I am delighted to be sharing the platform here today with an oppressed minority! I’ve been waiting to see how soon it would be before a half dozen of those alphabetical agencies in Washington, which have been created over the past twenty years to deal with the problems of allegedly oppressed minorities, turn their attention to the executives of major oil companies. They surely deserve at least as much sympathy, under present circumstances, as do many of the other allegedly oppressed minorities.

In talking about the problem of inflation, I am reminded of a story I heard some time ago about a man who used new cryogenic processes to have himself frozen for a twenty-five year period. Before he got frozen, he gave his stock broker instructions about what to do with his portfolio. When he was resurrected from his frozen state, the first thing he did was to rush to a telephone and call his broker. His broker said, “Oh, you’re in wonderful shape—you’re a millionaire many times over now.” “Oh, really”, said the man. Then the broker started to take one stock after another and tell him what it had done. At this point, the telephone operator interrupted and said—“Your three minutes are up … that will be $250,000 for the next three minutes, please.”

Secretary George Shultz Served His Country Well

On the radio this morning, I heard an announcement about the resignation of Secretary George Shultz, who is leaving the Treasury as of early May. Since George is one of us from Chicago, and more closely from the University of Chicago, I thought it might be appropriate to say a word about the extraordinary influence he has exerted. George Shultz is a rare exception. He is one of the few people who has occupied a high position in Washington, who has been able to maintain a consistent position of principle publicly, as well as privately. He had consistently opposed wage and price controls, governmental intervention, and other activities. He has participated in administering them, but he has never compromised his principles by expressing a belief in them that he did not feel. I remember very well one speech of his (this was after price and wage controls had been in existence for some time) which started out—“There is a rumor going around that I am against price and wage controls. That rumor is true.”

Nixon Moves in Opposite Directions

One interesting feature of George Shultz’s performance is brought out by noting that within the past three years—beginning on August 15, 1971—we have had a dramatic experiment which no economic scientist could have improved upon, even if he had deliberately gone about to set one up. On August 15, 1971, President Nixon moved in opposite directions with respect to the international sphere and the domestic sphere.

Abroad—Floating Exchange Rates

With respect to the international sphere, Nixon closed the gold window, and ended the commitment which the United States had to buy gold, or sell gold to foreign governments at a
fixed price. The ending of this commitment paved the way for the establishment of a system of floating exchange rates. It paved the way for a free market in the price of currency. It paved the way for ending controls on the price of the dollar in terms of the mark, franc, yen and the pound. So, this measure opened the way to a free market, where there was none before.

**At Home—Frozen Prices and Wages**

At home, President Nixon moved in the opposite direction. He froze prices and wages, and that was followed—as you all know—by Phases 1, 2, 3, 4, 5, 6, 7, 8, and 9!! Although some of those are in the future, prediction is easy in that area. Here was a beautifully controlled experiment. Compare the operation of free prices in the international market, and controlled prices at home. It is hard to conceive of an experiment, the results of which could have been clearer. In the international area, we have had a great success. In the domestic area, we have had a great failure. There is hardly a person today who will not recognize that price and wage controls meant more inflation—not less—that they meant disruption, distortion, a reduction in output, and an increase in the power of the government over the individual. Price and wage control has been a fiasco, and the administration is now proposing that it be ended when the present authority expires.

On the other hand, if you look abroad, the policy has been a great success. It’s gotten much less news, much less attention, only because failure is always more newsworthy than success. Suppose we had continued with the system of fixed exchange rates. There is little doubt what would have happened. When the Arab Israeli war broke out, and when the oil embargo came on, there would have been a major international financial crisis. We would have had tremendous flows of funds from the mark, pound, yen and franc into the dollar. Central banks would have lost, or gained, billions of dollars of reserves over night. There is little doubt that the foreign exchange markets of Europe would have been closed, little doubt that the headlines would have reported that the central bankers were retiring to some pleasant place like Bermuda to consider the world crisis, and to “solve the problem”.

