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- Hello, this is William Clark, Financial Editor of the Chicago Tribune, welcoming you on behalf of Instructional Dynamics again to this weekly series of commentaries on current economic developments. Reporting to you again will be one of the nation's leading economists, Professor Milton Friedman of the University of Chicago. Dr. Friedman, I noticed that the British government, in what was called a surprise move, has raised the Bank of England's discount rate a full percentage point to eight percent. What does the relation between that discount rate and what we think of as the discount rate here in the United States, is it the same thing?

- It's not exactly the same thing. There's been all along a difference in the meaning of the discount rate in the British financial structure and in ours. The most important difference is that the British rate has always been what's known as a penalty rate. That is, the discount rate by the Bank of England has always been higher than a market rate on securities of comparable duration and risk. That is, for example, in the American context, the rate that is usually referred to in connection with the discount rate is the Treasury Bill rate. As an ordinary matter, the Treasury Bill rate in the United States is higher than the discount rate. The corresponding rate in the British market, what would be the counterpart of the Treasury Bill rate, in the British market has always been lower than the British discount rate. Now, the reason for that, I don't mean the reason for that, but the way in which that's worked is that in Britain, the banks do not discount directly from the Bank of England. In the United States, it's the First National Bank or Continental Illinois Bank that borrows from the Federal Reserve Bank by discounting, that is, by taking some notes of its customers to the bank and getting a loan on that collateral. In the British market, the banks themselves, the commercial banks themselves, do not borrow from the Bank of England. There are what are known as the dealers in the market, the bill dealers. These are people who are not banks, but are involved in buying and selling commercial paper, and buying and selling government securities and bonds. They are the ones who borrow from the Bank of England and they in turn either lend to the commercial banks or buy the paper from the commercial bank. That is, if a commercial bank is pressed and needs money it will as they say, go into the market and by that they may not go to the bank, but they will go to the bill brokers. The bill brokers will then buy the paper, buy the commercial paper or the bills from the commercial banks or will lend the money.

- Do these bill brokers have any counterparts in the United States?

- Yes, I suppose their nearest counterparts are the dealers in government bonds and government securities in the New York market, who are, they are in a similar kind of position. In the British situation, the bill brokers are ordinarily borrowing from the commercial banks, as well as lending to them. That is, the ordinary situation is that the bill brokers are borrowing from the commercial banks and then if the commercial banks need to have those borrowings repaid, the brokers will go into the bank, will go to the Bank of England and borrow from the Bank of England. In our case, similarly as you know, we have dealers in government securities who ordinarily are carrying their inventories on loans from the commercial banks, but who in time of difficulty may make repurchase agreements with the Federal Reserve Bank, and that would be the direct counterpart. However, in the British system as I say, the idea has always been that borrowing, that the discount window, as it were, at the Bank of England is fully open. There is no qualitative control on it. Any one of these dealers, who has adequate collateral, is free to come in and borrow, without being examined for whether it's operating properly or whether it's conforming to rules or not. And as a result, in order to prevent loans from being indefinitely large, the rate has to be a penalty rate. Otherwise it would be profitable to borrow an indefinite amount.

- I see.

- In the U.S. when we first started on our system, way back, for a variety of accidental reasons, the Federal Reserve Bank, back in the 1918, 19, 20, were charging a discount rate that was below the market rate, and therefore it did become very profitable for banks to borrow on a very large scale. That's why, as I've mentioned in an earlier one of these tapes, member banks borrowings at the Federal Reserve system in early 1920, were the equivalent, in today's market, would be the equivalent of borrowing 30 billion dollars from them. And it was this episode that caused a change in the policy, and led to the Federal Reserve instituting the policy that borrowing is a privilege and not a right, and therefore led to what is called qualitative control or control over discounting, window guidance as the Japanese call the corresponding thing. And thus our discounts are held down to where they are. Currently less than a billion dollars, a good deal less, not by charging a rate which makes it unprofitable to borrow. On the contrary, if you look at the market, the discount rate now is about five and a half percent. Is it five and a half percent? I think that's right. Whereas the federal funds rate, which is an identical thing, it's the rate that one bank pays to another for loans, for a transfer of deposits at the Federal Reserve system has gone as high as something like six and three quarter percent. That is to say, it would have been profitable, very profitable for any bank to borrow from the Federal Reserve and lend it to other banks. And the reason they haven't done so is because of this qualitative component of control. If any bank did so, the Federal Reserve Bank would start talking to it and saying, "Well, now you're not behaving quite properly, "and we want you not to borrow so much." This is a very funny thing, 'cause I've talked time and again to Presidents of Federal Reserve Banks, and tried to get a detailed picture of just how they twist the arm of their customers.

