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Friedman (3)

Friedman presents some ideas

April 29, 1971

Dear Milton:

Thanks for your letter. Our conversation over the phone was much too brief and apparently has led to some misunderstanding. I have no quarrel with your points 1, 3, 4, or 5. I do differ, however, on point 2, and I think I can cite a lot of history to support my position. In any event, we are dealing here with a very short term matter, and you must not exaggerate its implications for the future.

I want to hear good news about Rose soon. My best to you both.

As always,

Arthur F. Burns

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April 26, 1971

Mr. Arthur Burns
Chairman, Board of Governors
Federal Reserve System
Washington, D. C. 20551

Dear Arthur:

After pondering over our conversation yesterday, I am moved to add some comments on a few items.

1. Money and interest rates. Your comments seemed to me to attribute a much larger role to the Fed in affecting interest rates than is justified by either theory or experience. On theoretical grounds, Fed transactions are a small part of the total market for credit; they dominate the behavior of the quantity of money but not the supply or demand for loans.

On an empirical level, the Fed and other central banks have repeatedly failed when they have tried to alter interest^{rates} or the interest rate structure appreciably. Operation Twist is widely recognized to have been a fiasco. The attempts in late 1965 and early 1966, and again in the second half of 1968, to hold rates down are hardly encouraging precedents.

There is no doubt that the Fed can affect some short-term interest rates but to do so to any significant degree involves major effects on monetary growth and even then can succeed for only a few months. The ultimate effects are in precisely the opposite direction. More rapid monetary growth initially lowers interest rates, but this effect lasts for, at most, six months or so and is then reversed, so that it subsequently produces higher interest rates. This has by now been thoroughly documented by Cagan, Gibson, Sargent, Yohe and Karnovsky.

The sharp decline in short-term rates in 1970 was partly due to the short-run effects of the acceleration of monetary growth after February 1970 but mostly to the delayed effects of the monetary restraint in 1969. Similarly, whatever the Fed does within conceivable limits, short-term rates

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will rise in 1971 because of the delayed effects of the rapid monetary growth of 1970.

Concentration on interest rates, and on the immediate effects on rates, is a Central Bank delusion that seems almost impervious to evidence. There is no more certain route to erratic and unwise monetary policy. Many the time I have heard you inveigh against this delusion in the past, which is why I felt so confident that you would not fall prey to it when you took over.

Do let me urge you to check the accuracy of the interest rate predictions of your staff, and particularly for some months ahead.

2. Interest rates and the expansion. Your remark that permitting short-term rates to rise might have nipped a putative expansion in the bud seems to me to put the cart before the horse. Given moderate monetary expansion, what would cause rates to rise? The rising demands for credit coming from an expansion in economic activity. Indeed, I have interpreted the recent tendency for rates to rise despite the massive acceleration of monetary growth in the past few months as the strongest piece of evidence confirming the emergence of expansion. I find it difficult to see any logically coherent argument that can make the interest rate movement an independent source of, or obstacle to, expansion. The monetary explosion produced by fear of nipping the expansion in the bud will force you to undertake severe restrictive measures much earlier in the expansion than will be desirable on other grounds.

3. The record of monetary growth. Your defense of recent policy in terms of M_1 alone and for a rigid pair of dates is completely out of character. I learned from you to cast my vision more broadly, to look at several series, and to look at the whole record and not only selected dates.

On such a view, monetary growth was ample from February 1970 to January 1971--much more rapid in M_2 than in M_1 because of reintermediation as interest rates came through the regulation Q ceilings. It is hard to form a good judgment on either aggregate alone because, prior to about 1966, we never experienced such diverse movements in these two magnitudes hence there is no satisfactory basis of experience on which to judge which is more closely connected with other economic magnitudes. Analytical considerations recommend looking at both. My judgment, and I believe yours, too, is that monetary growth was, if anything, somewhat too expansive from February 1970 to January 1971 but not dangerously so.

From January 1971 to date monetary growth has been explosive and the explosion has continued for about ten weeks by now. For M_2 , there is

nothing like it in the record since World War II. For M_1 , the closest recent episode is January to March 1967, hardly a good precedent, and even that was less extreme.

4. My answer to your query whether I was getting cooperation from the Fed, while literally correct, put the matter in the wrong perspective. Operating the desk through interest rates or through reserves or their equivalent is primarily an operating question for the Fed. My concern with it is not as a scholar, not as part of our research program here, but solely because I believe it is so important for good monetary policy. I am not seeking cooperation from the Fed to serve my scholarly interests. I have simply been trying to serve as a catalyst, to provide a forum for Fed people, in the hope of stimulating the Fed to do the job that it alone can do.

5. I remain persuaded, as I have been for at least two years now, that the Fed should give high priority to two tasks: (1) improving the monetary statistics; (2) altering the operating procedures at the Desk. This remains an urgent task.

I hope you will pardon me for burdening you with these comments. I realize how difficult your task is and how beset with pressures and criticisms on all sides. The urgent need is to keep one's eye fixed on the longer-range problems and the ultimate goals and not become diverted by the transitory annoyances. It is because I have so much confidence in your ability to do so that I venture to pass these comments on.

Cordially yours,



Milton Friedman

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