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- 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. Doctor Friedman, the flurry of finals messages by President Johnson touch on quite a number of economic issues. One that's received much attention is his request for a continuance of the 10% surtax. What is your reaction?

- The motto of President Johnson and the whole group of people who have been, who are urging a continuation of the 10% surtax seems to be that once wrong, twice right. The surtax was originally sold on the ground that it would be an effective measure to halt the inflationary pressure. This was by all odds the most important issue that was stressed by President Johnson and by the myriads of commentators who came out in favor of the surtax last year. In practice, it appears not to have had that effect. In practice, what happened was that whatever repressive effect the rise in the tax might of had was much more than overbalanced by the very easy money monetary policy, as I've commented on at great lengths in earlier tapes. But despite the fact, that the surtax seems not to have had the desired, the effect on the basis of which it was sold, President Johnson and other people are now reselling it on exactly the same basis. They are saying, well now inflation is still proceeding at a terrible rate, at a tremendous rate, you must not take off the surtax because to do so would stimulate further inflation. However, despite the fact that that's what all the talk is about, it seems to me very clear that that is not in anyway whatsoever the basic reason why Mister Johnson and other people are in favor of continuing the surtax. The inflationary issue is in many ways a smokescreen, the real issue is a very different one. The real issue has to do with the size of governmental expenditures in general. The major reason why Mister Johnson wanted in his final message, to suggest continuation of the surtax, was because he wanted in that final message also to suggest a very high-level and an increasing level of government spending. You will notice that his budget message calls for a very much larger increase in federal spending from this year to next than occurred from last year to this. Of course, the fact that the expenditures did not rise anymore than they did from last years to this was not of Mister Johnson's doing. It was because Congress imposed as a condition of raising the surtax, a reduction in government spending. And of course, the actual figures are not yet in, and my own guess is that actual government spending is likely to turn out higher than Mister Johnson forecasted. But all that is beside the point, he wanted to propose a continuation at a high-level of the various programs that had been introduced during his administration. He wanted to propose an increase in the amount of money going forward. He did not want to do that and at the same time appear to be irresponsible by suggesting a deficit. As a result, the only way he could combine those desires was by urging a continuance of the surtax. There was as you know an enormous amount to do, between Mister Johnson on the one hand and Mister Kennedy and Mister Paul McCracken, Mister Nixon on the other, about the form in which the statement would be made. Mister Johnson was unwilling to urge continuance of a surtax unless he could get at least some kind of a nominal indication from President Nixon, from President Nixon, that he would not, immediately move to an opposite recommendation. They finally worked out a form of phrasing which commits Mister Nixon to absolutely nothing and only commits him to saying that he won't recommend a different course of action unless his, until he has studied it, which of course he would not do in any event. But nonetheless, Mister Johnson was able under cover of that statement to urge a continuation of the smoke, of the surtax. The reason why I have been opposed, I was originally opposed to the surtax, and why I now am in favor of dropping the surtax at the earliest possible moment is precisely for, because on the one hand I do not myself believe that the surtax has much effect on inflationary pressure, that monetary policy is far more important from this point of view, and on the other I believe that the present size of the government is much too large and we are not getting our money's worth out of it. And therefore, that we must take whatever measures are effective in trying to get a curtailment, a prompt curtailment, in the size of government. The most effective way of doing that, I think the experience of the past several decades has demonstrated, is to keep tax receipts from rising, to cut them if possible. I think experience has demonstrated that Congress is going to spend whatever the tax system will raise plus a little more, and in recent years a lot more. If spending is to be cut, the politically effective way to do so is to hold down government revenues. And that is why, I on my side have been in favor of not imposing the surtax and indeed of cutting taxes. But in discussing this view, one point should be made that perhaps is not obvious at the onset, and that is that continuing the surtax at its present 10% rate in effect means a higher level of taxes. It means a higher level of taxes for two reasons. In the first place, the 10% surtax was effective only for part of the calender year 1968. It amounted to something like a 7.5% tax for that year, not to a 10% tax. Continuing it at the 10% rate will mean that it will amount to a 10% tax for the whole of the year 1969. The second reason why it means an automatic rise in taxes is because as