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- Hello, this is Rose Friedman inviting you on behalf of Instructional Dynamics to another conversation with Milton Friedman, professor of Economics at the University of Chicago. We are taping this conversation at the end of July. Chairman Burns has just given his regular testimony before the House Banking Committee and indicated that the money supply growth targets were reduced somewhat for the fourth time in as many quarters by the Board. The goals for the two key measures M2 and M3 have been cut to check inflation he said. For technical reasons, a narrower M1 measures target was left unchanged. Before discussing Chairman Burns' testimony however, let's talk a little bit about what's been happening to the monetary aggregates.

- Well, the monetary aggregates have continued on the slower path that we've outlined in the last couple of tapes. Indeed, if you take just the past two months, that is to say the average of the four weeks ending July 14th the latest figures available, M1 has actually declined at an annual rate of a minuscule two tenths of 1%. And M2 has risen at only 6.8%. For the past three months, those numbers are 4.9 and 9.3. In general, we seem to be in another one of those swings that we have become so accustomed to in which the rate of growth of the money aggregates swings first too high then too low then too high. Since these swings have been averaging something between three and six months recently, and since this particular swing, with respect to M1 at least, got under way in April. With respect to M2, perhaps a little later than that. We ought to be past the mid point of this downward swing and it ought to be sometime in a month or two months we ought to be starting up on another swing the other way. I hate to engage in that kind of chart reading, but yet there's very little other way, very little of any other way to read the tea leaves. Now to go to Chairman Burns' testimony with that as a background. The interesting thing about it is, the continuation of the policy of, giving the targets, in terms of growth rates, rather than in terms of target levels of the money supply. The effect of this is that whereas, he shaved by a minuscule amount of the growth rates for M2 and M3 in the upper range making it for M2 let's forget about M3 for the moment, for M2 making it 7.5 to 9.5% instead of 7.5 to 10%. In fact by comparison with his testimony a quarter ago, he has raised the projected target levels of the money supply both at the top and the low end. The reason for that is that, the Fed has adopted the practice of shifting the base to which it applies these target rates of growth from one quarter to the next to the average actually achieved during the quarter. Now when he testified three months ago, you could calculate that the target level of the M1 for the second quarter of 1976, the quarter just past, the April, May, June quarter, the target levels for M1 were 299.8 to 301.6. The actual average M1 was 302.7 or a little over a billion dollars above the top of the range. For M2, the target levels were 689.8 and 693.7 and the actual was 696.4 or about three billion dollars above the top of the range. Now if you apply the 7.5% bottom M2 target to this level and say, extend it to the first quarter of 1977, which was, that is three quarters ahead, which was what the projected targets which the Chairman gave three months ago were supposed to apply to. You would then get a number higher than his projected target at that time and therefore, it would be a little bit more accurate to say that the Fed has raised its money growth targets as it would to say it is lowered. But let me go on a bit there. I don't mean for this to be a criticism of the failure to hit those very, very narrow ranges precisely in the first quarter. It is intended to be a commentary instead on what I regard as an undesirable way of stating targets. Of adjusting them each quarter, so in fact the actual money supply growth becomes a random walk, instead of, stating the targets in terms of numerical totals like 693, 689, and then keeping them that way. If you go out of the range, explicitly saying that you're gonna move the range, or explicitly saying that you're gonna come back into it. To stress that this is not really intended as a criticism of excessively inflationary policies over a long period, let me note, that if I do the same kind of analysis that I've just done going back to the very beginning, as was done, in a very interesting little piece on the Federal Reserve money growth targets put out by the Pittsburgh National Bank in June, that's almost surely done by Jerry Jordan who used to be at the Federal Reserve Bank of St. Louis and is now at the Pittsburgh National Bank, what you will discover, is that, the actual targets for the second quarter of 1976, as stated three months ago, were decidedly lower than those that would have been implied by the growth rates specified in the second quarter of '75 or the third quarter of '75 or the fourth quarter of '75. Indeed, if you go to the M2 cases which we've just been talking about, if you take the second quarter of '75 when the first targets were specified, when this whole process got underway, and extend them for the whole year to the second quarter of '76, they called for a range of 788 to 700, and the actual range was 796 or fell within it so for the year as a whole, the Fed hit its target. But it's this shifting target levels from quarter to quarter, that makes the whole operation a very misleading one. Let me also add, that I agree very strongly with the announced intention of the Fed of cutting the rate of growth gradually over time. Mr. Burns has said, quite correctly, that in order to get to a non-inflationary posture it'll be necessary to get M1 down to a 1 or 2% per year rate of growth. He has said that the Fed does not intend to do that immediately, but it intends to do it over the next three or four years, two or three years, I think he said in his testimony, the other day. If that's the case, if they succeed in doing that I think it will be an enormous achievement. I remain somewhat skeptical, about whether they will achieve that result, not because I question in any way their intentions, but because it has seldom been the case that you could infer their behavior, strictly from their intentions.

