

MONETARY POLICY STRUCTURES

Milton Friedman

With respect to monetary policy, I only want to say a few words, not about the details of monetary policy, but about how we can get a more satisfactory monetary policy. All of us can agree that it has not been very satisfactory, not simply for the past year or two, but for as far back as you can go. I shall limit my comments mostly to the period since the Federal Reserve System was established in 1914 because most commentary is about that.

But any notion that the period before 1914 was a golden age in the double sense of a properly operated gold standard and in the sense that all went well is a misconception. It was a period that saw its ups and downs. But the period after World War II is a new era in one respect: in 1939 the price level in the United States was lower than it was in 1800. The notion that somehow or other inflation is endemic to the American economy—it's always been in our history—is a bunch of nonsense. The price level doubled during the Civil War; it doubled during the First World War. But each time after the war it returned to the initial level. There was a roughly stable price level. The period since 1960, the past 25 years, is the only period in United States history during which there has been a nearly continuous secular increase in the price level. Again there were ups and downs, but they were around a sharply rising trend.

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The monetary policy was unsatisfactory from the very beginning of the Federal Reserve System. The Federal Reserve System presided over a doubling of prices in World War I, a severe recession in 1920–21, then, after a few years of relative stability in the 1920s came the Great Depression of 1929–33. Subsequently, there was a doubling of prices during World War II. So when I talk about poor monetary policy, I am not referring simply to recent policy.

Public Interest Approach

For many years, I and other economists have been trying to improve monetary policy. I now realize in my later years that our approach has been misconceived. It was our view that the way to improve monetary policy was (a) to learn more about how money operated, (b) to construct appropriate rules for the conduct of monetary policy, and (c) to persuade the people who run monetary policy that they were the right rules. We took it for granted that if we could succeed in doing that, they would put them into effect. That is to say our approach was what has come to be known as the public interest approach to the role of government. The idea was that government bureaucrats, government officials were people who were trying to promote the public good. That's not the way we consider businessmen. We don't think that businessmen go into business to promote the public good. They go into business to make money. If we have the right structure of the economy, if we have the free market system that Adam Smith spoke about, then, as he said in his book, people who tend to promote only their own interests are led by an invisible hand to promote a public interest that was no part of their intent to promote.

I have come to the conclusion, belatedly, that we have to look at government in the same way. The people in government—that goes for all of you, me, congressmen, everyone—are here to promote our own interests. Our interests may be broad; we may want to reform the human race. They may be a narrow selfish interest but in either case we are here to promote our interests. And I have come to the conclusion that the political system that has been set up is one in which Adam Smith's invisible hand works in reverse. People who intend to pursue only the public interest end up pursuing private interests which it was no part of their intention to pursue. And so I have come to the conclusion that the way to do something about

monetary policy is not to persuade beneficent monetary controllers to do the right thing but to ask a different question: What is the structure of monetary policy that will have the effect of making the political invisible hand work the same way as the economic one? How can we set up a structure of monetary policy under which government officials who intend only to promote their private interests are led by an invisible hand to promote the public interest?

Political Invisible Hand

Let me demonstrate my point with a very simple and obvious example. Let me emphasize this, I'm not criticizing anybody. I'm only trying to describe. We don't criticize businessmen for pursuing their own interests. I don't criticize politicians and others for pursuing their interests; we're humans. We all do the same thing. Suppose that 20 years ago the Federal Reserve had adopted the advice that I was then giving them completely. That advice was that they should adopt procedures that would produce a steady rate of growth in the quantity of money at 3 percent a year. Suppose they had done that. There is not the slightest doubt in my mind that the country would have been far better off. We would have avoided the inflation of the past 20 years entirely. We would still have had a few ups and downs, but they would have been modest. But I ask you a question: Suppose the Federal Reserve had adopted that modest task and suppose you conducted a poll asking: Who are the most important persons in the country? Is there the slightest chance that the chairman of the Federal Reserve Board would be listed as the second most important person in the country? The Federal Reserve would have no great prestige. It would be a modest accounting agency that was carrying out a simple mechanical job. And it would have occurred to more people than me up to now that you might as well replace it with a computer.

So it was not in the self-interest of members of the Federal Reserve System to adopt that policy. The reason they didn't adopt the policy wasn't that I wasn't persuasive enough; perhaps I wasn't. It wasn't that I was wrong; perhaps I was. I don't think so. The fundamental reason was this was not in their self-interest to adopt that policy. Again, don't misunderstand me. You all remember that famous statement that got so much attention during World War II: "What's good for General Motors is good for the country." The one thing

every one of us is capable of doing is persuading ourselves of that. So I'm not criticizing anybody for any ulterior motive. But as long as proposed policies were against their self-interest, they would be able to persuade themselves very easily that those policies were not good for the country.

That leads me to the conclusion that *the only way to get a sensible monetary policy is to change the fundamental structure of our monetary institutions*. We shall not get better policies by appointing better people to the Federal Reserve Board, by changing the chairman. That might make a difference, a marginal difference. Some members of the board are better; some are worse. I've studied for decades the detailed history of the Federal Reserve System, and the last thing I will look at to see what the policy of the Federal Reserve is [is] the name of the chairman. That doesn't matter. It's a major institution that operates under its own terms.

I'm going to suggest what I think is the most promising ultimate reform and say we're a long way from it. We're not going to get there, but we ought to have in mind where we would like to go if we could. My ultimate ideal at the moment—I have changed this over time as I've become more and more persuaded what the real problem is—is to eliminate every element of discretion. At the moment, my ultimate proposal is that we freeze what is called high-powered money, that is to say, current Federal Reserve notes and deposits at the Federal Reserve. To put it more simply, we could replace those notes and those deposits by Treasury notes, just pieces of paper, and then never print another one except to replace those that wear out. Just freeze it, and you don't need a Federal Reserve System. You can cut the work of the Bureau of Engraving and Printing down so they can devote most of their effort to printing your reports instead of money. That really would replace the present discretionary monetary policy apparatus by a pure automatic system. Under those circumstances, what would happen would be that the markets would determine and would adjust the total quantity of money in the sense of the money we use including deposits plus currency. Because then commercial banks and other financial institutions would need to keep some of that high-powered money in reserve in order to be able to meet demands for it and so on. I won't go into details; you're all capable of doing that. In my opinion, the effect would be roughly stable prices. Judging from experience, I would expect the quantity of money as people currently interpret it to go up something like 3 percent a year,

which would just roughly keep pace with total output and give a roughly stable price level.

