

- Instructional Dynamics Incorporated welcomes you to this weekly series of commentaries on the current economic scene. Reporting to you, will be one of the nations leading economists Professor Milton Friedman, of the University of Chicago. Dr. Friedman, to begin this discussion we have a letter from one of our subscribers who's asked you to comment on the possibility that gold might be revalued upward. What is your opinion?

- Currently, there are two prices for gold formally speaking. One price is the price in the free market in London, that's a free market price and there's no point in talking about whether it's going to be revalued or not, it will be determined by market purchases and sales. The other is the so-called official price of \$35 an ounce, the second tier of the two tier system established last spring. The question I take it refers to the second tier, to the formal official price of \$35 an ounce. I think that there is very little chance indeed that that price will be raised by the United States in this coming 12 months or indeed in several more years after that. I think I may say, that it would be a major mistake to raise the price. That price of \$35 an ounce is, at the moment, a pure formality it has very little meaning. According to the agreement reached last spring, it was understood that the trades between central banks would be carried on at that \$35 an ounce price, that is to say, if the central bank of Germany wanted to turn in dollars we, technically speaking, are committed to giving them dollars at \$35 an ounce. I'm sorry, giving them gold for their dollars at \$35 an ounce. But although this is the understanding on paper, in fact what you really have is a situation in which gold is no longer really convertible on demand by anybody. If the treasury is asked to exchange \$20 million, \$10 million, \$30 million for one country or another I have no doubt they will do so. What I think everybody understands, the Germans, the French, the Italians, the British and all the rest. That a request for a conversion of a very large sum of dollars, for example if one of these countries were to come and say, "We have \$500 million that we would like to convert into gold." I think it is perfectly clear to everybody involved, that the answer the treasury would be, "Sorry boys, no so, that's not a demand for monetary purposes and we are not going to contribute to speculation in gold." So that the fact of the matter is, if you look beneath the surface, that we now have defacto, non-convertibility of gold or of dollars into gold I should say, non-convertibility of dollars into gold, not only so far as private people are concerned, so far as official central banks, government treasuries and so on, that's not a bad situation. In fact, I have for long been in favor of allowing gold to be a free market commodity, with its price determined by private purchases and sales. Nothing is less important to this country than what the price of gold is in London, it is foolish for us to make large sacrifices or engage in large measures in order to try to keep the price of gold one thing rather than another. So that, not only does that seem desirable but I think it is very unlikely that any administration would feel it desirable to raise the price of gold. (mumbles) Whether it be a Republican or Democratic administration, it is politically very difficult to say that we should raise the price of gold when the main beneficiaries of that would be South Africa and Russia, two countries with whom the people of this country feel about as little sympathy as they do with any other countries. And also, the speculators. This last point needs a little more emphasis. In the great gold rush of last fall, we sold several billion dollars worth of gold. We sold that gold at \$35 an ounce. It seems to me almost intolerable, politically, to say, "We are now going to buy back at \$70 an ounce, gold that we sold at \$35 an ounce." All of these political problems

would be as nothing if economic forces required or demanded a rise in the price of gold. Now economic forces do require and demand a rise in the free market price of gold and the price of gold in London. But there is no economic force whatsoever that requires the US to change the official price of gold or that requires the US to engage in pegging the price of gold at any level. And thus, I think both on political grounds and on economic grounds, the chance of a US revaluation of gold is very small indeed.

- Well wouldn't a revaluation of the price of gold by the United States, in effect, be devaluing the dollar?

- The term devaluation of the dollar is a complex one. It would be devaluing the dollar in terms of one sense of that term, in terms of the price of gold in terms of the dollar. However, if the US raised the price of gold, let's suppose we raised it, to take an extreme case, from \$35 to \$70, doubled it. If Britain also doubled the price of gold, if Germany doubled the price of gold, if France doubled the price of gold, then no exchange rates would be changed and the price of the dollar in terms of the Pound Sterling, in terms of the Franc, in terms of the Mark, would remain the same. Hence, a sharp distinction must be made between a general rise in the price of gold on the part of all countries involved and a rise in the price of gold only on the part of some countries. When Britain devalued a year ago, this involved raising the Pound Sterling price of gold but also changing the price of the Pound Sterling in terms of the dollar. It went from \$2.80 to \$2.40. In the present uproar in Europe what is being talked about is a devaluation of the Franc, which would mean a change of the official price of gold in terms of the Franc, but more important, a change in the exchange rates. In this second sense of devaluation, you could have devaluation, the United States exchange rates could change compared to some other countries, with or without a change in the price of gold.