incomes rise, in nominal terms, both because real output is going up, and because of the inflationary price rise, as nominal incomes rise people tend to get pushed up into higher and higher income tax brackets. The rates that become applicable to them get higher. As a consequence if you hold the tax rate schedule, the tax schedule constant, the effective tax rate imposed on people automatically rises as income rises. But if the effective tax rate rises, the basic effective tax rate, then clearly so also does the surtax because the surtax is 10% of the tax. In consequence, holding the surtax unchanged is equivalent to letting taxes, effective taxes, rise. While in my own view is that the best thing you could possibly do would be to let the surtax expire completely on June 30th and not renew it. I am by no means sure that that is the conclusion to which Mister Nixon and his advisors will come when they face out both of the economics and the politics of the problem in the coming months. Mister Nixon is very anxious indeed to get rid of the surtax as soon as he can. But he also, must accept the fact that informed economic opinion on the one hand and general public opinion on the other, does not accept the kind of view about the role of taxes and inflation that I have been expressing. They do not agree with me, or let me say I have not yet persuaded them of that view. As a result, allowing the tax to expire, to expire completely, will appear to be to many to be a step courting inflation. Mister Nixon from a political point of view, would like to, needless to say, to avoid that point of view. Especially since he is firmly committed to trying to hold down the inflationary price rise. As a result, my own guess is that what you will end up with is a kind of a compromise. Namely, the continuation of the tax but at a lower rate, rather than a complete elimination of the tax, could be that events between now and June will order that. Much depends on whether actual tax expenditures turn out to be higher, as I suspect they will and has been for, actual government expenditures not taxes, turn out to be higher than they will. Much depends on the course of the economy during the next six months, whether as I anticipate we shall have a continued expansion in continued inflationary pressure and so on. But that at any rate would be my guess as of the moment.

- What are your reactions to the economic report?

- Well the Council of Economic Advisors, or the outgoing Council of Economic Advisors, has just submitted of course its final economic report. And apparently there is nothing that is so conducive to frankness and candor, as going out of office. The reports of the Council of Economic Advisors have always been, to some extent, a political document. The extent to which they have been a political document has varied greatly over the years. Under the Eisenhower Administration they were put out as a report of the president, not of the Council of Economic Advisors, and so were explicitly political. But in recent years, the Council of Economic Advisors has been a highly political council that has testified before Congress, made speeches in promoting particular kinds of legislation and so on. And its reports have shown that. There has been a discrete silence in the reports about issues in which it was not politic to talk. This year, the council doesn't have to worry about the political implications, it's out of office. This is a testament, not a document, that the members of the council today will have to live with as part of government. And the amusing and interesting thing about it is, that as a result they have spoken frankly on issues which in the past they have been very circumspect about. There are three such issues that it's kind of interesting to know because they have, all have this character. One of these is a minimum wage rate. It is clear that the members of the council being economists have all along recognized that minimum wage rates produce unemployment among unskilled people, particularly among teenagers, and particularly among Negro teenagers. When there was pressure to raise the minimum wage rate a couple of years ago to a $1.60 as was in fact done, the Council of Economic Advisors, the Democratic Council of Economic Advisors, within the halls of government, was in favor of moderating that increase, keeping it as small as possible. They did add their voice to the pressures within the administration, precisely on the grounds, that increasing the minimum wage rates would cause unemployment among particular groups. But in their public positions they invariably and understandably, I'm not criticizing them for this, you or I would of done the same thing if we had been in their position as part of the administration, they understandably and public supported the administration's stand in favor of a higher minimum wage rate. But in this final, shall I say Valedictory Report, or Last Will and Testament, I'm not sure what you want to refer to it as, they have come out with a much more explicit statement about the adverse consequences of further increases in the minimum wage rate. With much stronger statements than ever before, that the way to solve the unemployment problem and to promote the interests of the low-income people is not by legislative enactment of higher and higher minimum wage rates. On a second topic that I have been particularly interested in is their treatment of exchange rates, of international trade. Some years back the council managed an extraordinary intellectual feat. They had a section in their annual report in which they purported to be presenting