- (chuckle)

- And, what I always get is that they never have any trouble twisting the arm but they never can describe in detail just how they do it. But it's clear that what is involved is that a bank does not want to be in a position where, in case it gets into real trouble, the discount window is difficult to access. And consequently, banks are very careful to maintain good relations with the Federal Reserve. So, as I say, from this point of view if you have an eight percent discount rate in London, that is equivalent not to an eight percent re-discount rate here, but to a much lower one. I don't believe the difference would be as much as a five-and-a-half to eight. But the explanation for the rest of this difference is that, of course, Britain has been having great balance of payments problems, they've been having more rapid inflation than we have in this country. They have, therefore, for some time past been having higher interest rates inside Britain than we have been having inside the United States, and therefore, in that context, there is nothing abnormal about their having an eight percent discount rate.

- Would the change in that discount rate, do you think, have any bearing or influence toward a change in ours?

- Well, it has some, obviously. The world capital market is, in many ways, a single market. That is, it's highly interrelated. What happens in one part of it affects the others. But I do not believe that this would have very much effect on our situation because, first of all, Britain is no longer a major part of the world capital market, as it would have been 50 or 60 years ago. The U.S. is now the dominant part of the world capital market. In the second place, you have, while in the discounting area in Britain, you don't have the kind of window guidance that I've been speaking of, or qualitative control here, you do have it in a different way. Because, just because, the commercial banks, by tradition, have not re-discounted at the Bank of England, you can't bring control on them that way. On the other hand, there has been an increasing development in recent years, in Britain, of qualitative controls over the banks in the form of the Bank of England, or some other governmental agency, setting a limit on the amount by which commercial banks are permitted to expand their loans. There's been a direct control, trying to keep down the expansion of loans. And as a result, well, come back to the U.S. Under present circumstances, I don't believe the discount rate is a very important instrument of policy. What's much more important is how tight or easy they are in granting re-discounts, and far more important than that, is their policy on open market operations, buying and selling Federal securities. Well in the same way in Britain, the discount rate has more importance than it has in the U.S., but it no longer is the central keystone of their system. I don't know if you remember the famous statement by Walter Bagehot. Walter Bagehot was the great English economist who was simultaneously the editor of the London Economist, a man who wrote on philosophy and politics, and a man who wrote the, what is undoubtedly the most famous work about central bank policy called Lombard Street, the name of his famous work. And in that book he discusses, this is bank in the 1880s or '90s, in that book or somewhere, where he is discussing central bank policy, he says, a bank rate, by which he means a discount rate, of seven percent would draw gold from the moon.

- (laughter)

- In that period, when you had none of these qualitative controls, none of these restrictions, a bank rate was undoubtedly the cornerstone of policy, and an increase in the bank rate at London would draw capital from all over the world. And every time London had balance of payments problems, in the sense that its gold reserve was going down, the standard response was to raise the discount rate. This would tend to drive the bill brokers into the bank, this would raise the market rate, this would make London an attractive place to invest funds, and funds would come flowing from all over the world. And that was what was in back of his statement, about drawing gold from the moon. Well that's not the situation now. The bank rate, or discount rate, occupies a minor position in the English financial structure, just as our re-discount rate occupies a minor position here. And the major position has been taken over in both countries by a combination of open market operations and more or less direct qualitative control on the banks. And one more thing: Qualitative control of this kind, what sometimes I refer to as an open mouth policy, as opposed to an open market policy, is far more effective in Britain than it is in this country, because, in Britain, you have something like six major banks that control the whole banking system; you have a nationwide branch banking system. We have in this country, still, something like 15,000 banks. You can get the heads of those six banks into a pretty small room, but it takes a pretty big auditorium to get our bankers in. And as a result, this kind of informal understanding, with the Bank of England dropping the word to the heads of these banks, about what is desirable policy, can be much more effective. But none of this, I think, alters the fact that basically the two structures are the same. Going back to your point, the reason for the rise of the discount rate in England, is that England has been, like us, experiencing very considerable inflationary pressure. Consequently, this move is an internal move designed to stop their inflationary pressure. The more they inflate, in a certain way, the easier it becomes for us, on our policy, because that takes the pressure off the balance of payments. Remember, if one man's surplus is another man's deficit--