**Free Market Abroad Able to Meet Major Crisis**

None of that happened. Why not? Because there was a free price system operating. These pressures were absorbed, not by massive flow of funds, but by the price of the dollar in terms of other currencies rising by something like 5% to 10%, and then afterwards receding a little. The market worked just the way a starry-eyed theorist like myself, who has been proposing flexible exchange rates for many years, had said it would. The results were not those that were feared by the practical bankers like David Rockefeller, who were fearful of letting the market work abroad. I remember very well an episode some seven or eight years ago when I testified at the Joint Economic Committee on the question of flexible versus fixed exchange rates. It just happened that David Rockefeller was testifying the same day, along with his then economic advisor, Paul Volcker. David Rockefeller’s position was that it was essential to maintain fixed exchange rates abroad; that there would be chaos in the world if the market controlled the price of foreign exchange. He would not say that today, because experience has demonstrated very clearly that precisely the opposite is true. The free market was able to meet a major crisis in the international sphere without serious difficulty, while the controlled market at home produced a major crisis without any difficulty.
Now, I come back to George Shultz. The free market in exchange rates owes more to George Shultz’s influence than to that of any other individual. From the beginning, he consistently and systematically pressed for flexible exchange rates, for allowing a free market to operate. I may say that one of his most difficult opponents was the banking community in the United States, including the Federal Reserve System. The Federal Reserve System was consistently opposed to letting the exchange rates go free. They wanted to intervene in the market, to control it. The Treasury, on the other hand, consistently stood against it, and it is fortunate for this country that on the whole George Shultz triumphed, though unfortunately there has been some intervention in the market by the Federal Reserve. The tragedy for this country is that his advice and his position was not followed in the domestic area.

**Short-sightedness at Home**

It’s hard to realize how much better off we would be today if we had never embarked on the ill-fated attempt to control prices and wages. The blame is not easily placed for that attempt. I said a moment ago that I had an enormous amount of sympathy for the people at this table, but they have brought many of their troubles on themselves. The president of Union Oil Company, Fred Hartley, was one of the chief proponents of price and wage controls in 1971. How short-sighted men can be when they get outside the area of their own knowledge. The business men in 1971, who thought that price and wage control would consist of wage control without price control, simply demonstrated their inability to count the number of voters. The so-called fuel and energy crisis today dates back to that period. Fred Hartley helped bring it on, not because he intended to, and not because he wanted to. I am not attributing blame in any other sense that the inability to see what the consequences would be.

Just in the same way, David Rockefeller and his fellow bankers in New York brought on the growth of the Euro-dollar market in Europe and were fundamentally responsible for driving international financial business away from New York to London. The insistence on fixed exchange rates led to the exchange controls that President Johnson imposed, and which earlier Kennedy had imposed. Those exchange controls, together with Regulation “Q” limits on interest rates that could be paid to depositors, drove international financial business to Europe, and caused the Euro-dollar market to flourish. This is another example of extraordinary short-sightedness. It was not deliberate—they didn’t intend to drive business away, but they did. George Shultz also achieved the objective of ending all those exchange controls. He thereby served his country very well, and deserves great credit for a few of the things that have gone right, and very little blame for many things that have gone wrong. I don’t know who will succeed him, but I was saying to someone that I hope he will be succeeded by Bill Simon, because if Bill Simon is taken away from the Federal Energy Office, where he is doing harm, and moved to the Treasury, he might do some good.

You know, an old teacher of mine who was a mathematical statistician, once wrote a report on the teaching of statistics. In this report, he said, “Pedagogical ability is a vice rather than a virtue, if it is devoted to teaching error.” That is a profound thought. Ability is a vice, not a virtue, if the able man is doing something bad. Mr. Simon is an able man, but the more poorly administered the Federal Energy Office is, the better the country will be.

**Six to Nine Month Outlook—Economic Slow-down**
Let me turn to what I had originally intended to talk about, which was first of all the short-term outlook, and later, the longer term perspective. Insofar as the short term outlook is concerned, we are clearly in an economic slow-down, recession, decline, or weakness—whatever you want to call it. I think the semantic issue is of no importance whatsoever. It couldn’t matter an iota to anybody in this country whether real national output goes down by one-tenth of 1% a year, or goes up by one-tenth of 1% a year. Yet, by some definitions of what is, or is not, a recession, that would be considered as making the difference between a slow-down and a recession. What is clear is that the growth of real output peaked sometime in the early part of 1973; that it has been going down erratically since, and that it is likely to continue to go down for sometime. Unemployment reached a trough sometime in late 1973; has gone up moderately since then, and probably will go up some more. The ability of economists—or I may say of anyone else—to predict short-term changes is not great. Any statements made about the future course of events are bound to be subject to wide margins of error. About the only statement I think you can make with great confidence for the next six to nine months is that there is little prospect that the current decline will turn into a major recession, or depression. That is just not in the picture.