We're not going to get that reform tomorrow, and, indeed, we're not going to get any major change until there's a crisis. You don't get major changes just because somebody believes they're good. You get major changes because there's a crisis. The role of people like myself, who suggest what ought to be done when there is a crisis, is not really to persuade anybody to do anything. It's only to keep options open so that when a crisis emerges, there's something available that can be picked up. The best example of that, of course, was the adoption of floating exchange rates. For decades, I and others had been urging floating exchange rates. We had no effect on anybody until a crisis emerged, and something had to be done. When something had to be done, there was a well thought through approach that could be adopted. The same thing is true in respect to monetary policy. Now some intermediate possible reforms, and then I'll open up for questions and answers.

Intermediate Reforms

One great improvement would be to put the Federal Reserve in the Treasury Department because right now you have a division of responsibilities. If you read the reports of the Federal Reserve System, as I have had to do for my sins, you will find that every Federal Reserve chairman in the history of the Fed has blamed fiscal policy for difficulties that have emerged. For example, right now, why do you have high interest rates? According to the Fed, that has nothing to do with what the Federal Reserve has been doing. It's you people down here who have created the deficits. It's the Treasury's fault. And every Secretary of the Treasury has blamed the Federal Reserve for what's happened. So you have a division of responsibility. It would be far better for those two agencies to be in one place.

I have always been in favor of greater congressional supervision of monetary policy. I don't think Congress will do the right thing, but there's an enormous difference between Congress and the Federal Reserve. The members of the Federal Reserve Board are appointed for 14 years; congressmen are elected for only two. If Congress had been in control of monetary policy, you would not have had the Great Depression. Members on the floors of Congress were demanding that the Federal Reserve do something different than it did in 1930,

1931, 1932. One of the most dramatic episodes was in 1932 when the Fed did undertake a large scale open market operation. It started it the day before the head of the New York Federal Reserve Bank, George Harrison, was supposed to testify in Congress. According to the minutes of the open market meeting on that day, they decided that they were going to have to engage in open market purchases in response to congressional pressure. Ordinarily, they would have started the next day. Harrison asked if they could make an exception and let him leave the meeting to phone New York to start the purchases that afternoon because he was going to testify to Congress the next day, and he wanted to say they had already started. That open market operation ended less than two weeks after Congress adjourned. I don't say congressional control would be ideal. It might lead to many more small mistakes, but it would avoid major mistakes like the Great Depression and the great inflation. Congressional supervision is not going to do very much. In 1975, when Congress passed a joint resolution requiring the Fed for the first time to state its monetary targets for a year in advance, the Fed completely emasculated the resolution first by what we call "base drift" and second, by creating multiple money definitions so they could shift from one to the other.

So I'm not overly optimistic about what congressional control can do. However, it would be better than what we have now. As you can see, I am not in favor of the independence of the Federal Reserve. This is a democracy. And I believe that money is too important to leave to [a] central bank, that it is intolerable that a group of non-elected people should have the power to create a major inflation or a major recession. Entirely aside from the economic effects I believe it is not an acceptable political system. To repeat, as a minor change I'd have the Fed made part of the Treasury. As an alternative, it would be better to have the Fed more directly under congressional control. The best change of all would be to abolish the Fed completely, and simply have zero creation of high-powered money and no discretionary powers anywhere. I hope I said enough to stimulate some questions.

Questions [from Members of Congress] and Answers

Question: What if Congress decides it wants to seek growth in high-powered money?

Friedman: My preference is to have a constitutional amendment to enforce a zero growth in high-powered money. That is, as I said,

an ultimate solution and a major reform. If monetary policy is under Congress, and Congress wants to increase high-powered money, there will be an increase in high-powered money. I'm not saying that's a good thing. I'm saying that the effects of the inflation will force changes in that policy more rapidly than when the Fed makes a major mistake. I'm talking about the lesser of two evils.

Question: I believe in the past you predicted that there will be an increase in inflation. I don't remember the exact time frame, but [I think] it was second quarter 1984. How is that prediction faring?

Friedman: Not badly really. I have been saying for a long time, oh, since late third quarter 1983, that inflation has passed its low point. I believe the low point of inflation in this cycle was in the first or second quarter of 1983. The consumer price index rose at the annual rate of 3.3 percent during the first six months of 1983, 4.3 percent in the second six months, and about 4.9 to 5 percent in the first five months of 1984. So far as the future is concerned, I am a little more optimistic now than I was a few months earlier. That's because I have been doing a more careful evaluation of the effects of the various changes in regulations, and particularly the introduction of Super-NOW's. Whereas earlier, I was saying that by the end of this year, I thought that the inflation rate—not year-over-year but during the fourth quarter—would be somewhere between 7 and 10 percent. I'm now inclined to cut it down to something like 6 to 8 percent. Before I said that there was a better than 50-50 chance that inflation would be above 10 percent in 1985. Now I would say there's a decidedly less than 50-50 chance it would be above 10 percent.

Question: Would that also tend to explain why interest rates have gone up? And then secondly, why haven't gold prices tended to be more volatile?

Friedman: Gold is a terrible index of general prices. If you look at the pattern of gold over the past 10 years, the price of gold has fluctuated very widely. There is not a close relation between the short-term movement of the price of gold and the short-term movement of price indexes. It simply is a lousy indicator for where inflation is going. It depends on many other things including the interest rate. Higher interest rates discourage people from holding gold. So I don't believe gold is a good indicator.