- That's right.

- If it's properly defined. And vice versa. So that I don't believe, myself, that the British bank rate change, per se, has any important influence on what American policy will be. American policy is dominated, and must be dominated, by the desire to slow down inflation in this country. We have been moving at it, as we discussed last week in more length, rather ineffectively, and I'm not saying we will succeed in that policy, but, that's what's dominating the policy, not whether Britain raises a bank rate to eight percent.

- What you say suggests that the problems of the two countries are not entirely dissimilar, however. What are the economic debates in Britain? Do they sound rather like those that have been going on in the United States?

- Well, it's a very funny thing. If you had gone back to the United States in the 1930s, let's say 1935, you would have said, if you want to know what the debate in Cambridge, Massachusetts is in 1935, find out what it was in Cambridge, England in 1933.

- (chuckle)

- But if today you were asked the question, and you said, what is the debate going on in Cambridge, England in 1969, you would say, what was the debate going on in Cambridge, Mass. in 1966, and in Chicago, if I may add a personal note, in 1963?

- Yes, indeed.
(laughter)

- So, instead of the trend being from Europe and England to this country, it's been the other way. Let me be much more specific and precise about that. In the 1930s you had, Cambridge, England was, unquestionably, the center of the academic economic world. It was the place where economics was being made, and from which it was being distributed around the rest of the world, to put it in, a little, somewhat, but not very extreme form. This had been true for something like 50, 60 years, ever since the reign of Alfred Marshall, who was a great economist of his time, at Cambridge, a great Cambridge economist, followed by a whole series of great figures. A.C. Pigou, Dennis Robertson, and of course, Maynard Keynes, John Maynard Keynes. And in the 1930s in particular, when Keynesian economics was being developed at Cambridge, it was spreading throughout the rest of the world, and we were on the receiving end, the U.S., we were a backward country in the field of economic analysis and had been for many years, influenced by the trends, not only in England, but another aspect of our economic development was influenced by the trends in Germany. We had a considerable number of our economists who were trained in Germany, got their degrees at German universities, and came back to this country. So-called institutional and historical school in this country. That was true in the 1930s. But in the post-war period, the situation has almost exactly reversed itself. There is no question right now, but that the United States is the center of work in economic theory, economic analysis, and economic studies, and Britain is in a backward state. Now, all of us are aware that in this country a major dispute has been going on, raging in this country, between the so-called monetarists and the so-called fiscalists, or between the notion of the supply-of-money school versus emphasis on fiscal policy. Or, it's put in different ways, quantity theory school versus income-expenditure school, Keynesian versus non-Keynesian. Now that battle was at a low tempo in this country in the academic world, until about 10 years ago, at which point it started to speed up, and in the past eight or 10 years, there's been not only a speeding up, but a very, very real shift of opinion.

- In which you've played a very important role, personally, Dr. Friedman.

- Well, thank you, I hope so.
(chuckles) But at any rate, this dispute, or this change, on the academic level has reached the public press, only in the last year or two, when it got involved in the argument about the surtax, and particularly, more recently, when the surtax failed to deliver. Now the interesting thing is, that if you go over to Britain the academic dispute was very quiet, much beyond the point at which it was quiet in the United States. And it's really only in the past two or three years that you're starting to get, in the academic world in Britain, exactly the same kind of a Keynesian, anti-Keynesian, monetarist, fiscalist dispute that you had in this country. It's being spearheaded in Britain, in part, interestingly enough, by Harry Johnson, who is a professor who spends half the year at the London School of Economics, and half the year at the University of Chicago. Now, when he's at the University of Chicago, he's representing the English Keynesians, but when he's at the London School of Economics, he's representing the American monetarists. (laughter)

- He's a carrier.