Over-reaction Leads to a Heritage of Inflation

I think the much greater danger is the one to which Mr. Gage referred in quoting from the Chase Bank. Over-reaction to this temporary recession will leave us with a heritage of inflation. But whatever happens in that way, it will not take effect for some time. The course of events in the next nine to twelve months is more or less in the pipeline. As far as one can see, it looks like a continued recession at a rather mild rate in real output, with very little relief on the inflationary front. I believe that there is some reason to expect the rate of inflation to taper off in the next six to nine months. Some very special factors—the oil problem, the food problem, and so forth—made the rate of inflation in 1973 rather higher than would have been produced by the basic underlying economic forces. As those special factors taper off, there is every reason to suppose that the rate of inflation might come down from its present nine or ten percent per year, to a slightly lower—but still horrendous—rate of maybe six, seven, or eight percent a year. That slow-down in inflation may continue in 1975, but sooner or later it will be reversed.

Long-term Interest Rates

If there is a continued recession, you would expect it to be reflected in a continued weakness in short-term interest rates. However, there is very little reason to believe that long-term interest rates will show any moderation whatsoever. The reason is that long-term rates are now incredibly low. That sounds like a funny statement, but it isn’t if you look at it right. Long-term interest rates are somewhere in the 8% to 9% range on high-grade corporate securities. We have been having a rate of inflation of about 9%. What is the cost of money to people who borrow at 9% and have a rate of inflation of 9%? Roughly zero. People who have borrowed at long-term in the last five or six years have gotten away with murder. They have borrowed at essentially negative rates of interest in real terms. But the lenders have been taken to the cleaners. They receive an interest rate which does not compensate them for the decline in the value of the dollar, and they still have to pay tax on that hypothetical return.

Role of the Treasury Department
The biggest offender in this area is the United States Government. As I have said over and over again, there has been no bucket-shop operation in the history of the United States to compare with the one that has been conducted by the U. S. Treasury Department. This is an aside, but one of the great mysteries to me is how prominent business leaders can lend their names to such a misleading and deceptive campaign as the savings bond campaign which emanates from Washington. How can any man stand up and say to his fellow citizens, “Buy these savings bonds—it will be good for your future, and patriotic for the country”—when the facts are that anybody who buys these savings bonds is likely to end up paying for the privilege of lending the government money; especially when the inflation which produces that result is produced by government itself. At any rate, going back to my main theme, there is little reason to expect long-term interest rates to come down, unless inflation comes down very sharply.

1974 Versus 1954

I think you will get a better look at the immediate, current situation if you place it in a much longer term context. I want to set the stage for that by quoting from obviously the most appropriate authority—namely myself. Just twenty years ago, in 1954, I gave a talk in Stockholm, Sweden, at a time when the United States was in a recession, under the title, “Why the American Economy is Depression-proof”. The reason for that title was that at the time there was still a widespread fear in the United States and abroad of a great postwar depression, a fear that 1929 to 1932 was about to be reenacted. Each minor recession that developed at that time was looked on as the forerunner of a major depression. I closed that talk by considering the prospects for the future, and this is what I want to read to you. I said….

I can perhaps best summarize the implications of my argument by outlining what seems to me to be the prospect of the American economy for the next few decades.

Our present monetary and fiscal institutions are so constructed that anything more than a minor economic recession is extremely unlikely, even if, or especially if, no explicit action is taken by Congress or the Administration. But unless the recession is exceedingly minor, explicit action will be taken. The widespread general fear of depression would lead Congress to force such action on any Administration whatever its political complexion. Political considerations render a Republican legislature and Administration particularly likely to take explicit action.

Now, remember, this was written twenty years ago, but the next sentence could just as well have been written today in light of the present situation: “The present recession, and the political reaction to it, is a clear example of these tendencies.”

I think the statement by President Nixon—“There will be no recession”—the statement by Mr. Ash that the president is willing to bust the budget, if necessary, to avoid a recession—are clear examples of the tendencies which were already present twenty years ago. To continue quoting

If my basic premise is sound, such additional action will be unnecessary. Even more, it will be positively harmful… Any actions that are taken are not likely to
have much effect until after recovery has already begun. But even if they should, their effects are certain to last well beyond the onset of recovery… The result is that measures taken to stem a supposed depression will serve to stimulate the succeeding recovery, and to convert it into another round of inflation.