Historically, a change in monetary growth tends to have its first impact on total [spending] one or two quarters later. The change in total spending in turn will take the form mostly of a change in the real

volume of sales, partly out of inventories, partly out of new production. It will have very little impact in the first instance on prices or on inflation. As time rolls on, the impact on real output and real sales declines; the impact on inflation grows. Typically, the effect of a change in monetary growth takes two years to work itself through to inflation. That's not a new phenomenon. William Stanley Jevons, the famous English economist, in a paper he wrote in the 1880s or '70s—I've forgotten the exact date but more than a century ago—said that the change in the currency shows up in prices two years later. I've studied the data for the United States for over a century, and in all of that period, on the average, there is about a two year gap between the rate of change of money and the rate of change of inflation. The low rate of inflation in the second quarter of 1983 reflected a relatively low monetary growth rate in 1981. From 1982 to 1983, you had the fastest monetary growth rate in the postwar period. Fortunately, part of that, a considerable part of that, was offset by the change in regulations; particularly the Super NOWs which made it more attractable to hold cash. So you did have a decline in velocity, but let me explain to you how I get these forecasts; I don't pick numbers out of a hat. I have tried to investigate the effects of these various changes on inflation and on velocity. They produced about an 11 percent drop in velocity. That is to say, that quantity of money people wanted to hold (all other things the same) went up about 11 percent because of the availability of deposits in which interest was paid on these deposits. That's after allowing for the typical change in interest rates on the holding of money. Of that 11 percent, I estimate that 3 to 4 percent was absorbed by a lower level of real output. And about 7 to 8 percent was absorbed by a lower level of prices. What I have done is to take the money figures since then and correct them by taking 8 percent less than they actually were. Then I've taken the multiple correlation equations I use for prices now related to monetary growth four quarters ago, eight quarters ago, 12 quarters ago. And I've extrapolated that using, not the actual money figures but the adjusted money figures. That's what gives the predictions that I've been citing. Essentially, the answer to your question of what's producing the inflation is the speed up in monetary growth from 1981 to 1983, which is producing a speed up in inflation, from 1983 to 1985. What happens from 1985 on depends on what happens from here on out. Since November 1983, [the] money supply has been going up at about 7 percent. If that were to continue, if the Federal Reserve

continues at 7 percent for 10 years, then inflation after going up to something like 10 percent in 1985 would ultimately settle at something like 6 to 8 percent. That's too high, and so when you ask about monetary growth, I think it ought to be brought down. It ought to be lower than it is now.

Question: You spoke earlier of the fact that we all, political as well as private business, tend to act in our private interest. How about the Secretary of the Treasury, on the assumption that he was now responsible not only for the ordinary business of that department but for monetary policy as well, is he not involved in a conflict of interest? As an agent of the administration, he has to meet the deficits that Congress and the administration may hoist over him. He's got to meet the deficit. On the other hand, he's also being made, under your assumption that the Federal Reserve is under the Treasury, responsible for the maintenance of the stability of [purchasing] power. It seems to me there's a conflict of interest in there. You can do one or the other, but you can't do both. And we've had that situation during World War II and up to 1951.

Friedman: Let me say two things about this. First, that conflict of interest is there now, but it's between the Treasury and the Federal Reserve.

Question: But they're independent.

Friedman: Are they independent? They're independent in one sense but not in another, and it's in the self-interest of the Federal Reserve to blame the Treasury. It's in the self-interest of the Treasury to blame the Federal Reserve. And I would rather have the right hand of the Secretary of the Treasury blame the left hand than to have him blame somebody else.

Question: No, we have it in the open. In this case, it would all be buried.

Friedman: No, it wouldn't be buried at all. It would be in the open; the numbers would be there. The results would be there, and there would be only one man to go to. What happens to you people in Congress? Mr. Volcker comes up and testifies to you, and you ask what in the world have you been doing? He says, "Oh, don't blame me. It's those terrible deficits you and the Treasury are producing." Secretary Regan comes up and testifies before you, and you say why are you producing this high interest rate? He says, "Don't blame me. It's the Federal Reserve that's been producing our high interest rates." Surely it's better to have one man on whom you can put

responsibility for both than it is with each one passing to the other. I'll now tell some experience.

One advantage of having studied history is having past examples of the world. Until 1934, the Secretary of the Treasury was an ex-officio member of the Federal Reserve. I have gone through the minutes of the Federal Reserve Board in those earlier periods though I was able to get them only by accident. The Federal Reserve Board wouldn't let them out. One of the achievements that Anna Schwartz and I are very proud of is that after we published our *Monetary History*, the Federal Reserve wanted to provide ammunition for a counter attack. So for the first time they made their minutes available after a five-year gap. The only way we ever got to go through the minutes was the accident that George Harrison, after he retired as governor of the New York Federal Reserve Bank, deposited his papers in the Columbia University Library. They accidentally included minutes of the open market meetings. That's the only way we could get them. As I have gone through that record, I would say that on the whole the Secretary of the Treasury was a voice of prudence on that committee.

Short-Term Interest Rates

Question: Based on what you've said about money supply growth and prices, I can understand how you might explain the current rise in long-term interest rates. How do you explain from a monetarist viewpoint what's happening with short-term rates?