- Yes, well no, oh, he's more than a carrier. Harry Johnson is a very important economist in his own right, he's done major work in the field, particularly in international trade and international theory. But in this respect, he has been something of a carrier and a catalyst. In addition, in Britain, about a year or two ago, in the course of all the British difficulties about their balance of payments problems, the International Monetary Fund had a mission, which went to Britain, and studied British internal policy, and it made some reports, which stressed, very heavily, the extraordinarily rapid rate of expansion of the quantity of money in Britain, and the fact that this expansion in the quantity of money was behind the developing inflation in Britain. This was a view, which to begin with, received very short shrift indeed, from the British economists and commentators. It did so partly, as I say, because of this long Keynesian tradition. Partly also, because of a so-called Radcliffe Commission, which was a group set up in Britain, oh, it must have been 10 years ago, for the purpose, similar to our own Commission for Money and Credit some years back, of a broad-scale survey of the financial structures. And under the influence of Professor Sayers of the London School of Economics, it essentially came out with the doctrine that the quantity of money was one of the least important things you could possibly think about, that what was important was liquidity in a broad sense, in which you included not only what we call money, but also liabilities of savings institutions, also Treasury Bills, also, everything you can think of. You lump it in, that's liquidity, that's what's important, and money itself is unimportant. Well, subsequently to this, there were some articles very critical of this, in the British professional and other journals. But it was this Radcliffe Committee report that has more or less led to an almost complete neglect of a quantity-of-money approach in Britain. Then came the IMF report, plus, the imports from the United States of the backwater of the dispute that was going on here, which started to spread toward Britain. And in the last year or two, you now have raging in the British press, in the British magazines, exactly the same dispute that you have in this country. A recent issue of The Banker magazine in Britain had a series of three articles on different faces of the monetary dispute. The London Times, in its weekly business section, has been carrying a whole series of articles. Some of them, of course, I may say, one of them was written by Harry Johnson and an English collaborator. Another one, on the other side, on the Keynesian side, was written by an American, who was visiting over (laughs) at one of the universities, he's been one of the active participants on that side in this country. So that, in this sense, you are having the same dispute. As yet, the influence of the money supply school has not reached as high a level in Britain as it has in the United States. In the United States, Mr. Martin, in testifying before Congress, has now for the second year described his objectives, in terms of the rate of increase, desired rate of increase, in bank credit. He said that the objective for 1969 was to have bank credit rise at the rate of five to seven percent, instead of at the 11% rate of the prior year.

- And by bank credit, he means?

- Well, by bank credit, as I pointed out, I think, in one of these talks the other day, what the Federal Reserve means by bank credit is really bank deposits, and it's therefore very close to the quantity of money, and it's a way in which they can look at the quantity of money, while pretending to still be looking at the credit market. Well now it was a drastic change. Up until about a year ago, if any Federal Reserve spokesman talked before Congress, he stated what their objectives were in terms of interest rates, or availability of credit. He never would have issued a numerical statement of this kind. And the fact that he does, is an indication that this is having an inroad on him. Of course, the fact that it was 11% last year shows that it didn't have enough of an impression on him--

- (laughter)

