

- Hello, this is William Clark of the Chicago Tribune saying welcome once again to a visit with the distinguished economist, Professor Milton Friedman, of the University of Chicago. We're recording this visit very early, just about the turn of the month into May, 1975. And Dr. Friedman has just returned from a long trip that carried into Chile, to Australia, and to Japan, and we want to hear about situation in those countries and how they reacted to developments in Vietnam. But first, Dr. Friedman, I wonder if anything has occurred while you were away to change your thinking about the timing of an economic upturn here at home?

- I have only had time, since I got back, to look rather casually at the figures that have been coming out. But they, as well as the ones I saw while I was away, after all, there is a world news service and it's amazing how easy it is to keep up with what's happening in the United States from the most distant points in the world, but the combination leads me to feel that the position I was taking earlier is essentially the same. Before I left, it looked as if the Fed had changed its monetary policy and had started on a monetary explosion in February. The most recent figures which I have seen, which go through the middle of April, confirm that, that whereas the quantity of money narrowly to fund M-1 had grown from July of 1974 to February '75 at the extremely low rate of 1.4%. In the past two months, from February to now, it has grown at the rate of over 12%, which is an extremely rapid rate of growth. The same thing is true for M-2. Money plus time deposits, including time deposits, for the corresponding two dates from July 1974 to February 1975, M-2 grew at the rate of 5.7%, and for the past two months at the rate of 12 1/2%, or more than twice as much. Thus both monetary series combined to suggest that there has been a very rapid expansion in the quantity of money in the past couple of months, and that the turnaround came just about early in February. If one takes into account that there is typically a six to ninth months lag between a change in the rate of growth of the money supply and in the economy, this would lead you to something like August to October as the expected time of the bottoming out of the recession. That's, of course, contingent on a continuation of monetary expansion, not necessarily at this pace, but at a pace larger than that which prevailed at the end of last year. I continue to believe that the real danger is not that money will grow too slowly, but that it will grow too rapidly. Rates of growth such as have occurred in the past two months, if continued, would spell a resumption of inflation in late '76 or early '77 at very high rates. It remains to be seen whether that fear will be realized. The Federal Reserve people and others talk about maintaining moderation in monetary growth. One could justify such rapid rates of growth for a two months period, on the ground that you were offsetting the extremely slow rate of growth earlier, and that what one should really look at was a longer term rate of growth, the rate of growth over a year, rather than the rate of growth over these brief periods. Over the past year, the rate of growth of M-1 has been at only 4%, and of M-2 has been only 7%. Those are rates of growth which would be good for the long run. But, as is already clear from what I've said, those averages are made up of two very different periods, extremely slow growth for the period from mid '74 to early '75, and extremely rapid growth for the past two months. We shall have to wait and see how that develops. My own guess is that while the rate of growth may not be maintained at this high level, it will be maintained at a higher level than is desirable under the pressures which will come from the need to finance very large deficits and from the

continuing concern about high unemployment. I continue to believe that this tendency will be reinforced by the sigh of relief, which everybody is now expressing at the sharp decline in the rate of inflation. But that sharp decline in the rate of inflation will prove temporary, unless monetary growth is pulled back to lower levels.

- Thank you. Now there are two sets of observations that you might make about your travels, Dr. Friedman. One would be essentially political, including the reactions you saw to the developments in Vietnam, and the other would be economic. I hope that we'll have time for you to do a little of both, but I wonder if we might start first with the political.

- Now, ordinarily, I am hesitant to comment on the political situation--

- Yes, I know.