- And Dr. Friedman, you've mentioned the current turmoil in Europe perhaps you could go into more detail about that. What's really happening in France and in West Germany?

- That is a fascinating episode, France of course has been on the verge of difficulties ever since last May, when there were the great social, political, economic difficulties. These difficulties were resolved by measures which were widely believed to presage a very sharp rise in prices and wages in France and therefore made holders of French currency anxious to exchange French currency for other currencies. This was really an extraordinary event which had far reaching implications because France had seemed to be one of the hardest currencies in the world. Here was General De Gaulle on top of his great pile of gold yelling about financial discipline and about how sound money should rule. And all of a sudden overnight, that pile of gold is undermined by a few students who go on strike at the Sorbonne, joined later by some workers, then France topples from a position of a hard money, to a position of a money in danger. This, I may say, this situation was reinforced a few months ago when Russia invaded Czechoslovakia. The reason it was reinforced was because already the French episode had led speculators of the world to say to themselves, "My god, "here's a country which seemed to have such a hard currency "and overnight it can go on to become a soft currency. "Maybe we shouldn't be so happy about the German Mark, "it's a very strong currency, "but maybe the German Mark" "could overnight be weak currency." And then along came Czechoslovakia with the threats that you might have West Germany involved in war, or at least in political difficulties. Then this caused speculators worldwide to wonder about the German Mark. But now, you have all the turmoil that's going on there, the most interesting feature of that turmoil, is that it doesn't seem yet

to have affected the dollar. Now why? Well I think the answer is very straightforward. The papers talk loosely about people running on money, or people trying to get out of currencies, or flight from the dollar. In order to fly from a currency, you have to fly into something. The crucial question you must ask yourself, is if you're a holder of one currency, what other currency would you prefer to hold? Now if you're going to hold one of the European currencies, then at the moment, it clearly seems far more sensible for you to hold the German Mark which is a very strong currency than to hold the French Franc which appears to be a very weak currency, or to hold the Swiss Franc rather than the British Pound let's say. But suppose you ask yourself, I've got dollars, would I be wise to put those dollars into a European currency? Then the dollar holders in this world are at the moment faced with a dilemma. They may be very leery of the US economy, they may think we're engaged in inflation, they may be worried about the dollar's safety in that sense. But they have no place to go, they're stuck, since the French turmoil, since the Czechoslovakia invasion, if they ask themselves where shall I go? It seems like going from the frying pan to the fryer to convert dollars even into Marks. You might do a little of it. This has been from the point of view of the US balance of payments, a very fortunate or unfortunate turn of affairs, depending on how you look at it. It was fortunate in the sense that it is a major factor that underlies the deceptive, current balance of payments figures. These balance of payments figures for the third quarter show a slight surplus, but that surplus is entirely due to a capital movement which involves this kind of a transfer of funds from Europe to the United States. Incidentally, I should go back and say, you might say, "Well if he's going to get out of the dollar, "he might get into gold." But that raises the price of gold but doesn't get rid of any dollars, it just means somebody else holds the dollars. The person who sold the gold. And now you have to ask what will he do with the dollars and you're back to where you were before which is why I left gold out of the picture when I was talking about it that way. Well to come back then, here you are, it looks as if the speculators of the world have no place else to go, and as a result the weakness in the Franc and the turmoil in Europe has not communicated itself to any attempt to get out of gold. As I already said, that made the balance of payments figures look very strong. That may seem fortunate, personally I think it's a very unfortunate development, because our basic underlying balance of payments situation is not necessarily strong. It would've been far better for this country if we had had a financial crisis like Europe is now having, in this country, in the world this summer. That would have forced us to do the sensible thing, which I'll come back to later, but the sensible thing in my opinion would be to let the dollar go free, let its price be determined in the open market just as I earlier suggested that the price of gold should go free.