This inflation will not get out of hand; the same built-in stabilizers that would prevent a depression from getting out of hand will also prevent a run-away inflation. Sooner or later another recession will come along. After all, we have been having such recessions for hundreds of years and we doubtless shall continue to have them for some time. When it does, the same process is likely to be repeated.

The prospect is, therefore, for a period of recurring rounds of inflation produced by over-reactions to the temporary recessions that punctuate the period. How long will this period last? How serious will the inflation be?… These questions seem to me to admit no easy answer…

Economists have known—at least intermittently—for over a century and half two propositions: first, that by printing enough money you can produce any desired degree of activity; second, that the ultimate result is destruction of the currency. The American public has learned the first proposition. It once knew, but has forgotten the second proposition. Only experience is likely to teach it once again. *

I think that has turned out to be a reasonably accurate forecast of what the situation was going to be during the next two decades. The process has gone on at a slower pace than I anticipated. It went on at a slower pace largely because of a political accident—the fact that for two terms we had a non-political president. Mr. Eisenhower was willing to hold the rate of growth relatively low, and to keep unemployment relatively high for a time, in order to break the back of inflation. As a result, what I then expected to happen was to some extent aborted during 1956 to 1960—and then started over again in 1960. Since 1960, I believe the description I gave has applied.

**Accelerated Inflation**

There has been great pressure to stimulate the economy. Every time we stimulated it, and started an inflation, sooner or later a recession, or slow-down has come. Panicked by the recession, the authorities have stepped on the accelerator, have over-reacted, and have provided, after a delay, another burst of inflation. So, we have had this succession of ratchet-like moves to higher and higher levels of inflation. In the past fourteen years, we have gone from essentially a zero rate of base inflation to something like a 6% rate of inflation. It is hard for me to believe that we shall not go much faster in the next ten years. After all, people do learn. Everybody is now aware of this process, and adjustments will take place more rapidly.

The prospects by the next ten years, or perhaps the next twenty years, is therefore that this process will continue. Maybe inflation will drop back to a rate of 6% in 1974–1975. If so, as the delayed effect of the inflationary measures taken this year start taking hold, we shall then run into the 10% to 12% rate of inflation. Then after awhile, we shall get panicked at that, and we’ll have another recession. A couple years later, that will leave us in the 15%, 18%, or 20% rate of
inflation. Those are the numbers we are heading for via our present process. If you think that is exaggerated, just look at the process going on elsewhere.

Look at the process in Britain, which is the closest analogy, except that Britain is about three or four years ahead of us. Britain’s current rate of inflation is heading towards 15% this year. Japan is 20% this year. I don’t believe that I am being irresponsible in citing these numbers. They are not numbers that apply to this year, or next year, but they are numbers that are in the future. The important questions are—what will be the further reactions? How can we get out of it? It is not easy to see what will happen. Sooner or later, the public is going to be fed up. Sooner or later, it will no longer be politically profitable to step on the accelerator in order to bring the rate of unemployment from 6% to 5%. Sooner or later, the public will demand that the inflation be stopped.

**Price and Wage Controls**

Before the public will demand inflation be stopped, you will have recurrent episodes of pretending to stop the inflation by price and wage controls. You have a widespread recognition that price and wage controls are bad. But three years from now, when the rate of inflation is heading up to 10% or 12%, there will again emerge a demand for wage and price controls. Look at the situation in Great Britain. The Labor government under Harold Wilson put in widespread wage and price controls. Mr. Heath got elected on the promise of eliminating them. He did eliminate them. He tried to stop the inflation. But when unemployment reached a million, he lost his nerve, and turned on the accelerator … and then as inflation heated up, he reimposed price and wage controls—even though they had been a complete failure before.

The reason governments impose wage and price controls, you must realize, is not because governmental officials are so foolish and so ignorant as to suppose that controls can stop inflation. They know, as well as I know, that in the past 2,000 years there has never been a single example of price and wage controls stopping inflation. The reason why governmental officials impose price and wage controls is because they want inflation, but they want to give the appearance of doing something about it. Unfortunately, we pay a big price for that appearance. That’s what Mr. Heath did—that’s what Mr. Nixon did—and that is one of the things that is likely to happen in the course of the next ten or twenty years several times over. If nothing else happens, sooner or later as I said, the public will get fed up and they will demand that something be done about it. And at that time, the only way to stop would be by going through a major depression. That is why I said in my talk twenty years ago—“You will not experience a major depression until you have first experienced a major inflation.” Is there any other way out? I think the answer is yes. I think there is one other way out, which may develop, and which should be encouraged.