- As an economist, but this was rather an exceptional circumstance. I was in Australia at the time that Cambodia fell and while the final stages of the Vietnam tragedy were unfolding. I was in Japan just a few days ago, when Saigon was on the verge of being entered by the Vietcong and the North Vietnamese. Both countries are critical countries in the Far East. Both are highly affluent countries. They both are extremely tempting targets for anybody who would want to expand or want to get further economic power. Australia is, in some way, an even more tempting target than Japan, 13 1/2 million people on a continent with a land area roughly the same as that of the United States, with tremendous mineral wealth of coal, of iron ore. You name it, Australia has it. Australia has depended, and Japan have both depended for many years upon the umbrella of the United States. Both have been maintaining military forces that are very small compared to their potential. That is, if you take the expenditures on armed forces, the percentage of national income spent is very much lower in both Australia and in Japan than it is in the United States. By very much lower, I mean 1/2 or 1/3 as much. I don't remember the exact numbers. Both were obviously unsettled by the collapse in Vietnam, but the main impression I carried away was that neither had reacted to it in a realistic sense. Both were continuing to have an artificial appreciation of the role that the United States could or would play in the Far East. Let me illustrate that by a little anecdote. I talked with the head of one of the oil companies, large oil companies in Australia. We came around to talking about the consequences for Australia or for the Middle East, Far East. I mentioned the possibility that Iran, with its new-found munitions, with its rearming, would seek to make itself the master of the Persian Gulf, might move in and try to take over Saudi Arabia, Kuwait, and the other countries. "Oh," said my host, "that won't happen." "Why not?" Said I. "Why, the U.S. wouldn't let it happen." He said. Now that is an attitude that seemed to me inconceivable. He was very much taken aback when I told him that I thought there was not a chance in a million that the U.S. people would stand for American troops being sent to the Mid East in order to prevent Iran from taking over Saudi Arabia. In general, what I'm getting at is a lack of appreciation of the vacuum that has emerged in the world as a whole, not only in the Far East, as a result of the events in Vietnam. The official party in Australia is the Labor Party. It took power about two years ago after a long period out in the wilderness, 23 years of a prior government. It was a party that pulled Australia out of Vietnam, and indeed, one of the major forces that enabled the Labor Party to come to power was the great dispute within Australia about whether Australia ought to be involved in Vietnam. And it was exactly the same kind of a

dispute that we had in this country and the arguments about the Vietnamese situation. The present Deputy Prime Minister of Australia, a man by the name of Dr. Cairns, was one of the leaders in the so-called Peace Movement. He, in fact, almost exalted in triumph on TV at the Vietcong's capture of South Vietnam. He restrained his exaltation cuz it was obviously politically unwise to do so, but it was very clear that he was extremely happy at the outcome. The official policy of the Labor Party with respect to defense is premised on a report in which the key statement is that Australia faces no threat from the outside for the next 10 years, for at least the next 10 years. That's the atmosphere within which policy is being made, and it's quite clear that there is no disposition at the moment to do anything about increasing their own armed strength. And when you ask them, the more knowledgeable ones are concerned about this. They feel that Australia oughta do more to defend itself. But they are continuing to rely on the United States as the ultimate source of strength. The same thing occurs in Great Britain, I mean, in Japan. When I talked to the editor of one of the major newspapers in Japan, he was, himself, extremely concerned about the Russian and the Chinese threat to Japan. He has always been a strong supporter of a Japanese-American alliance, always one of the people whom I would have regarded as pro American, and he still is. He personally felt that Japan probably oughta be very concerned about its own safety, but his attitude was that the constitution which the U.S. forced on Japan after the war makes it illegal for Japan to rearm, and that beyond that, any government which sought to rearm on any major scale would be out of office almost instantaneously as a result of the reaction of the public at large. So his attitude was, "Well, maybe we can't "depend on the United States, "but we have to depend on the United States. "It's the only recourse we have."

- Which concerns Japan more, Russia or China?

- I would say at the moment, the more immediate fear is that of Russia, because of the Kuril Islands and the fishing rights up in the north and the dispute about that. So, moreover, I think that the Japanese kind of have a feeling that they know better how to get along with the Chinese than they do how to get along with the Russians. Now this is an interesting thing, because the fact is that while Japan has, in a way, severed diplomatic relations with Taiwan to renew them with mainland China, the trade which it is now carrying on with Taiwan is considerably larger than the trade which it is carrying on with mainland China.

- That's interesting.