Friedman: I agree with you that there's more of a puzzle with short-term rates than long-term rates. I'm glad, needless to say, that you bring this up because obviously I've thought about it. Let's take them separately. So far as long-term rates are concerned, my interpretation is perhaps a little different than most. I start with the observation that we do have a market measure of real interest rates in Great Britain. Great Britain has been wise enough, and we have not been, to issue purchasing power securities. That is to say, securities in which both the principle and the interest payments are adjusted for inflation. For example, in dollars, suppose you issue a \$1,000 purchasing power bond now. It's a 10 year bond, and suppose that 10 years from now prices are double what they are now. The person gets back \$2,000 not \$1,000. And year-by-year, the interest coupon is adjusted in dollars for inflation. So the yield on those bonds is a market measure of real interest rates. The British reintroduced those

originally only on a very narrow basis—available, I think, only for superannuated people. But they were so popular that the issue was broadened. What hasn't been done is always impossible; what you have done is optimal. We've been fighting this for 25 years trying to get the Treasury to issue purchasing power securities.¹ And everybody says you can't do it, and here's Britain doing it. So now, they've got to think of a different reason. At any rate, the real return on those securities has been running at about 2 to 3 percent. In our study of interest rates in the United States and Great Britain over the past century, we found that on the average real interest rates, after allowing for inflation, were about 1 to 1.5 percentage points higher in the United States than in Great Britain. So I conclude that the real interest rate in the United States has to be something like 3 to 4 percent. If we take, say, 13 percent rate on a long-term security and take 4 percent off that, you get 9 percent to explain. Most estimates of most peoples' judgments about expectations for future inflation run to about 6 percent. That leaves 2 to 3 percent to explain. That, I believe, reflects the fact that these prospects are highly uncertain. Long-term bonds have become one of the most speculative investments there is. The interest rate may now be 13 percent. On the one hand, it's possible that five years from now it'll be 2 percent. On the other hand, it's possible it'll be 32 percent. And, therefore, borrowers have been very hesitant to borrow long, and lenders have been very hesitant to lend long. These two balance. You would think that they would all flow into the short-term market, and you'd just have a big short-term market. But I believe there's an asymmetry partly due to the U.S. Treasury Department.

The U.S. Treasury Department erroneously continues to borrow long. I think that's a terrible mistake. The U.S. Treasury Department is talking out of both sides of its mouth. If you listen to what the administration says, it says we're going to have zero inflation in the future; we're heading for low inflation. If you look at what they're doing, they are selling long-term bonds. That makes sense only if they expect high inflation. Now, do you believe what they say, or do you believe what they do? I believe what they do, not what they say—and I believe the market joins me in that. As a result, the Treasury continues to borrow long. There are few other borrowers who are

¹The U.S. Treasury introduced Treasury Inflation-Protected Securities (TIPS) in 1997 (ed.).

required by law to borrow on that fixed interest form—some insurance companies with pension funds and so on. As a result, I think there's some asymmetry and that the remaining interest rate percentage is in the sense a premium that has to be paid to overcome the uncertainty. You know, the actual amount of borrowing has to equal the actual amount of lending. But how do you encourage these reluctant lenders to lend? Only by paying a higher interest rate. And I believe that's the major reason why the differential between the long and the short securities is as high as it is.

Comment: That gap disappears once you plug in a tax rate.

Friedman: Well, we'll come back to the tax rate. I'm going to talk about the tax rate in a moment. You're right, and I was leaving out the tax rate at the moment. Because in our historical studies, we've never really allowed for a tax rate. If I did, I'd get a different historical basis.

Let's turn to the short term, and this is where I was going to bring in the taxes. Short-term rates are something like 10 to 11 percent depending on what you look at; say 10 percent. Now, there is a real tax problem. How much of a tax rate do you allow? If you look historically at the difference between tax exempt and taxable securities, that implies a marginal tax rate of about a third. If you look at it currently, you have a bigger marginal tax rate than that. The differential between one-year taxables and one-year tax exempts is more than 30 percent. However, I think that's a fluke because the differential should be less than that given the changes that have occurred in marginal tax rates. That 30 percent marginal differential prevailed when the top tax rate was 70 percent. Now it's 50 percent; it ought to be less. Say it's 30 percent. Then you've got about a 7 percent short-term rate. If you take now that 7 percent, you've got the inflation rate running about 4 percent. That leaves you about 3 percent of the real rate. That is high for this stage of the business cycle. Typically, in a period of inflation and rising inflation, short-term real rates are zero or negative. So I come out with the conclusion that short-term rates are relatively high. The problem is of much smaller dimension than I believe that most people suppose, but nonetheless I don't have a good explanation as to why short-term rates are that high. I've heard various explanations; all of which make sense, such as the fact that the changes in the tax law [increased returns on investment and], therefore, made the people willing to pay a higher real rate. And that makes some sense. Now if we go back to this short-, long-term

comparison, as you'll see if you allow for tax effects on the long term as well, you still are left with [an] abnormally wide margin between long and short rates at this stage of the cycle. And that I think is attributable to this uncertainty I was talking about. I don't know if that gets to your point, but at least that's all I know.

Targets for the Monetary Base

Question: How do you improve the congressional process? As you know, they send us a report to the banking committees in the House. We have Chairman Volcker up here. We say, "Thank you much." We ask a few questions. We're supposed to file a report and send a story. Last time the House Banking Committee didn't even file a report required by law. It wasn't signed off by the members. How do you go back and examine the process to hopefully improve the process?

Friedman: First of all, I'm not the right person to answer this. I have never served in Congress, never been a congressional employee. I really am not an expert on the operations of Congress. I'm looking at it strictly from the outside. I think the thing that would improve the congressional process most would be to have Congress ask the Federal Reserve to state its targets for the monetary base and nothing else for a year from now. Then ask them to report quarter-by-quarter how they're coming on that making no change in the target once they have adopted it. Now, let me explain.

M1 is more closely related to business activity than is the monetary base. From the point of view of controlling the economy, M1 is marginally more important. However, the Federal Reserve cannot make excuses about the monetary base. There is no doubt that it controls it. The monetary base is the only thing you can really hold them accountable for. And the real problem in my opinion is to make them accountable. Currently, when you ask them for their target, they give you M1, M2, M3 and now they've introduced a credit aggregate. It's very hard to pin them down. So I think the best improvement would be to simplify and get it down to one target. The view that they should be required to say what their forecasts are for real income is a mistake. They cannot control real income. The one thing they can control is the monetary base. And, therefore, they should answer for it.