**Inflation Withdrawal Pains**

The problem of stopping the inflation is fundamentally like the problem of curing an alcoholic. Indeed, inflation is in many ways like alcohol. When you start drinking, the good effects come first, and the bad effects come later. When you start inflating, the good effects come first, and the bad effects come later. When you start inflating, the first effect is false prosperity that everybody experiences. It’s wonderful. But then, you get socked with the inflationary price rise, just as you
get socked with the hangover the next morning. By the same token, when an alcoholic tries to
cure himself, the bad effects come first, and the good effects come later. And that is exactly the
same way with curing inflation. If you try to cure inflation—as we should by slowing down the
rate of monetary growth, holding down government spending and budgets—the bad effects come
first. Namely, the first thing that happens is that you have a recession, and you have
unemployment. Why? Because everybody has entered into contracts which build in a rate of
inflation. If somebody today borrows, and he pays 10%, 11%, or 12% for his money, he will be
in a terrible spot if the rate of inflation slows down to 2% a year. If you have entered into an
agreement with your employees in which you have promised to raise their wages 8% or 10% a
year, because you, and they, expected inflation at the rate of 5% or 6%, and then inflation slows
down, you are in a terrible spot. You are led to curtail output and cut employment. That is why
an attempt to slow down inflation inevitably—under present circumstances—produces a
slowdown, or a recession.

It doesn’t matter what the level of inflation is. The example I like to cite is that of Brazil, which
in 1964 was experiencing inflation at a rate of 100% a year. Brazil followed a tight money
policy, which brought that rate of inflation down to 30% a year within three years. But in those
intervening three years, they had a major depression, because people had been adapted to the
100% rate, and there were strong costs in readapting to a lower rate. What can we do about that?
How can we reduce the withdrawal pains from inflation?

**Cure Could Be Escalator Clauses**

One answer is by widespread and universal escalator clauses. Instead of having fixed wage
contracts, have contracts which have a base growth, plus an allowance for inflation. These labor
escalator clauses have spread very widely. You are all aware of them. Let me take some other
examples. … Instead of borrowing at a rate of 11% a year, borrow at a rate of 5%, plus the rate
of rise in the cost of living. If the cost of living actually rises 6%, that will make the interest rate
11%. If the cost of living rises at 2%, that would make the interest rate 7%.

The only way I can see that we are going to get out of our present fix, without a major economic
adjustment, is to have such cost of living clauses developed and extended all over. They ought to
start in Washington. The most important place where we need an escalator clause is on the
personal income tax. We have a personal income tax under which inflation automatically raises
the tax, because it pushes people into higher and higher brackets. We ought to have an escalator
clause attached to the personal exemption, the rates on the income tax brackets, the base for
computing capital gains, and the base for computing depreciation on physical assets. The
arrangements I have just described now exist in Brazil. On the tax side, they have just been
adopted in Canada. Similar arrangements for securities exist in many countries of the world.
Wherever you have a great inflation, there is a strong tendency to develop these arrangements,
and they will develop here. The only question is—how soon and how rapidly?

**Support from the Private Sector**

These arrangements should develop first in Washington, but they almost surely will not. There is
nothing that Congress and the Administration likes better than being able to impose taxes
without passing a law. A great virtue of inflation to governments is that it is a way of imposing
taxes without having to legislate it. Consequently, it will take a great political move on the part of the people—a grassroots move—to get this changed. I think escalator arrangements will develop and emerge in the private sector, and if they do, they would offer the hope of being able to come down off this high rate of inflation without too large an intervening cost. You will hear over and over again the foolish statement (which appeared in Newsweek, the magazine I write for)—“No doubt, escalator clauses increase the pace of inflation.” Now, that statement is 100% wrong. What it leaves out is that escalators go down, as well as up. The foolish argument is made … prices go up if wages go up, and that is going to cause another round. They don’t ask where the first price rise came from. The wage rise under an escalator clause is a reaction to inflation—not a source of inflation.

