binding, every time you hit the regulation Q going up M2 is now defined, shows a sharp tapering off, by comparison with M1 and M1 either rises more rapidly or doesn't fall as much. On the other hand, every time interest rates fall and you come through the ceiling the other way, you have this reversed. So that most of this noise in the system is being produced by the government policy, affixing regulation Q. You have no business fixing interest rates any way. Why should the government be fixing prices? And the answer to that question is, that in order to have any kind of sensible monitoring policy at all, by any criteria, we're gonna have to eliminate regulation Q. Now let's go back, for a moment, to the... to these...diverse..

- Alright, yes.

- Because the next question I discussed, and, too, now I want to talk about M1.

- Alright.

- Because the next parcel, here is one of the monetary bases expanding at a very rapid rate. But M1 has been horizontal. How come? Who's been leading up that monetary base? Have the banks been accumulating excess reserves? No, if you look at the figures on excess reserves they have large barter (mumbles). They haven't been accumulating excess reserves. Where has that base been going? Well, the answer turns out to be another technical feature of statistics and another... Not something to do with the private market, but due to government incompetence. Pardon me for using such a strong word, currently. It had to do with the treasury, building up enormous treasury balances in the past few weeks. The treasury has been building up these balances at a very rapid rate. They are now extremely high and this is a result of some of the debt operations there. They have been...I don't know the exact details but I suppose they've been issuing debt in order to accumulate funds for later expenditures or for securities that are due to come due and that they expect to run off or an attrition on them. At any rate, treasury balances have been going up very rapidly and the base has been absorbed and providing banks with the reserves behind these treasury balances. However, when we calculate M1, quite properly, you do not include treasury balances. You include only the money held by the public at large. The reason for that is partly, that we're really interested in looking at M1 and what the public holds, not what the government holds, but the main reason is a different one. And that is, that the total amount of treasury balances both at the fed and at the commercial banks is a purely bookkeeping numbering can be made anything you want. Tomorrow morning, if a fed and the treasury desired they could jointly write an entry in the book that the fed had 20 billion dollars worth of treasury balances, at the fed. It would just involve, there are some technical legal difficulties about the debt ceiling and so on, but I'm trying to...

- Yes.

- What could happen is that the treasury writes one piece of paper, "I owe you 20 billion dollars" and the fed gives him another piece of paper saying, "I owe you 20 billion dollars" and so you show up as a high treasury balance. And treasury balances are purely bookkeeping phenomenon in the reserve. What is important about treasury balance is when they are transferred back and forth from commercial banks to the federal reserve. Well, this build up in treasury balances is largely what has been observing the base and it is what accounts for the fact that M1 has been moving horizontally whereas the base has been rising at a very rapid, indeed, a more rapid pace than earlier. Now, the next question is, "What does this mean? What is the implication of this? What lessons do we ascribe from this?"

- Exactly.

- Well, the first thing is so far as the current monetary situation is concerned, so far as current availability of money is concerned, there's no doubt these figures mean it's tight. Because from that point of view, we want to look at what people actually hold. And whether you look at M1 or look at M2 you have a clear decline in the rate of growth of the total money supply held. That shows up as a much less extreme movement in M1 than it does in M2, and from this point of view, probably in this period, M1 is a better indicator, because of the CD effect. But the... And I may say, in my opinion, it is this current tightness. The fact that there is this real tightness right now that's showing up in the stock market. It explains why you have a decline shock, in the stock market, because we have much experience that the impact of tightness or ease of money, in this sense, shows up much more rapidly on financial markets and understandably so, than it does on income on the flow of payment of goods and services. It can show up right away on financial markets because as all things do, because you're buying and selling existing stocks and prices can move rapidly. Whereas it takes time before it affects how much people are going to spend before these decisions about spending are translated into actual expenditures and so on. And that's why, historically, as I've indicated before, changes in monetary, the rate of change of the money supply have preceded changes in the stock market by a much briefer interval than they have preceded changes in the economy at large. My... as I say, going back, as a description, you have to say that the present situation is tight but now the whole question always is, is this tightness temporary or is it going to last? Can I predict that the M1 will continue to go horizontal? Can I predict the M2 will continue to go down? Because so far, this is only left at something like three, four, five, six weeks, depending on what predictor measure you look at. Now, we know from experience that so far the effect on the economy as a whole is concerned, the economy as a whole is capable of averaging out these disturbances. If I have the money supply going in 0% for one month at, let's say 10% for the second month, that's not going to have much different, it's gonna be a little worse, but not much different than having going up steadily at 5% for those two months. Of course, if I extend that, if I have zero for six months and then 10% six months, then I'm really gonna introduce bigger rations, but the, since these effects are spread out over a long period of time, the economic system is pretty good, pretty good at adjusting itself to the legalities of governmental policies and these... shocks.