- Of course, I must confess personally, with respect to Japan, I have very mixed feelings. I don't know whether I am more worried about the possibility that they will rearm or about the possibility that they won't, because neither one is a very happy thing. The fundamental thing that comes out of all of this, in my mind, is that there is a real vacuum of power, not only in the Far East but in the world. When Great Britain was the defender and guardian of the world's peace and it gave up that task, we were there to take over. Now that we are giving up that task, and I see no other way to describe what's happening in this country than to say that we are giving up this task, that there is a tremendous isolationist movement sweeping the country, that we are going to retreat back, into not even a fortress America, but we have the same attitudes, it seems to me, that our defense needs no strengthening that Japan and Australia has. I don't believe that they have different attitudes, really fundamentally on this, than the American people have. I think we are all living, in a sense, in a fool's paradise, in a sense of supposing that a vacuum can exist for a long time without

any harm. Now maybe that's right. I had breakfast in Tokyo with a group of graduates of the University of Chicago, half Japanese and half Americans who were over there for various business ventures, and one of the Americans there maintained very strenuously that the vacuum idea was a meaningless concept because the world was perfectly safe without any single great power there to guard it. I hope he's right but I fear he is not, and I believe, therefore, that the next five or 10 years are going to be very dangerous years, not only in the Far East, but throughout much of the world.

- Those are interesting and certainly provocative comments on the political aspect of what you observed, Professor Friedman, I wonder if we might turn now to the economic side. How's the inflation in Chile these days? (laughter)

- Well, Chile is a textbook example of what a real honest to God inflation is like. I may say inflation plagues all of the countries I was at, but with rather differences in Chile, which I'll come back to in more detail in a moment. Inflation is currently running at the rate of something like 300 to 400% a year. In Australia, it's currently running at 17% a year, and it's been going up in Australia. In Japan, it's currently running at about 15% a year, and it's been coming down from about 30%. So that all three countries, like the United States, have had an inflation problem. The Chilean problem is the easiest one to describe. It is a carryover from a long period of developments in Chile. It's tempting to think of it as simply a momentary phenomenon arising out of the Allende regime, the overthrow of the Allende regime and the establishment of a military junta, but the roots go back much earlier than that. They really go back to something like 1908, when Chile was one of the earliest countries, certainly in the Western Hemisphere, to start on the road toward a welfare state. And fundamentally, the basic problems of Chile today are very much the same as the basic problems of Great Britain today. They stem ultimately from a welfare state, carried to a point at which, on the one hand, it absorbs so large a fraction of the nation's income that it cannot be met with the kind of taxes that people are really willing to bear. And on the other hand, it involves so large an intervention and private activity as to destroy individual incentive and the free market system. I was very much struck by the parallel, in this respect, not only in Chile, but all of us are going down the same path. From this longer range point of view, Chile is a cautionary tale that we should all look at with great care, because it brings out in sharp contrast the possible consequences of the past that Britain has followed, that the U.S. has followed, that Australia is following, that Japan is following. The common feature of all of the countries around the world is that as it goes down onto a welfare state line, the fraction of income which government spends tends to go up. As that fraction tends to go up, it becomes more and more difficult to finance it out of taxes, which the public is voluntarily willing to bear. There is more and more pressure to turn to the inflationary tax. Moreover, it stimulates social unrest, because to begin with in this process, it's possible to provide substantial benefits to small groups at very minor costs to a large group. Taxpayers are a large silent majority. As the process proceeds, this becomes more and more difficult, and finally you're getting to the point where 50% of the people are trying to get funds out of the other 50%. And at that point, you have added to the economic problem, the political problem of a breakdown in political cohesion. I think Britain is very close to the end of that process, as I've said before on these tapes. Now, go back to the Chilean case, it's a relatively poor country. The per capita income in Chile in real terms, if you believe the numbers that come out, is about 1/10th of that in the United States. That's probably an exaggeration because these international comparisons tend to overstate differences in income, but it is a relatively poor country. That