- There is another piece in The Wall Street Journal this morning, which I think is interesting. About gas producers and the price that they are going to be permitted to charge, pipelines for gas newly discovered or newly sold interstate after January 1st 1975. One of the most interesting features of this piece is the estimate that the FPC makes of the cost to consumers of 1.5 billion dollars for this increase in, price.

- These reports always send me up the wall because they involve such terribly bad economics. As you know, the situation is, that the price of natural gas has been subject to control for a very long time. Something over 10 years. As a result a large fraction of the natural gas now has to be sold at something like 29 cents, whatever it is, a thousand or a million cubic feet I always forget the unit, but whatever the unit is. At the same time that we are simultaneously buying liquified natural gas from abroad, for some purposes at $2, the same unit. Now, the Federal Power Commission has gradually been trying to work itself out of this, part of the reason and incentive for doing this is it has had control only over interstate prices that is gas that moves between states. Intrastate gas has been free to respond to the market, and as a result intrastate gas has been selling at prices somewhere between a dollar, dollar and a half, somewhere around there. Some time, quite a time back, the FPC raised the minimum price to just roughly 50 cents, I guess it was really 52 cents per thousand cubic feet, and, now now what it has done, is to make it possible, for, newly discovered gas, or gas newly sold into the interstate market, that is gas that heretofore has been sold in intrastate but is now going to be sold in interstate, to be sold at as much a $1.42 per thousand cubic feet. Now, these are certainly desirable measures, they still leave the price system in a shambles it is just insane that some gas should simultaneously be required by law to be sold at 29.5 cents, others be permitted at 52, others $1, others at $1.42. It's an absurd structure, but it certainly is a move in the right direction to freeing it. What really sends me up the wall, is the statement by the Federal Power Commission itself, repeated on every news program, TV news program, no doubt repeated over again in every news weekly, in The Wall Street Journal and The New York Times and so on, that the effect of the action by the FPC will be to cost consumers 1.5 billion dollars. Why does that send me up the wall? Because, in my opinion, a true economic analysis would show that the effect will be to reduce the expense that consumers pay, not for gas, but for heating their houses. A lot of good it does to be able to buy gas at 52 cents a thousand cubic feet if there is no gas available to be purchased. If companies which have been importing, if gas companies, to provide their customers with gas which have been importing gas from abroad, liquified natural gas at $2 a thousand cubic feet, are now able to buy it, at the price of $1.42 a thousand cubic feet, that lowers the cost to consumers. If the effect of the higher price of gas is to encourage the production of more gas, then that enables people to substitute gas, for more expensive petroleum, or for, perhaps cheaper but less attractive, less valuable coal, why then, surely the effect is to save consumers' money not to raise it. Yet it is hard to see how you can get sensible economic policies adopted, when the very agencies such as the Federal Power Commission which are supposed to represent knowledge on this, proceed to, utter such complete nonsense, which misrepresents completely, the situation. If this is really going to cost the consumers $1.5 billion, then if it's an easy thing in the world to save consumers money simply by holding down the price why doesn't the FPC in good logic lower the price instead of raising it? In fact, if they made it zero, just think of how much money they would save the consumers.

- Turning abroad, for a moment, The Times of London has been paying a great deal of attention recently, to monetarism and the money supply. I think your subscribers would be very much interested in these stories.

- I received in the mail the other day, from Mr. William Rees, I don't know how you pronounce it, Mogg or Mowg, it's M-O-G-G, it's R-E-E-S hyphen Mogg, M-O-G-G, who is the editor of the London Times and a gentleman who wrote a book a while back coming out in favor of a gold standard. He sent me a clipping from his paper of Tuesday July 13th, containing a long article he had written which has a fascinating title. The title of the article is "How a 9.4% excess money supply "gave Britain 9.4% inflation." And what he does, is to present essentially, the straightforward monetarist argument about the relationship between money supply and prices, he has an interesting table. In which he, quite rightly, allows for the change in output. We have always stressed that what will affect prices, is what happens to the money supply per unit of output not simply what happens to the money supply. Thus, with, very rapid, output increases, as in Japan, a higher rate of monetary supply growth will be less inflationary, than in a country which has a low rate of output. And for each of the 11 years from 1965 to 1975 he has a little table. Showing the increase in the money supply, the increase in domestic product or in output, and the difference between these two, which he has labeled excess money supply. He then compares those, with the increase in prices and taking into account the kind of work I and others have done, he allows for a two year lag, between the change in the money supply and the change in prices, so he compares, the increase in the money supply, the excess money supply, in 1965, for example, when it was 4.7 percentage points per year, to the increase in prices in 1967 when it was 2.5%. On this kind of a year to year basis, there is a great deal of variation. For example, in