- What can you predict at this way?

- Well, you see, that's what's really interesting then, because therefore, as you say, what can you predict about the money supply because if this turns out to be a temporary change, well, then, you've... Then that will mean the market again will turn around and get soft on it, but more importantly, the economy doesn't have any negative implications for the economy. Well, now we look at the base. The base has been going up very rapidly and that means that commercial banks have reserves available with which if the treasury runs down its deposits, they can turn them into private deposits. And it looks very much, from past experience what's happened is the treasury has been very erratic in these movements in its deposits. When its deposits have built up very high, as they have in the past few weeks, in the next few weeks they tend to run them down very much. So, just for that technical feature it looks very much as if the.. Vat fact will tend to make for a rapid expansion in M1. The question then comes, "In order to prevent that rapid expansion the fed would have to change drastically the policy it's followed with respect to the base. That is to say, if the fed were to continue expanding the base at its present rate of 8% then you can be almost sure that the next month is going to see just as sharp a reversal in the behavior of M1 as the last two months of the other way. In that case, the picture looks like one of continued rapid expansion in the relevant monetary totals. What the picture confuses now, at that state, only by a continued CD affect, which will continue to produce or run-off in timed deposits. Under those circumstances, the implication would be that the weakness in the financial markets is very likely to turn out to be temporary when this additional money floods into the system. And then so far, as the economy is concerned, you still will not have taken any effective steps to taper off the economy. Now, as I've indicated over and over again, the danger, you're between a, you're between two poles, given the way the fed reserve system now operates. Given the way it operates, given the additional difficulties imposed by the CD thing. On the one hand, you're always faced with the danger that the fed will overreact; step too sharply on the brakes. And behave as it did, let's say, in '66. And I may say, my own view on this has been changing after looking over these figures more carefully. Because, I had been looking at M1 and M2. And had just about come to the conclusion that the fed was sharply overreacting when some other students of this called my attention to what was happening to the base and treasury deposits. And once you introduce those, I have been led to downgrade my own estimate as to the face of the likelihood that the fed was gonna, at this stage, sooner or later, it'll do it. It's behaved in the past like this, but the fed at this state was really stepping too hard on the brakes. So I would say, if you ask me, "What are the overall implications of this at the moment?" They sum up to say monetary supply as of today is very tight. But there looks like a very, very high chance that this is a temporary phenomenon. That it's going to sharply be succeeded by a very rapid expansion of the money supply in which case, we are still in the problem of having no, not only, no overdoing of the anti-inflationary measures, but no effective measures whatsoever to hold down the inflationary movement that has been going on and has been continuing at a rapid pace.

- Doctor, we're at this point now, now what do we watch in order to try to detect changes and direction?

- Well, we have to keep on watching the things I've really been talking about, I believe, if, in fact, they... What I've said about treasury balances turns out to be right. If treasury balances run off very sharply, then that will show up fairly quickly in a very rapid rate of expansion of M1, of currency and demand deposits. Next, we want to continue to look at the base. Because if the base continues to go up at its present rate, that will obviously mean that the where-with-all that's being provided to the banking system, to the commercial

banks, with which to support a higher volume of deposits. So, what, as observers of the outside, we ought to be looking at, are these figures in M2 and M1 and base, and interpreting them along the lines that I've suggested in this case. What the government ought to be doing is one the one hand, moving to abolish regulation Q and its disturbance, and on the other hand, asking the treasury, for goodness sakes, to stop this whip-saw process of building up large deposits, running down large deposits, and building them up again.

- Thank you very much, Dr. Freedman. 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. Freedman and I will be talking with you again next week.