Question: There are people around here who are not sure we can get the Congress to take some of your suggestions. There are others

who, while talking to the Republican Research Committee, suggest that we ought to go back and do some things that we're done before. There are those who recommend that we go back to a gold standard. Other people who are certain that is the way to go suggest that an alternative might be to have a competitive money system to keep the Fed honest, the commodity basket or whatever. Will you comment on that?

Friedman: I'll be glad to. The Gold Commission demonstrated that the supposed support for a gold standard is nonexistent, when you try to pin down what you mean by the words "gold standard." Lots of people favor a gold standard. But when you probe them, they all mean different things. The only person in the Congress and the only person on the Gold Commission who was in favor of what would be regarded as an honest-to-God real gold standard was Ron Paul. Appearances are very misleading with respect to a gold standard. There is negligible support for any particular version of the gold standard. People who say they're for a gold standard vary from people at one extreme, like Ron Paul, who is for an honest-to-God gold standard in the sense that gold would be the medium of exchange and nothing else would have legal tender status. That's an honest-to-God gold standard, and I may say I would not be against such a standard. That would work very well, but there isn't a chance of a snow ball in hell of your getting it. I'm not unaccustomed to being in favor of politically unpopular or unreasonable ideas, but there's a limit. At another extreme, you have people like Art Laffer and Lew Lehrman who are in favor of a system under which the Federal Reserve would operate its discretionary monetary policy by looking at gold as a criterion. They would introduce a monitoring range for the price of gold like the present monitoring range for the monetary base. Now again, whether that's good, bad, or indifferent, [there is] an enormous difference between that and what is called a gold standard. You have people everywhere in between, those who want a fractional gold standard, those who want a gold exchange. Next, any kind of gold standard only makes sense if it's international. If there's any country in the world that you would think would be in favor of a gold standard, you think it would be South Africa. They could adopt a gold standard all by themselves. Have they made any moves in the direction? No, I believe that people who are talking about having a gold standard are really talking about something that is not going to exist.

Let me add more; the gold standard as it operated in the 19th century had some virtues. It did maintain a relatively stable price level. It did put restraints on government discretion, but it was very far from an ideal situation. There were wide fluctuations in prices. Much more important, it was possible to have it then because the federal government was spending 3 percent of the national income. It was possible to have it then because there was a widespread public mythology about gold. The tendency for gold to leave the country was an important thing, and the public at-large would support very severe measures in order to stop it. Neither of those conditions exists today. I'm not saying it won't happen if you have a worldwide catastrophe, if you have hyperinflation in every country of the world, the kind that you are shortly going to have in Israel and might have in Argentina. If that happens in the United States, Great Britain, France, Germany, and Japan, then you conceivably might have a gold standard, but I believe that the chances of that are fairly remote. So, I believe it's an utterly false issue for people to raise.

The other notion that you're raising is not to have a gold standard, but rather competitive money. I'm all in favor of competitive money, but that has nothing to do with a monetary standard. It has to do with banking regulations. We have moved some direction in that way. These two are linked to the gold standard. You could have a gold standard by purely private action. There's no reason why people shouldn't decide to buy and sell goods in terms of gold, and in fact there's a gold standard bank in Kansas City. Anybody here who wants to have a gold deposit can have a gold deposit there. He can transfer that to somebody else by writing a check on it. There's no reason why private people could not conduct their operations on a gold standard base. The problem is that there are tax difficulties in the way. If you own gold and the price goes up and you've sold it, you're subject to a capital gains tax on that difference. I would be strongly in favor of eliminating any such barrier to using gold or anything else as an alternative. I am strongly in favor of changing the laws in such a way as to permit competitive banking. As an economist and student of money, I would predict that none of those competitive monies will displace the official government money unless there is really extreme mismanagement by the government. That doesn't mean I'm not in favor of it; I'm in favor of it. Maybe I'm wrong. And if I'm wrong, I'd like to see it operate. I'd like to see it have the opportunity. But it's not going to get through Congress.

Question: How do you see the transition from our present situation to one in which we freeze high-powered money as far as the Banking Committee, the stock market, commodities market, and bond market [are concerned]?

Friedman: That is a very good question.

Question: Also, would you guess that there would be calls for deregulation and reinstatement of the Federal Reserve in this situation?

Friedman: So far as the banking community, the stock market and so on, they would be unaffected. Consider two scenarios: one scenario under which the present Federal Reserve System operates in such a way over the next five years that inflation comes down from its present level to zero and stays at zero. That would have identically the same effect on all these other groups. In an alternative scenario, you abolish the Federal Reserve System but set a definite pattern that you're going to increase high-powered money 6 percent next year, 5 percent the next year, 4 percent and so on, until you get down to zero and then hold it. Those two would have identically the same effect on all the institutions you mentioned, the banks, the stock market and so on.

The second question that you asked is whether there will be pressure for reintroduction of the Federal Reserve. It is just as relevant to ask the question whether you would have great pressure for the Federal Reserve to expand the money supply. And the answer is yes, of course, you would, but I do not think that once you got into a regime in which you had zero growth in high-powered money that there would be any strong movement to reestablish the Federal Reserve. I shouldn't be talking politics to you people; you people know the political system better than I do. It's hard enough to establish an institution of any kind. It's 10 times as hard to get rid of it because once you establish an institution, there is a vested interest in retaining it. If you once got rid of the Federal Reserve, it would be a very hard thing to reestablish. On the other hand, it's very hard thing to get rid of any such institution, including the Federal Trade Commission.

Question: I would like to explore your preference for putting the Federal Reserve either under the Treasury or as a creature of Congress. David Meiselman has done some interesting work on political monetary cycles. And it would seem to me that that suggestion would make it much more political, and I could think of some

interesting scenarios where the Congress being one party and the administration being another coming up with a monetary policy to put that administration out.