1969 the excess money supply was 1.3, and two years later the price rise was 9.4. While in, by contrast, in 1972 the excess money supply was 23.4 while the increase in prices in 1974 was 16.1 or less. Now this is the phenomenon we have often observed and noted, that there's a great deal of noise, a great deal of random perturbation and variation in these year to year figures, the lag is not exactly two years it's sometimes one year, sometimes three years. Other forces contemporarily disturb it as, in the United States occurred with the price controls in '71 to '73 and so on. But what Rees-Mogg does next, is to take an average over the eight years from 1965 to '73, for the excess money supply, and over the eight years from 1967 to 1975 that is two years later, over the price rise, and lo and behold, the average is 9.4% for the excess money supply and 9.4% for the average price raise. Now of course, this close agreement is an accident. It would be a mistake to make very much out of it. I made similar calculations for many periods and it will sometimes be like this, sometimes there will be a difference. It will depend a great deal on which money supply total you use. He used M3 he would get a slightly different, that's a British concept that really has, does not have quite an identical counterpart in the United States, it's not the United States M3, and it's not the United States M2, my impression is it's broader than our M2 and narrower than our M3. And you might get a somewhat different result if you'd used M1 in the United States, you'd certainly get a different result if you'd used M1, if you used M1 over the period in question, the price rise would've been decidedly larger, than the M1 excess money supply. If you had used M2 on the other hand, the price rise would in the United States, as in Britain, have been almost identical, to the excess money supply as he defines it. I have made similar calculations for other countries, for South Africa, for Australia, for Japan, for Canada and so on. And, as I say you'll get roughly comparable results though very seldom do you get a precise identity to a single decimal place. The fact that it is identical, of course, enabled him to make his article rather dramatic. What's more interesting in some ways, is the analysis which he provides in the article and I think it's an extremely good analysis. But let me refer to a couple of points in it that I think are rather interesting. One of them is and Mr. Rees-Mogg says, quote, "These figures have changed further "my own attitude to incomes policy. "If the excess money supply determines the rate of inflation "equally closely in years subject to incomes policy "and in years without, "there seems to be no evidence left "that incomes policy has any significant influence "on inflation." Now let me add that what he means by incomes policy is of course what we mean by wage and price controls, mostly wage controls. "Nor did incomes policy help in these years "to keep down the increases in money supplies "which are actually highest in incomes policy years." Now the fact that they were highest in incomes policy years is not an accident. I think it's a point which I've stressed on these tapes many many times. A government engages in incomes policy when it wants to inflate. When governments understand perfectly well that wage and price controls don't do any good in holding down inflation, why do they do it? Because they want to give the impression of doing something about holding down inflation and perhaps have a temporary effect, while at the same time they proceed to inflate, in order to offset unemployment or whatever other difficulty there many be at the moment. And thus it's quite understandable, that incomes policy years are years of very rapid money supply growth. But nonetheless, the main point which Mr. Rees-Mogg is making is a very important and vital one. The most in his country, or in any country that I know of, that incomes policies or wage and price controls have done is to change the timing, not necessarily of the inflation, but of the record of the inflation in the statistically computed index numbers. In the United States, the recorded rate of inflation in 1971 to '73 is surely lower than the true rate of inflation. In 1973 to '75 it's higher than the true rate of inflation because you're unveiling the price increases that were concealed or diverted during the inflation, during the period of price and wage control.