country is one which had a very long tradition of a political democracy in a reasonably free society, the longest in South America. The Allende regime brought that to an end, but the Allende regime was a logical consequence of what had gone down before. It was not introducing anything very different. It was just carrying out to their logical implication many of the laws that had been passed before. The junta took over from the Allende regime. It is not a free government by any manner or means. It certainly is a dictatorial government, but Chile had only bad choices at that time. To turn to the economic side of it, the basic situation is that government spending in Chile, at all levels, amounts to about 40% of the national income. That's not very different from the percentage in the United States, and it's very much lower than the percentage in Great Britain, where government spending is now approaching 60% of the national income. But, as I mentioned before, Chile is a far poorer country than either Britain or the United States. Of the 40% of the national income being spent by government, roughly 30% is currently being raised by taxes. I might mention that the 40% is lower and the 30% is higher than at the end of the Allende regime, when the Allende regime had driven the spending higher and taxes lower. And several of the first acts of the government that came in were to try to reform the collection of taxes on the one hand and to hold down government spending on the other. But they have not gone anything like, so far, as they would like to go, or as would be desirable to go. At any rate, the bare facts, 40% government spending, 30% taxes, leaving 10% that has to be raised in some other way. With inflation at rates which ran as high as 900%, at the very early stages of the takeover by the junta, capital market has been almost completely destroyed, so there is no way the government can finance any of its expenditures by issuing bonds or securities. Although, of course, any that it does issue are indexed. The only other recourse is printing money, and here again, the situation is very simple. The Allende regime took over what had been private commercial banks, they are all in government hands. In order to try to offset its own inflationary actions, it raised reserve requirements on them so that 85% of the assets of the government banks are pure cash. As a result, it's approximately correct to say that 100% of all money issued is pure government money, and that 100% of all new money issued goes to pay for government spending. It's a straight, clear, fiscal deficit, as clear as anything could be. Now, the arithmetic of it works out very simply. The tax base is the amount of cash. Inflation is a tax. And here's a clear case that the tax base is the amount of cash that the public holds. The amount of cash that the public holds, currency and deposits at these government banks, is equal in amount to about 3% of the national income. Now that's worth stopping to contemplate a moment. In the United States, a corresponding number would be something like 30% for M-1, 50% or more for M-2. But with inflation rates of 900%, or now 300%, obviously people want to hold their cash balances down to a very minimum. And they have managed to reduce them to about 1/10th of the level that we hold, say to 3%. Another way of looking at that is that total spending is probably something like two or three times national income because you buy it wholesale from the manufacturers or retail so that gross payments are a much higher number than national income, which is only the final value of goods and services. And I roughly estimated that the money stock is enough to handle about three days payments, so that people have to live from hand to mouth, and a large fraction of the attention of all of the people in Chile goes to how do they make their receipts exactly match their payments, so that they won't have to hold any of this wasting cash. There's no doubt in my mind that Chile cannot really recover until it gets the inflation under control for this kind of a reason. At any rate, the tax base has been reduced to a very low level of 3% of the national income. If on a tax base of 3% of the national income, you're gonna raise a sum of money equal to 10% of the national income, you need a tax rate of over 300%. And that's exactly what you have, you have a rate of inflation of something over 300%, with a rate of money

creation, which increases the quantity of money by something over 20% a month. That's a clear pure case. I mentioned that the inflation had come down from some 900% to about 300% as a result of the measures which the government had already taken in reducing expenditures and raising the explicit taxes. Along with that decline came, as people should expect, but most people might not, an increase in unemployment, so that unemployment in Santiago has doubled over the past year from about four or 5% to close to 10%. And although the government is a military junta, it is very much concerned about the level of unemployment, and the one refrain we heard repeatedly in talking to government people and people in power was that how would such and such a measure affect the level of unemployment. From the longer run point of view, the policy which Chile must follow, if it is to recover and have a respectable economic situation must include a sharp reduction in government spending. There is no other way, in my opinion, on which it can get itself into a position where it can really cut the inflation down sharply. And unless it cuts the inflation down sharply, it is hard to see that it can recover in a very effective way. On the other hand, one of the amazing things is how a country can operate under such conditions. Walking in the streets, going in the stores, you would not have the feeling that there was anything really very abnormal going on. The capacity of the human being to adjust to what seemed like intolerable circumstances is tremendous.

- Thank you very much, Professor Friedman. Perhaps we can hear a little more about Australia's and Japan's economy on your next tape. If you subscribers would like to pose questions for Dr. Friedman to answer or suggest subjects for him to discuss, please write them to Instructional Dynamics Incorporated, 450, four five oh, East Ohio Street, Chicago, 60611. Dr. Friedman will be with you again in a couple of weeks.