Friedman: I said before that either bringing it under the Treasury or putting it under Congress would give you more small mistakes. It would worsen monetary policy from month to month, or even year to year, but it would prevent major disasters. You would not have had the Great Depression; you would not have had the inflationary roller-coaster of the last 20 years. Going back to David's political cycle, he and I have some differences about the statistics. I was very much interested in his article in the *Wall Street Journal*, and so I fed into my computer all the figures I could get going back as far as I could. And I found that my computer did not give me the same answer as his did.

Meiselman: I didn't use a computer; I used the eyeball.

Friedman: I know. And the eyeball is a more valuable instrument, but it needs to be checked by the computer and statistics. And when I checked, I found that the events that your eyeball found were not outside the range of what random fluctuations might have produced. So I am not persuaded that there is that kind of a political cycle. After all, the political cycle did not prevent the Federal Reserve from defeating Jimmy Carter. I mean that more literally. In the case of Jimmy Carter, you had a very severe recession in the first half of 1980. The fact of the matter is that the notion of the political cycle assumes a greater capacity on the part of the Federal Reserve to figure out what the consequences of their policy will be than they have.

Question: In your fixed monetary base for high-powered money, aren't you assuming a declining reserve base or are you assuming something else? Will the private banks be willing to come in?

Friedman: Sure, because you'll have an increasing sophistication in the use of high-powered money; you'll have more use of deposits and less use of currency. Even with a fixed reserve rate, you could have it. If you look back at the record, the record is first of all that the velocity of circulation—that is, M1 [velocity]—has been going up for the last 30 years at about 3 percent a year. The velocity of the money multiplier, the money [supply] versus high-powered money, has been going up about 1 percent a year over the last 30 years. I think the 3 percent [for M1 velocity] is an overestimate for the future because the 3 percent was based on the period when what was called M1 had no interest bearing deposits. So I expect that the increase in

velocity of M2, of our present M1 which is essentially equal to the earlier M2, will be somewhat lower than 3 percent, maybe 2 percent a year. If you put that together with the money multiplier, you have a 3 percent per year growth in what [we] can expect in total spending. Now, I may be wrong. But you know the world would exist very well, it would be a very fine world, if prices were going down on the average of 1 percent a year or 2 percent a year. So that's not what I would call a disaster. The crucial thing is that you would not have major increases or major decreases in prices. You would not have the kind of fluctuation that you now have. I believe that the Federal Reserve does a large part of its harm by its continuous fine-tuning in the market. It's in and out, in and out. It's introducing an additional uncertainty in the market that need not be there. The Federal Reserve itself can do a lot better than that and cut out this fine-tuning it's engaged in. But if it did, it would lose its influence and importance so it isn't going to do it.

Question: The prime minister of New Zealand, Prime Minister Muldoon, wants to reconvene the Bretton Woods to address the debt problem in their countries. He found himself in a lot of trouble in New Zealand. What's your assessment of that? Do you see a favorable outcome to the country?

Friedman: There's not going to be a reconvening of Bretton Woods, and I don't know what the outcome would be if there were. Everybody complains about the present system, but nobody really wants to change it. It's going to last indefinitely. In New Zealand, Mr. Muldoon's former head of the central bank, whose name I've now forgotten, rediscovered the tabular standard. He wrote a whole series of articles that were published in the bulletin of the central bank. But what did Bretton Woods do? Is there really anybody who wants to go back to fixed exchange rates? I don't think so. Some people want to talk about it, but talk is cheap. The situation with Bretton Woods would be the same as with the gold standard: everybody would agree you ought to do something, but everybody would want to do something different.

Question: I was also asking what the banks or the countries should do about the debts—specifically, like Brazil.

Friedman: Oh, that debt! There's no doubt in my mind what should happen. The government should stay out of it and let the banks make their own deals with those countries any way they want to. That's their business. They made the loans; let them take

care of it. We have no business bailing them out. As you may know, I was strongly opposed to the increase in quotas for the IMF. The IMF has, in my opinion, been a very damaging institution. You know, there are quite a number of people who have some doubts about how well a central bank within a single country works. They should contemplate how a world central bank would work. What has the IMF been doing with respect to these various countries? It's been encouraging them to do the wrong things. I'm not talking, as most people are, about the question of whether they've been trying to cut their deficit. The problem, in my opinion, in the underdeveloped countries is primarily excessive government control of the economy.

Whom does the IMF deal with? Have you ever heard the IMF make a deal with a private Brazilian company? The IMF deals with governments. What does it do in the process? It strengthens the government vis-à-vis the private sector. Well, what's the problem in those countries? The government is already too strong vis-à-vis the private sector.

Why is it that nobody ever talks about the countries that aren't in trouble? How come the IMF isn't having to do something about Hong Kong? Now there's a country that's really in trouble. Here's Hong Kong with no resources at all; it has a population that has multiplied 10-fold in the past 20, 30 years. It's got an enormous neighbor that's threatening to take it over, and as a result, there is a tremendous flight of capital out of the country. And yet, they don't seem to be needing the IMF. How come? Why is it the IMF hasn't had a problem with Singapore, with Taiwan, with Japan? You know, the funny thing is that a few years ago, Japan was an underdeveloped country. The reason the IMF hasn't had any problem with those countries is because those are all countries that have relied primarily on the market to organize their activities. Every single country, to the best of my knowledge, with which the IMF has a problem, is a country that has relied primarily on the government to organize and control its economy. That's why I think that the IMF is an instrument for harm, not for good. It strengthens governments. That's also why many, many years ago I was opposed to U.S. foreign economic aid because it has the same effect. We strengthen the government; we destroy the private sector. A recent piece in the *Wall Street Journal* said something about destroying private agriculture in India. I saw that happening in India when I was there 20 odd years ago. We give them wheat; wheat is fine, but the effect of that is to destroy their

own agriculture. So I don't think we want to strengthen the IMF. The only thing I could see coming out of [a new] Bretton Woods that would be good would be abolishing the IMF.