Unless you get such widespread and universal escalator clauses, I think we are going to be in for a long period of very difficult times of very high rates of inflation—which will sooner or later end up with a smash. That is the longer term prospect, and we can fit the shorter term into it. The shorter term picture is that we are now in one of those recession, or slow-down periods. We are going to have an over-reaction, which will in the first instance affect output and employment, so that we will then have a turn around in the economy at the end of 1974, or early 1975. It will take another year before the expensive monetary and fiscal policy works its way through to a higher rate of inflation—1976 or 1977 we will start climbing up to 10%, 11%, or 12% inflation. We will then be back in the situation of pressure to do something about it, and ready to go through this again.

**You Can Do Something About it!**

I stress this because I think people like yourselves are in a position to do something about this. It would be in your own interest, as well as the public interest. Stretch your minds a little to see how, in your own business, you might start building in these escalator clauses. We already have a great many of them. Every contract for renting a store in a super market has a built in escalator clause, because the rent is a percentage of gross. Allstate Insurance has an escalator clause on some of its fire insurance policies. These clauses are emerging here and there, and I think they will emerge more broadly.
Questions and Answers

Domestic Effect of World Inflation

QUESTION: I follow your thinking regarding the ups and downs of inflationary periods internationally and domestically. How will the world-wide picture affect the domestic picture here in the United States?

MILTON FRIEDMAN: The same forces that are at work here are at work in almost every other country. However, it will have very little effect on us, as long as we can maintain a system of flexible exchange rates. The argument that inflation is imported from abroad, or exported, is an entirely valid argument as long as you have fixed rigid exchange rates. But it loses its validity completely at the moment you have flexible exchanges.

Let us suppose, for example, that Japan continues to inflate at a rate of 20% or 30%. (I doubt that it will, because Japan still has a great deal of internal discipline, and is able to impose a fairly tough policy). Would that force such an inflation upon us? No. It would simply mean that the yen would depreciate in terms of the dollar—that the number of yen you could get for a dollar would go up. Consequently, the rate of inflation in the United States depends to a negligible degree on the rates of inflation elsewhere. It depends primarily on our own domestic monetary policy.

I don’t mean to say we are not affected by what happens elsewhere in the world. Of course we are. If other countries of the world have a recession simultaneously, (as they may very well have in the next year), that will reduce the demand for our products. It will therefore hurt us in a real sense—in the sense that we will not have as good an export market for our products, and therefore our balance of trade may suffer. But it has very little effect on the rate of inflation, because of the insulation afforded by flexible exchange rates. In fact, that is a major argument in favor of floating exchange rates—it insulates us from what happens elsewhere in the monetary sphere.

Energy Companies and the Public Interest

QUESTION: Do you feel that if the energy companies are in control of the fuel situation, we need somebody to protect our interests?

FRIEDMAN: What the gentleman said, if I may paraphrase it, was—“Was Senator Jackson not right when he called those energy officials in front of him, saying—‘You bums are producing this crisis by profiteering’? ” The answer is that it has been impossible for me to understand how anyone makes a profit by not selling something. It is beyond my conception how—if I were Exxon or Union—I would consider it profitable to have two-mile long lines in my gas stations. How does that add to my profit? Surely, what Senator Jackson should have said is—“I will give a medal to that company which shows the greatest profit.”

How does a company make profits under these circumstances? By finding a way to bring in oil through the embargo. There has been lots of talk in the newspapers about leaks through the embargo. Do you suppose that those leaks occurred by themselves? Don’t you suppose that there was somebody who leaked? And why do you suppose he did it? All of us, of course, would like
everybody else to be moved by patriotism and goodwill for the community, but we tend
ourselves to be moved by our own interests. And I suspect that people had an incentive to get oil
through the embargo because it was profitable to do so. The company that was most successful
in getting oil through that embargo would have made the most profits. Don’t misunderstand me.
I think the people that run the oil industry are just like you and me. There’s no difference—they
are not noble creatures. They are out trying to make a buck, and I don’t blame them. So are you
and I. And I don’t doubt that in the process of trying to make some money, they have tried to
collude, and they have tried to keep the prices up.

They have been able to have considerable success in that, only because of the connivance of the
United States Government. The oil industry, through getting the U. S. Government to give them
percentage depletion allowances, through getting Texas and Oklahoma to set up prorationing
arrangements, through getting the government to impose import quotas on oil from abroad, have
harmed the public at large. I have repeatedly berated us—not them—for being so stupid as to let
them get away with it. I can’t blame them if they try to get away with it, but I can blame us for
being so stupid as to let them get away with it: Without government connivance, they have
negligible monopoly power. There are too many of them—there are over a hundred companies in
this country owning refineries. If, indeed, the present energy situation is a result of these big, bad
oil companies exercising their monopoly powers, tell me—why were they restrained for so long?
Why didn’t they do it five or ten years ago? Have they suddenly gotten more monopoly power
somewhere?