- Well Dr. Friedman, getting back to West Germany just for a moment, just the other day the bond government decided against revaluing the Mark upward. What is this going to do?

- Well the German government has not decided against revaluing the Mark upward, they have decided not to do it in an open and obvious way. The fact is that the pressure of economic forces in Europe leave very little alternative. Something has to be done to alter the relative values of the Mark and the Franc. Under present circumstances the fact is, that the Franc is too expensive in terms of other currencies and the Mark is too cheap. And as a result you have this steady pressure on the Franc in favor of the Mark. Now, what the Germans have done is a rather ingenious thing, they have in effect, said they are going to revalue the Mark. Raise its value. But they're not going to call it that, they're going to do it in an indirect way. Let me explain. Suppose you consider the problem of trade alone, purchases and sales of imports and exports. Then a 10%

upward valuation of the Mark, which means changing the price of the Mark from \$0.25 a Mark to \$0.275 a Mark, is absolutely identical in its effect with a more complicated set of things, namely, imposing a 10% tax on imports into Germany and giving a 10% subsidy to exports out of Germany. Now let me show why that's exactly the same thing. Consider a German, a German now for four Marks can buy something worth a dollar if the Mark cost \$0.25, for four Marks he would be able to buy something costing a dollar, I should say \$0.275, he would be able to buy something costing \$1.10 that is for his four Marks he would then get \$1.10. This means that American goods become more attractive to him, before he command over \$1 worth of American goods, now he has command over \$1.10 of American goods that's why an upward valuation of the Mark would increase imports into Germany. Looked at the other way from the point of view of the American, at \$0.25 a Mark, he has to pay \$1 to buy something that costs four Marks. At \$0.275 a Mark, he has to pay \$1.10 to buy that same item, which costs four Marks. And therefore, he is discouraged from buying German goods. So an upward valuation of the Mark, raising its price from \$0.25 to \$0.275 will encourage imports into Germany and discourage exports from Germany. Now consider the following, consider a case where the German government instead of doing this, give us a subsidy on imports. I think I spoke before backward, I think I said a tax on imports and a subsidy on exports, that's equivalent to a devaluation. I should have said a subsidy on imports and a tax on exports that's the equivalent to an upward revaluation. Take the same case. The German government leaves the price of the Mark at \$0.25, but it says to anybody who imports goods from the United States, "For every Mark you spend, "we will give you an extra 10% of that Mark (mumbles) "as a subsidy." Now the Germans, if they use four Marks they get a dollar in addition they get a government subsidy of 10% or \$1.10, so an importer of US goods can again import exactly \$1.10 he's in identically the same position as if the Mark had been revalued upward by 10%. Now, let's suppose the government now says, "We're gonna impose a tax of 10% on exports." Well, then again, the American who before with \$1 could buy four Marks, now it will take him \$1.10 to buy that same amount of goods. Because in addition to the four Marks, he has to pay the 10% tax. So, so far as purchases and sales are concerned, a 10% subsidy on imports and a 10% tax on exports is identical with a 10% upward valuation. Now, in order to get this right, we gotta look at what the German government is really doing. They aren't doing it even quite that open. What has been happening, is that they have something called a value added tax. And they have been rebating this value added tax of 11% on exports, and they have been imposing it on imports. So they've been putting a tax on imports and as it were, giving a subsidy to exports. Now what they propose to do, is to reduce both that tax and subsidy. They're not gonna go the whole way, as of this stage of talking I don't know how far they're going to go, I haven't seen the precise detail but suppose they cut that in half. Then that means, that instead of there being a tax of 11% on imports there will be tax of only 5.5%, that's equivalent to giving a subsidy to imports, that encourages imports. Instead of there being a rebate of 11.5% on exports there will be rebate of only 5.5%, that's equivalent to imposing a 5.5% tax on exports. So if they were to cut this value added treatment precisely in half, that is economically equivalent, so far as purchases and sales are concerned, to a revaluation of the Mark by exactly 5.5%. Why do it this very complicated and roundabout way, instead of straight out and open and above board? There are two reasons. One is pure human reason of saving face, they have said over and over and over again that they will not revalue the Mark and they hate to admit that they're gonna do it when they said they weren't. But there is a substantive reason beyond that. This arrangement is perfectly equivalent with respect to all imports and exports, so long as its maintained in effect, it will be equivalent with respect to future, actual physical capital movements investments in Germany, because, in so far as those require imports, they will get the benefit of