- Because the question, if I had been on that committee, the question I would have pressed Mr. Martin with was, well, if you now think-- Let me go back. Mr. Martin stated explicitly, that the credit expansion of 11% was too much, that the Federal Reserve made a mistake in expanding it. Now, I would have asked him, well why did you do it? Because, or if I preceded that, if I said to him, well, could you have made it less? He would have had to say yes. And then I would have said, well, why did you let it go 11%? And the answer is the one I've been stressing here, that while they had begun to pay some lip service, and more than lip service, to the notion of these quantitative targets, they have not really embodied it in their working operations in such a way that they really direct their attention at controlling it. But, you haven't gotten to this point as yet in Britain, but I wouldn't be surprised if you did. One of the interesting things about Britain is that because it is a more homogeneous, centralized country, with six banks, one central bank, Britain can change its policy and its approach more rapidly, in a sense, than we can. Thus, if we go back, it moved much more rapidly, and I'm now talking on a much broader field than money alone, Britain moved much more rapidly toward a welfare state and toward centralized control than we have been able to do, fortunately, from my point of view. And I have always said, for a long time, I would not be surprised if Britain moved more rapidly back again. Because of this character of Britain, as a much tighter society, with a relatively small number of people who are in control, aristocratic structure, whether, not necessarily an aristocracy of birth, but an aristocracy of one kind or another, with a small class that really runs the country, a meritocracy is what they've been calling it more recently. And similarly, in this monetary field, I would not be surprised to see them move fairly rapidly toward a much greater emphasis on the quantity of money.

- That's interesting.
This discussion seems to be rather European oriented this morning. We used to worry about France causing us trouble, by withdrawing our gold. Are we apt to face a threat from France this time, to devalue the franc, and cause us trouble that way?

- Well, the threat, France is, of course, a troublemaker. (laughter) Mr. de Gaulle makes a kind of a specialty of being a troublemaker. The situation, when France as accumulating gold, when France was accumulating dollars, I should say, and, at that time, as now, we had a formal commitment to provide gold for dollars at 35 dollars an ounce, to central banks, that was a real threat, because it was true that France, at any time, was technically in a position to come with a billion dollars worth of dollars, and say we want gold for this. That threat is largely non-existent at the moment, because France has been losing gold. In fact, the U.S. gold stock has risen in the past, since the two-tier system last, when was it, February, I think it was, almost entirely because France has had to acquire dollars to meet her obligations. So that she has been contributing gold rather than the opposite. Now, as you say, the point comes up, well, can't France cause this threat again, in a different way, by threatening to devalue by 30%? Well, that's a complicated issue. If we go back to the source of France's accumulation of dollars, it was initially an over-devaluation. In 1958, when Mr. de Gaulle came in, the French franc was in a bad position, but Mr. de Gaulle devalued sharply the franc, much too sharply, so much so that he created a surplus in his balance of payments, and the surplus in his balance of payments enabled him to accumulate dollars, and it was later this accumulation of dollars that enabled him to get gold. But I do not believe the situation is at all comparable right now to what it was then. Because at that time, while the franc was fundamentally weak, the economy had great hidden reserves of strength in it. And by monetary stabilization, of the kind that Mr. de Gaulle achieved at that time, the devaluation of the franc was only one of a group of measures, which essentially removed a lot of controls on the French economy, which allowed it to free up. As of the moment, it's not clear that he's in that position. He's now been holding the franc peg, and he's been holding it by a whole bunch of internal controls, direct controls of a variety of kind, keeping down imports, subsidizing exports. He has made promises of wage increases in connection with the May difficulties, which will come home to plague him, and which are causing a good deal of danger of forcing him to expand the money supply, underpin inflation, in order to make good on them. Thus, if he were to devalue, it is very likely that the major effect of that would be simply to enable him to eliminate direct controls which are holding the present rate. You see, one of the problems in this area, is that people think of devaluation without contemplating what else it makes possible, or goes along with it. Let me see is I can be more precise on that. Generally speaking, when you have a case of devaluation, under modern conditions, where you've been trying to hold a fixed rate, what happens has been, that the country in question has been restricting imports by direct controls, by quotas, by things like that. The effect of such a policy is to make the internal price of the good different from the external price. If Mr. de Gaulle keeps American cars from being imported in France, that means that the price of the American car in francs inside France is higher than the price at the dock, multiplied by the official exchange rate. Remove the import control and devalue, and the effect of that may well be to permit the price within France in francs to go down, even though the price computed as the dollar price at the dock multiplied by the number of francs per dollar goes up. That is, you eliminate this wedge. And if this is what happens, it doesn't hurt us at all. In fact, I would say, it helps us by freeing up the markets a little.

- Thank you, 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 with you again next week.