This point is one that has been made often, as I say, and so is the next point that I wanna call your attention to, but I think the second one is not so fully recognized even now. And that is when he says, quote, "The evidence also suggests "that a high excess money supply is bad "rather than good for employment. "A leading article recently discussed the reasons "for supposing that inflation naturally produces "higher levels of unemployment "than would result from price stability. "During this period the excess money supply tended to rise "and unemployment tended to rise with it. "Sharp reductions in money supply "can also increase unemployment, "and a stable but low rate of increase "would seem to be best both for employment and for prices." And then he goes on to make comparisons among countries, and points out that if you take the six major industrial nations, the order of the rate of increase of the excess money supply is US lowest, Germany, France, Japan, The United Kingdom and Italy highest. These are the rankings for the period 1969 to '73, they are also the rankings for the standard of living of the nations concerned. This article by Rees-Mogg is interesting in its own right but also, for what is obviously, a change that is going on in the pattern of opinion within Great Britain. The Times in some ways is spearheading it. In addition to the editor, its financial correspondent Peter Jay, who incidentally, comes from a Labour family and is the son-in-law, as I understand it, of the present chancellor, James Callaghan. Peter Jay, who ten years ago, was writing leading financial articles poo-pooing the monetarist position and, was an unreconstructed Keynesian, has come full turnaround and has been writing a whole series of articles in The Times, making essentially the same points Mr. Rees-Mogg makes, but in addition he has also been proposing, a very specific proposal. He argues that the most important thing to do in Britain is to give the public at large confidence that a firm money supply policy will be followed. That in the present political environment this cannot be done by leaving it in the hands of the government or the Bank of England, the Bank of England, of course, in Britain, is a nationalized bank owned by the government, has no fundamental independence in a legal sense, though obviously it has a good deal of independence influence in a bureaucratic sense. He therefore proposed the establishment of a currency commission. Made up of, people who are outside the government, who would be given exclusive power, over the, money supply, over the high powered money, the currency, and who would be given very specific instructions by parliamentary order that within x years, I don't remember the details of it and it doesn't matter, what matters is the principle, but within a few transitional years, It was to bring the rate of increase in the money supply down to a specified and announced total and keep it there. Another sign of the times, along a sign of the same kind of thing, is that the Bank of England, the head of the Bank of England, in a recent, I don't remember whether it was an annual report or a speech, directed himself explicitly to the proposal that, there be an announced growth rate. We were talking about the announced growth rates by the Federal Reserve bank here by Chairman Burns recently, this same policy of announcing growth rates has now been adopted, by Germany, by Switzerland, and by Canada. And in his speech, the chairman of the Bank of England pointed out, that three out of those four countries have the best inflation experience of any of the countries involved. Now, he was, essentially coming out against the announcement of the growth rate. But what he was doing, and felt forced to do because of the amount of discussion of this, was to indicate what the arguments were for a growth rate, what the arguments were against it, and indeed, his analysis was hardly, an unequivocal, rejection of the idea of a growth rate. Now what Peter Jay is proposing would be essentially an announced growth rate but not turned over to the the Bank of England to enforce, but turned over to the independent currency commission. Both Rees-Mogg's article and Peter Jay's articles along this subject have, produced an absolutely incredible flood of correspondence. A friend of mine in Britain sent me clippings from The Times of letters to the editors on this subject, from the 13th to the 20, I think the last one I have here is about the 22nd. That is for something like a 10 day period and there are over 25 articles, 25 letters, in reaction to it on all sides of it. From a whole variety of people including people like Reginald Maudling, who is a former Chancellor of the Exchequer. Numbers of members of parliament, batches of economists of all kinds, and of course the letters are on all sides of the issue. Many of them take the usual position that after all, this is just correlation without causation how do we know this is really so? The usual immediate knee-jerk defense. Others of them are much more sophisticated, accept the fact that the correlation is a valid one, that it does, but insist that money growth, while it's a necessary condition for price increase, is not a-- well, let me put it differently. 'Cause I'm, I should state that view backward, they would agree, that a, rapid money supply increase on its own is both necessary and sufficient for a price increase. But the position they usually take is that holding down the rate of money increase is a necessary but not a sufficient condition to end the inflation. That in order to end the inflation in addition to holding down the money supply increase you have to do something about the trade unions or about the other forces that are at work. At any rate, my point is not to provide a discussion of the contents of those 25 letters, but simply to cite them as an example of how active and widespread is the discussion on this issue, in Britain. The Chancellor of the Exchequer, has been Mr. Healey, in Britain, has in various of his recent speeches, done what was unprecedented for British Chancellors of the Exchequer, talked about, the money supply growth rates that were implied in his forecasts and what was relevant to 'em. Now, all of this is talk. And by no means is there any indication that it is really going to be very effective. The fundamental fact remains so far as Britain is concerned, that government spending is enormously high, Mr. Healey has just just announced a program for a reduction of government spending by $1.8 billion, but, that's not really a reduction in spending that's a reduction in the increase in spending. And moreover it's really for the next fiscal year so it doesn't really start to take effect 'til next summer. In the meantime, the borrowing requirement is extremely high, and it's very dubious whether, the British will in fact be able to succeed in holding down the rate of monetary growth to levels that would halt the inflation.

- Whether they will or not, we've come to the end of our time. So remember subscribers, if you have any questions or comments, please send them to Instructional Dynamics Incorporated, 450 East Ohio Street, Chicago, Illinois, 60611, we shall be visiting again with you again in about two weeks.