lower tax, in so far as they produce exports, they will get the lower subsidy. But consider the people who bought Marks in the hope a formal revaluation of the Mark. This is indirect and concealed revaluation will give them no profits. They will get nothing out of it. Because they changed money for money, they took Francs and converted it into Marks and the price of the Franc in terms of the Mark on this step will not be changed. So if this method works, it will have the effect on trade movements of a revaluation, but at the same time it will not reward the people who speculated in favor of the Mark.

- So in other words, the spectators might get burned a bit?

- They won't get burned, the difficulty with our present system of currencies which have fixed exchange rates, and the reason why you have these big speculative movements, is because it costs you nothing to speculate with a government guarantee of a price, everybody knows that the German Mark isn't gonna go down in price, it isn't gonna be devalued and therefore, it's a free ride. Indeed, one of the things that always strikes me as so terribly amusing under these circumstances, is that people like myself, will for many many years have been arguing that what you ought to have is a free market in exchange rates, are always being met with the argument, "Oh that would be terrible, "that would introduce uncertainty into the market." And then the result of the fixed rates, is that you have things like the Pound Sterling crisis of a year ago, like the French-German situation now, I suppose this isn't uncertainty, this is something else, so it seems to me kind of amusing that you should adopt in the name of certainty, in the name of assuredness, you should adopt a system which maximizes the extent of destabilizing speculation. Because it imposes no cost on it. See let's suppose you had a free exchange rate now. As speculators at the very beginning started to leave the Franc and go to the Mark, that would've driven up the price of the Mark in terms of the Franc. Under those circumstances, speculators would've been deterred, they at least would take a chance at a loss later on if the Mark price came down. But when you have government guarantee that the price of the Mark in terms of the Franc will be fixed, you have a one way deal. The most you can lose is your transaction cost, there is a little cost of buying and selling. But beyond that you cannot lose a great deal because the German government, in effect, guarantees you a bottom price.

- With this turmoil between the Franc and the Mark in the current economic news, what is all this going to mean to President-elect Nixon when he takes over, as far as our balance of payments is concerned?

- That is a very very complicated issue, and I am not completely certain how to answer that. These kinds of eruptions, have a tendency of suddenly springing up and then dying down again. If indeed the Franc is not devalued, if this German concealed revaluation suffices to bring some measure of equality into the balance of payments between France and Germany and other countries, well then the whole thing may die down again. But that's a very optimistic picture. I think the odds are that the Franc will sooner or later be devalued, regardless of what President De Gaulle or his premier may say. Now that's not a certainty, De Gaulle has been willing to take very strong measures and take very extreme measures in order to defend the Franc and he may be able to pull this chestnut out of the fire, but it's a difficult chestnut to pull out. In the mean time there will be continued turmoil within the European money market as between the Franc and other currencies. When the devaluation occurs, even that may not solve the problem look at the case of the Pound Sterling, it devalued a year ago and now it is again in difficulty and it's been involved in this recent

mixture. So it's not clear that the thing will settle down. But so far as the United States is concerned, the circumstance I mentioned before of the fact that holders of dollars have almost no place to go, gives President-elect Nixon a wider range of options than he otherwise would have. Because I think that there is a very very good chance that no crisis will emerge with respect to the dollar in the next few months. As I say, from my own personal point of view, not speaking for him at all, on the contrary, I think this is a bad thing. I think a crisis which produces a right resolution of our problem would be a good thing, we'd get it over with quick and we'd be through. I think the gold panic last year was splendid from this point of view, it forced us to let the price of gold go on a free market as we should've done out of our own volition earlier, then you know there's been almost no talk about gold speculation since then. So Mr Nixon will have a wide range of options open to him, I can speak very easily of which one I'd like him to take but as to which one he will, that's a more difficult question and I'll have to leave it for the moment unanswered.

- Thank you very much Dr Milton Friedman. If you have questions or comments or suggestions or topics you would like discussed in this series, please send them to Instructional Dynamics Incorporated, 166 East Superior Street, Chicago, Illinois 60611.