The reason why the world-wide price of oil went up is because the Arab oil companies formed a
cartel and reduced the output of oil. They did themselves great harm. Tell me, what happened to
that meat crisis we had a year ago? Have you heard about it recently? Well, the same thing is
going to be true a year from now about the oil crisis. For a very short period, by cutting down
supplies, prices will go up tremendously—because people for a time are locked into whatever
they are doing. It’s hard for them to adjust. But when they quadruple prices, as they did, how
much are they going to have to cut down their output to keep prices up there? The answer very
quickly emerges that within a few months, they would have to quit producing, and they still
couldn’t keep prices up there. As time goes by, people in general will adjust their consumption to
the higher prices, and other people would adjust their production.

The Arab countries, as a whole, control 40% of the oil of the world, and the countries that are
really cutting production are only controlling 20% of it. Several of the countries like Libya and
Iraq are yelling as loud as they can to their fellow Saudi-Arabs, telling them—“You must hold
up prices”—while they themselves are producing all they can produce, and selling it at these
high prices. It’s—“You keep the wolf from our door!” How long are Kuwait and Saudi Arabia
going to be able to do that? They can’t do it for very long—oil prices are going to tumble. They
have already started down, and they are going to come down much more sharply in the next six
months.

What’s causing the problems in the United States? Not the oil embargo. It’s what I said in
November—the foolish and absurd regulations emanating in Washington. West Germany
imposed no price controls—no rationing controls. For a couple of weeks, it did curtail driving on
Sunday, but it eliminated that restriction. It has had no problem with lines, or the supply of
gasoline. The price of gasoline went up about 20%, and that was enough to equate demand and
supply. Every country in Europe that imposed rationing has eliminated it by now. The United States, at the moment, is the only country in the world that is having problems. Why? Well, tell me—if you are a refiner who has enough oil to produce at 85% capacity, and you are required to sell the excess over 76% to other refineries who are producing less at your average cost, are you going to go out and try to get oil through that embargo—pay $10 a barrel—when you are going to be required to sell it to another refinery at $7 a barrel? Let us say you are one of those refineries that only has enough oil to run at 35%. Are you going to go out and try to buy oil at the $10 a barrel price abroad, when the Energy Office says that Texaco and Exxon has to sell you oil at $7 a barrel? Of course not. The effect of those absurd and stupid allocation arrangements has been to give Americans an incentive not to buy oil abroad.

It isn’t the embargo. You must realize that all this talk about lifting the embargo is an utter smokescreen. It had nothing to do with the situation whatsoever. The embargo is an excuse, and not a reason for our problems. If you eliminated these foolish allocation arrangements, there would be no difficulty at all in getting all the oil that the United States public wanted to use and to pay for. The embargo is not the source of the problem. In fact, it drives me up the wall to think of the way in which we cooperate with the Arabs in enabling them to give the impression of having power they don’t have.

Markets for Precious Metals

QUESTION: What is your advice about the soundness, or lack of it, in the markets for precious metals? Will the price of gold continue to rise as it has?

FRIEDMAN: In my opinion, what you have been seeing in gold and silver is a bubble, on top of a long-term price trend. There is no doubt that the long-term trend of the price of gold and silver will be upward, along with general inflation. The doubling, or more, in recent months of the price of gold and silver is a kind of bubble that is very hard for me to believe can be maintained. It’s out of proportion to the sort of general underlying inflation. My guess is that sometime within the next few months, or year, both prices will come down drastically. However, from the long-term point of view, they will both start to rise again gradually over time. But that doesn’t preclude the possibility that a speculative burst will raise them much above their present levels in the next couple of months. The price of $180, or $160, for gold right now is well above what you would expect to prevail, if you eliminated the speculative impulse, but that doesn’t mean that speculation won’t carry it to $200 before it drops.

The role of gold has changed in the world. Gold, at the moment, is almost entirely demonetized. Gold, today, is a speculative commodity, similar to soybeans. It is hard to believe that, because of the long history of gold as a monetary metal, but the up and down gyrations in the price of gold are undermining its role as a fundamental value as a monetary medium.

Common Stocks and Inflation

QUESTION: We would all be interested in your comments about common stocks and the part they play in a hedge against inflation.