Question: Both houses of the banking committees are engaged in a great debate on how the banking system ought to be restructured, going back and looking at the Banking Act of 1933. What are your comments on how the system ought to be restructured, particularly . . . deposit insurance?

Friedman: There is a gentleman, whose name I've now forgotten, who has written a very good article proposing to restructure the system which makes an enormous amount of sense to me. The essence of his argument, and I think it's correct, is that you have to distinguish between two problems: the liquidity problem and the solvency problem. The liquidity problem is something no insurance system can handle. And that's the problem the Federal Reserve has to handle, should handle, can handle. But the solvency problem, given that you have a firm commitment to handle the liquidity problem, the solvency problem is one that could be handled by strictly private insurance. What you ought to move is to dismantle the Federal Deposit Insurance Corporation and establish private insurance companies that will provide private insurance to banks and other institutions. Let me pin that down a little more and talk about Continental Illinois because what people don't recognize is the order of magnitude of the liquidity problem on the one hand and the solvency problem on the other. Continental Illinois had deposits of \$25–50 billion. Given the scare about Continental Illinois, there was a demand to draw out \$40–50 billion. No insurance company is going to be able to handle that. On the other hand, suppose you stop the liquidity problem, suppose you stop the drain. Then the difference between the going value of Continental's assets and the going value of its liabilities, in excess of the stockholder's equity, was probably in the area of \$1–2 billion. That can perfectly well be handled by a private insurance fund. Private insurance companies handle much more than [that].

In our study of the monetary history of the United States, there is a similar comparison about the Great Depression. The problem during the Great Depression was not the loss of capital in the banks that failed; it was the effect of the failure of banks on the total quantity of money. In the same way, the problem with the liquidity run on Continental was the problem of what it might do to the entire

monetary structure if it weren't stopped. And I may say under present circumstances, unaccustomed as I am to approving anything that any federal agency does, I believe they did the right thing in stopping that run on Continental by guaranteeing all the depositors. It was not a very good thing to do from one point of view, but I think it was the right thing to do under the circumstances. From the long-run point of view, what we ought to have in mind is private fund insurance plus a firm commitment by the Federal Reserve that it will prevent and stop any liquidity run. The FDIC has proposed . . . differential rates on risk, but I believe government is in no position to consider risks. On the other hand, private insurance companies would be in a position to graduate the rates—to charge various rates according to the risks involved.

Question: Could you comment on the current proposals before Congress, or at least being talked about, such as Kemp-Lott? There are two bills. One is to have immediate disclosure of Fed actions; the second is to adopt an unspecified form of commodity standard.

Friedman: I've always been in favor of immediate disclosure of Fed action. There is absolutely no justification whatsoever for the Fed waiting a month before they disclose what they said and what they have decided at these meetings. I have always felt that the Fed should hold an open market committee meeting on Thursday or Friday so that they use Saturday and part of Sunday to check the minutes—they have to check the minutes with the members to make sure they're accurate—and issue the minutes on Sunday. Now, the problem there is that it isn't going to do anything because the minutes will be vague. They'll write the minutes in such a way that they won't say anything; they come as close to that now as they can. And they would be even more vague. But at any rate, I see no justification for keeping any of that secret. In fact, I would be in favor of publishing transcripts of the discussion at open market investment committee meetings. So I'm all in favor of immediate disclosure.

On the other, I am not in favor, as you can see, of any monetary proposal as I understand it. As I understand the proposal—maybe I don't—but my impression is that they propose that the Fed should operate its discretionary policy by looking at various price indexes, whether it's gold or simply a commodity price index. And I think that—entirely aside [from the] fact that it's almost impossible to do—it would not achieve their objectives. There are many objections,

but fundamentally they're barking up a bad tree. Let me explain. Many people are saying that the problem we face is deflation not inflation because many commodity prices are going down. And that's true. Now I ask all of you to consider what fraction of the total GNP is made up of those commodities, raw commodities? It's a trivial fraction. Some years back, I had what I thought was a fine idea of how to get a market measure of inflationary expectation[s]. We had futures market[s] in a wide variety of commodities. These markets show what people expect the price to be six or nine months from now. Why not, I thought, combine all of those in an index to get an indication of what people expect inflation to be. I had a student who was exploring for a PhD topic go into this. The first thing I had him do was to calculate an index of such commodities for a past period and compare it with the actual behavior of a broad-range index on consumer prices. There was essentially no relation between the months. That's because the commodities constitute a small fraction of the total basket of goods, and they're not a representative sample by any means. Similarly, with current so-called sensitive price [commodities]. As a result they are not a very good indicator of price movements. Therefore, it would make no sense at all to guide your monetary policy by them even if you could.

Question: Professor, if we could freeze high-powered money, what reduces the uncertainty that people have about the monetary base, that the Fed will be consistent?

Friedman: There wouldn't be a Fed. What do you need a Fed for?

Question: What about the Treasury Department changing the numbers for the monetary base?

Friedman: As I said, my preference would be to have a constitutional amendment. After all, that's what the original Constitution does. We have forgotten that the original Congress prohibited states from emitting bills of credit and gave Congress only the power "to coin money, regulate the value thereof, and of foreign coin." As I read the original Constitution, it intended to limit Congress to a commodity standard.

As you know, Samuel P. Chase, who was Secretary of the Treasury during the Civil War, was in charge of issuing the greenbacks during the Civil War, [and after the war was] appointed Chief Justice of the Supreme Court. In the first greenback case as Chief Justice of the Supreme Court, he ruled the actions he had taken as Treasurer were unconstitutional. Perhaps you haven't read enough history to

remember that period, but most of you have read enough history to remember the famous F.D.R. court packing in the 1930s. But the first court packing case was in connection with the greenback issue. That decision was so unsatisfactory that the then president expanded the size of the Supreme Court and appointed some new members, and they reversed the greenback case. Samuel P. Chase was overruled; he was in the minority in the second greenback case. I agree more with the first; the greenbacks were an illegal, unconstitutional emission of a bill of credit. So personally, as I say, I would like to have it put into the Constitution.