an economic discussion of the alternative ways of resolving balance of payments difficulties. And in the course of that they managed to be able to carry through the whole analysis without once just commenting on, or even referring to, the possibility of changes in exchange rates. This time they proceed in a very different way indeed. This time they have a explicit discussion of exchange rates, they even refer to the possibility of complete exchange rate flexibility. Though, obviously people can't change completely overnight and they can't go all the way in that direction. They say that that is a alternative to be considered only as a desperate last resort, when international cooperation has completely broken down. But they do stress the desirability of at least considering wider fluctuation in exchange rates. They discuss in particular, the two ideas that have been the most popular Fed's recently in the, among the people who are shifting from unquestioning faith, in rigid exchange rates to some desire for flexibility. Namely, the two expedients are a wider band and a crawling peg, that is the fact that exchange rates should be permitted to fluctuate more than plus and minus 1% about the parity established with the IMF, that's the wider band. They talk about 2%, they talk about possibly wider ranges. And the other is a crawling peg which is the idea that the parity itself should change in a gradual way over time, either by being expressed as an average of prior exchange rates or by, in a announcement by the country in question that it is going to change the exchange rate at a certain time, pattern over time. My present point is not so much to discuss the merits or demerits of these, these arrangements would be better than what we have now, but from my point of view they are far from ideal. I much prefer a straight flexibility, a completely free market in exchange rates. But my purpose is not to discuss the pros and cons but only to call to your attention the fact that the outgoing council does have something to say about this and it has something to say about it which is quite different from the line which it has taken in the past. It's fair to item on which they have some discussion that I think it's worth a bit of comment here, is the Federal Reserve Board, its independence and its relation with the executive. It comes out with a proposal that was first made, I shouldn't say first, but which was made in a formal public way a number of years back by the private Commission on Money and Credit which was established, I've forgotten the exact date, but the reports with the commission were published in something like 1961 or 62, and there were then hearings at that time before the Joint Economic Committee, or perhaps it was the Banking and Currency Committee on that report. In their report the Commission on Money and Credit at that time recommended that the term of the Chairman of the Federal Reserve Board be made coterminous with the term of the President of the United States. The idea of this being that this would be a step whereby you could get a greater coordination of other governmental policies with monetary policies. At present, as you may know, the President names the Chairman, but the term of the Chairman is not coterminous with that of the President. Mister William McChesney Martin has testified before Congress on a number of different occasions that he also favors such an arrangement. He has discussed some variance of it, one of which under, would involve the term of the Chairman ending six months after a new President took office in order to separate the appointment of the Chairman of the Federal Reserve Board from the Cabinet appointments. The council, I believe for the first time, to the best of my knowledge they have not made this recommendation before but I am not certain on that and I may be wrong, but the council in their report this time does come out with a recommendation of exactly the same kind that the term of the Chairman of the Federal Reserve Board be made coterminous with the term of the President. That is a recommendation which would be, all three of these recommendations I may say are fascinating, all three of these areas I emphasize because they all go against the line which the council has taken in the past, but are very much in the line of what Mister Nixon has expressed and what the Nixon Administration is interested in. The Nixon Administration is clearly anxious to try to get down high unemployment rates among the disadvantaged groups, and Mister Shultz in testifying in his hearings for confirmation of Secretary of Labor made a special point of stressing the importance of getting down the 25% unemployment rate among Negro teenagers. And one way to do this is to keep the minimum wage rates from rising. In the international area the Nixon Administration is strongly opposed to the present direct controls, and the only way to do something satisfactory about that is to provide for more flexibility. And similarly, in the area of monetary policy, as I've stressed repeatedly, one of the great disadvantages of the next administration is that it has no control over the Federal Reserve Board which dominates monetary policy. That situation would be greatly improved if the recommendation of the council were to be taken, or if Mister Martin were to act in accordance with his own recommendations of some years back and make it possible for the President Nixon to appoint his own Chairman of the Federal Reserve.

- The price of gold in London has been hitting new peaks recently Doctor Friedman, does that mean that a new crisis is coming?