FRIEDMAN: Common stocks are a hedge against inflation over long periods. I don’t think there is any doubt about that. If you are going to talk about ten to twenty years—yes. However, as we
all know from painful experience, they are a very unreliable hedge over short periods. What this country needs in this area, more than anything else in my opinion, is some vehicle whereby the small man (not the man who has a great sum of money) but the man who has accumulated $100,000 or $50,000, or even $20,000, can invest that money in a form that will protect against inflation, and which would yield a reasonable return.

The best way to provide such a medium would be for the United States Government to issue a purchasing power security … an honest bond. That is to say, to sell you a savings bond that will yield 3% a year interest, plus at the end of that time, an adjustment to make up for the rate of inflation. Also, to amend income tax laws so that the inflation adjustment is not treated as either capital gain or regular income. That would be the ideal way to do it, but I don’t see much chance that the government will do it. In lieu of that, as I was saying before, I think you will have instruments of that kind emerge through the private market. The sooner that happens, the better. However, it takes a long time for such innovations to go through.

Expansion of Money Supply

QUESTION: Many people are blaming inflation on excessive growth in the money supply. Do you agree with that, and can you project what the future should be?

FRIEDMAN: There isn’t any doubt that the reason for inflation has been too rapid an increase in the money supply. There has never been a rapid increase in the money supply that has not produced inflation. These two go together like night and day, except that the relationship is a little looser. Look at the facts. In the three years from 1970 to 1973, the rate of growth of the money supply grew more rapidly than in any other three-year period in the postwar period. It is not an accident that in those three years prices grew more rapidly, so there is no doubt in my opinion that the primary major source of inflation is too much money. But that is not a full answer. You have to ask—Why was there too much money? Was it because of those ogres down at the Federal Reserve wanting to impose inflation on the public? Not at all. The people running the Federal Reserve are able public-spirited people like you and me. Why did you have so much money created? Because of the feeling that if you do put out the money, you would have unemployment.

So this goes back to my earlier analysis. The money supply is the means through which these political forces work themselves. Now, it isn’t always that way. The United States had a significant inflation from 1848 to 1860 because of the discoveries of gold in California that increased rapidly the money supply of the United States. The world had a great inflation from 1896 to 1914. Why? Because somebody discovered how to perfect the cyanide process, and made it possible and feasible to extract gold from low-grade ore, and that increased the supply of gold.

But today, money supply is not affected by things like gold. It is affected by government processes of printing money. There is no way of stopping inflation, without stopping the printing of money. As to my predictions, I’ve said we are going to have a good deal of inflation, and that implies that the rate of monetary growth is going to be relatively high.

Dollars in Arab Countries
QUESTION: What will be the impact, either internationally, or domestically, of the excess dollars that the Arab countries have recently accumulated?

FRIEDMAN: They are not excess dollars. Nobody is holding a dollar who doesn’t want to hold it. I think the whole notion of excess dollars is erroneous. There was a real problem at the time that the United States had a commitment to provide gold for officially held dollars at a fixed price. At that time, it was meaningful to talk about excess dollars, because central banks had dollars, and we were committed to redeem them in gold. The problem so much bruited about in the papers about the Arab countries accumulating $50 to $60 billion dollars a year is a fake problem because it isn’t going to happen. Do you suppose that the people of any country in this world are going to be willing to run a deficit of $10 billion dollars in their balance of payments in order to get—not investments—but simply to buy oil?

The other side of the picture that the price of oil cannot be maintained at present levels is that the Arab countries are not going to have any sums approaching the magnitudes talked about. Indeed, over the next ten years, the Arab oil countries are going to earn less money, in my opinion, than they would have if they had never embarked on this process. By embarking on this process, they have made it certain that every country in the world is going to subsidize alternative sources of oil. So they have created competitors for themselves in the oil market. They have made it certain that every country in the world is going to take measures to conserve on the consumption of oil. They have reduced the demand for their product. No, I don’t believe there is any problem, or any serious danger arising out of large accumulations, but if they did get lots of dollars, it’s their problem what to do with them.

Notes

*“Why the American Economy is Depression-Proof”, reprinted in Milton Friedman, Dollars and Deficits, Prentice-Hall, 1968, pp. 72–96; quotations from pp. 89 and 90.

In addition to Dr. Friedman, the O’Hare Executive’s Club honored a group of prominent individuals representing important energy suppliers. They included:


5/2/13