Question: What role do you give to the foreign sector or to the large trade deficit in reducing inflation? Since the trade deficit is in the order of \$100 billion, it's as if the foreigners are depositing \$100 billion of goods in the United States. That has got to have a monetary effect on inflation.

Friedman: Well, number one I think you'll have to go a little bit more slowly. By the trade deficit, you don't mean the commodity deficit; you're including the invisibles. Over and above that, remember that some part of what is going to capital inflow is direct investment in the United States. If Datsun builds a factory in the United States, that's part of the trade deficit. If it were to buy all the ingredients of that factory and ship them out of the country and set the factory up somewhere else, it would be reported as exports. It would reduce the trade deficit. So that's what we want to do is to take that \$100 billion and narrow it down still further for direct investment, and the rest of it undoubtedly does have a minor effect in making U.S. inflation somewhat less than it otherwise would be. But it's probably [a] small order of magnitude. After all, the total GNP in the United States is of the order of \$3 trillion. You're talking at most of \$100 billion so you're talking of \$100 billion out of \$3 trillion. You figure out the percentages; it's very small. So I don't think it has a major effect on the inflation rate. I think it does have a minor [effect].

Comment: Maybe 1 or 2 percent.

Friedman: I don't believe it even has that much—but at most maybe 1 percent.

Comment: But see, it does affect the strong dollar, which is part of the whole scenario.

Friedman: You mean it produces a strong dollar. The deficits are producing the strong dollar, not the strong dollar producing the deficits.

Comment: Right, I understand, but that has particularly pronounced effects on some of these sensitive commodity prices which are internationally traded. That strengthens your point about possible errors or bias in focusing on this narrow range of commodities.

Friedman: No, I agree with you 100 percent. That's why I was saying before that I thought this group of commodities that people are talking about focusing on in order to conduct monetary policy is a misleading indicator. First of all, so far as the so-called strong dollar is concerned, I'm surprised that nobody ever talks about the most obvious way to lower the dollar if you wanted to lower the dollar. Suppose you think the dollar is too strong. What's the most obvious way to reduce it? The answer is very simple. Cut out trade restrictions. Eliminate the import quota on Japanese cars which we ought to eliminate anyway. Eliminate all other restrictions on trade. That would not affect the trade deficit; don't misunderstand me. The trade deficit would remain exactly what it is. But what it would do would be to lower the value of the dollar. People have short memories. In 1931, John M. Keynes wrote a famous article which his reputation has never lived down in which he proposed a tariff because he said it was politically not feasible for the British to devalue. And while he believed that devaluation would be preferable to a tariff, the tariff was an indirect form of devaluation. Two months after he wrote that, Britain devalued. Economists are lousy political prophets as you can see. But if a tariff is a substitute for a devaluation, then taking it away is equivalent to devaluation and will lower the exchange rate. The import quota on Japanese cars is utterly inexcusable and should never have been adopted. But with all the talk about the strong dollar, why don't you people say that the way to make the dollar less strong is to eliminate restrictions on trade. People believe that would make the deficit worse, but it wouldn't.

The deficit is produced by the fact that there are people abroad who would like to have U.S. dollars. The only way a foreigner can get U.S. dollars is through, on net, the U.S. having a trade deficit. There's no way in which a man in Germany who has marks can get dollars except by persuading somebody to sell him the dollars. But somebody sells him dollars, receives marks in exchange. What's he going to do with the marks? Eat them? He doesn't want to eat them. If he holds them, there's been no net exchange. The reason he wants the marks is to buy German goods, and he imports them, and that pro-

duces a trade deficit. So the size of the trade deficit is determined by the amount by which foreigners want to add to their stock of dollar assets.

I'm exaggerating only a little because of speculative and similar short-term influences, but fundamentally the reason we have had a large trade deficit and an increasing one over recent years is because the United States has become increasingly the safest haven to hold your assets. If you're a Lebanese, you don't want your assets in Lebanon. If you're an Argentinian or a Brazilian or a Mexican, you have already gotten your assets into the United States. We talk about the debt problem of the LCDs, it's a government problem. Mexico's debt is some \$80 billion, something like that. It is estimated that the citizens of Mexico used some \$30 billion of those dollars to get assets in the United States. Private people were getting their money out because of their lack of confidence in their own government. And we were putting money in there because we did have confidence in their government. But my main point is that wherever you go in the world today, there are real questions about whether you want to hold your assets there. The Germans worry about the Russians, about the increased troubles there. In Lebanon, in Iran, in Iraq, anywhere in that part of the world you don't want your assets there; you'd rather have them in the United States.

To get a sense of proportion, foreign asset holders have to want to transfer only a very tiny part of their total portfolios into dollars to produce an enormous trade deficit in the United States. Consider the United States. Nationally, income is something like \$3 trillion. Total assets must be something like \$10 trillion. The GNP of the rest of the world, Europe alone, is greater than the United States. So worldwide, total assets must be in the order of \$20–30 trillion. You only have to shift a little bit of that to produce a \$100 billion deficit in the U.S. balance of payments. If holders of assets around the world would like to have one-third of 1 percent more of their assets in the United States, you have a \$100 billion U.S. deficit. So that the idea that somehow or other this \$100 billion deficit is something we ought to be worried about—or is very large and so on—is a question of confusing stocks with flows. And tell me what harm has it done? What's the deficit doing, that trade deficit? Number one: it's building factories. Number two: it's buying U.S. government bonds so it's holding interest rates down. Number three: it's buying securities in the stock

market so it's holding stock market prices up. Number four: it gets invested in bonds of private enterprises. It's contributing to the flow; it isn't costing any jobs. I don't think there's any statement that is more nonsensical than the statement that is repeated so often that somehow or other the trade deficit is costing us three million jobs. It's utter nonsense. It isn't costing us a single job. What it's doing is providing us with goods that we otherwise would not have.