- It may or may not, a new crisis may be coming, but the fact that the price of gold has reached new peaks is no sign of a new crisis. I have been very much interested in the way in which the newspapers and commentators have been handling the price of gold and the whole gold situation. They have been treating it in the way in which people tend to treat the stock market, with a very, very short-term point of view. Every time that the price in gold hits a new peak they talk about some temporary scare in the international market or some other particular event which might occasion. And every time it falls, they talk as if you're on the verge of going back to $35 an ounce. I think that to get a fair understanding of the gold market and what's happening in the price of gold, one must look at it in a much, much longer-term context. From that longer-term context there are two facts that are critically important. The first fact is that the commercial non-monetary demand for gold has been rising and rising at a rapid rate over recent years. This commercial demand, I should say the non-monetary demand consists not only of the use of gold in an industry, though that is rising at a very rapid rate. It consists not only of the use of gold in adornment and decoration as jewelry in our countries. It consists also of the demand for gold as a way in which people should keep part of their assets, the demand for gold on the part of the Indian citizen, not the great, in amount of great wealth, but the ordinary upper class or middle class Indian citizen who as a ordinary and regular matter keeps part of his wealth in the form of gold. Or of the citizens of Africa, or the Middle East, people throughout the world in underdeveloped countries who have no great confidence in their country's monetary system or in such financial institutions as savings institutions and the like, who have no such alternatives as bonds and stocks that we're accustomed to. And who as a regular matter keep part of their wealth in the form of gold. They are not foolish to do this, it's a very sensible thing for them to do. This regular demand, this permanent demand, this demand from commercial purposes and for this kind of hoarding, has been rising as world income and wealth has been rising over recent years. On the other hand, the supply of gold, the amount of gold being mined has reached a peak and in recent years has been declining a little. The result of this is, that this regular standard commercial demand has in recent years been larger than current output. That's fact number one. Fact number two is that, that I think is crucial, is that of total world holdings of gold roughly half are in monetary holdings of central banks. That's not the fact number two, the crucial fact number two is that the central banks show no disposition to let their monetary gold holdings decline substantially. Had they been willing to do so, they could've prevented the going to a two-tier system last March, they could've kept the price of gold at $35 an ounce, but they were not willing to do so. And the fact that they were not willing to do so is the most important second fact. Given those two facts, the conclusion follows inescapably that the long-run price of gold must rise. At $35 an ounce, the former fixed price, the demand for current gold is greater than the supply and there is no stock from which the difference is going to be supplied. What is a long-run equilibrium price? I have made some calculations, starting not from 1933, when the price of gold was raised to, or 34, when the price of gold was raised to $35 an ounce because at that time that was much too high a price. But I have made some calculations starting from 1929, and these lead me to believe that at the moment the equilibrium price, the price that would clear the market of current production and current demand, must be somewhere in the neighborhood of 60 to 70 to $75 an ounce. Now today the price of gold is $42 an ounce, if this analysis is right it means that the long-term price trend is up. What determines the rate of that price trend? What determines the rate of that price trend is that in the great Monetary Gold Crisis of the early part of 1968, something like three to three and half billion dollars was drawn out of monetary hoards, most paid out of the US Monetary Reserves and went into private hands. This amount of gold did not go into the strong private hands, not into the private hands of people that wanted to keep it permanently, it went into the private hands of short-term speculators. The people who were holding it for a short-term movement in the price of gold. This gold overhanging the market is what is holding down the present price of gold. But it also tells us something about the rate at which the price of gold will rise. People will not hold such gold in storage unless they expect to get recompensed for doing so. The cost of holding gold must run somewhere around 10 to 12, 13% a year if you count storage cost plus foregone interest. As a result one would expect an omni-average, the price of gold would be rising at the rate of about 10 to 12 to 15% a year. In this way the excess gold, the short-term gold hoards, which overhang the market, would be drawn into final use. Partly this is being helped along of course by South Africa's hoarding of gold, and this would continue until the price, until this gold overhanging the market, which was three and half billion, which by now has probably been reduced to something like one and half, two billion dollars, until it has been completely absorbed. At that point there is every reason for the price of gold to get up to 65, $70 an ounce. That will occur on this analysis in the course of the next three or four years, and the gradual trend will be up. And therefore you could be absolutely sure that the free market price of gold in London will be making new highs year after year, if not month after month. I should emphasize that I am talking about the free market price in London, not the official price of $35 an ounce. There is no reason why that should change at all, that's a purely artificial thing which has almost no relevance to anything as the monetary system is now being run. This is Milton Friedman reporting.

- 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.