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Political Economy: Some Lessons Of Recent Experience

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ARTHUR M. OKUN*

Political Economy: Some Lessons Of Recent Experience

THE PERIOD FROM THE START OF THE NIXON ADMINISTRATION, on January 20, 1969, to the President's adoption of a new economic policy on August 15, 1971, marks a distinct chapter in macroeconomic policymaking in the United States. The latter half of that chapter, beginning early in 1970, must be regarded, along with 1958-60 and 1965-66, as one of the unsatisfactory episodes in stabilization policy since the passage of the Employment Act of 1946.

I should like to present my views of this experience and its lessons for the future. I offer personal observations rather than definitive history. I speak entirely as a spectator; I have watched the plays carefully during this period, but I do not know what went on in the huddles. As a former player, I know how rough the game is, and how much easier it is to sound smart when one is sitting in the comfortable seat on the fifty-yard line that I now occupy. But I have done penance by putting my true confessions of the mistakes and problems of 1965-68 on the record,[1] and I shall take the liberty of being candidly critical of developments in the 1969-71 period.

I. THE GAME PLAN

The hallmark of the policy strategy during the period from January 20, 1969, to August 15, 1971, was the attachment to a "game plan" or steady course of fiscal-monetary policies, or, to put it negatively, an aversion to "fine tuning." As Paul

*The views expressed are my own and are not necessarily those of the officers, trustees or other staff members of the Brookings Institution.

[1] Arthur M. Okun, *Political Economy of Prosperity* (Washington: Brookings Institution, 1971), Chapter 3.

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McCracken put it back in 1968, "The most fundamental requirement for orderly movement along the full employment growth path is that fiscal and monetary policies themselves pursue a more steadfast course. It is here that the greatest gains are to be had. . . . If we can keep expenditures in reasonably close balance with revenues that the tax system will generate at full employment and if the course of monetary expansion also moves more steadily along the full employment growth path, we can reasonably expect that the economy will come even closer to . . . 'maximum employment, production, and purchasing power.' "[2]

This theme was repeated again and again through the period. In his *1970 Economic Report* (p. 10), President Nixon stated, "We must achieve a steadier and more evenhanded management of our economic policies. Business and labor cannot plan and consumers and homebuyers cannot effectively manage their affairs when Government alternates between keeping first the accelerator and then the brake pedal to the floor."

The dedication to a steady course of policy reflected in part the conviction that the basic policy mistakes of the 1965-68 period had been that of over-reacting to changes in the economic situation. The Nixon economists viewed the fiscal stimulation of 1965-66 as an unwarranted and excessive follow-up to the full employment program.[3] They saw the monetary squeeze of 1966 as an excessive though belated reaction to the inflationary boom, and the subsequent easing of money as an overly dramatic shift in response to the economic pause of late 1966 and early 1967. They also pointed to such fiscal actions as the temporary suspension and subsequent restoration of the investment credit within six months as further examples of oversteering. They argued that the frequency and magnitude of changes in discretionary economic policies had been pretentious and had created unreasonable expectations that the economy could be held on a precise narrow track.[4] More generally, the "game plan" approach to economic policy fitted in with the concept of a "low-profile" administration that President Nixon stressed.

In identifying the steady course as the hallmark of vintage Nixon stabilization policy, I disagree with some critics who stress other dimensions–and suggest that the administration favored the interests of the wealthy or of business, that it gave much greater weight to price stability than to unemployment, or that it put top priority on holding down the size of the public sector. To be sure, Republican and Democratic attitudes differ to some degree on all these matters. But these alleged differences do not illuminate the intrinsic nature of the Nixon stabilization policies

[2] Paul McCracken, "Economic Policy and the Lessons of Experience," in Melvin Laird (ed.) *Republican Papers* New York: Anchor Books-Doubleday, 1968, pp. 389–90.

[3] See, for example, Arthur F. Burns, "The Perils of Inflation," *The Business Cycle in a Changing World* (Columbia University Press for the National Bureau of Economic Research, 1969).

[4] For some "outside" views along these lines, see Charles B. Reeder, "Business Economists and National Economic Policy," *Business Economics*, 3, (Fall, 1967), 7–10; Beryl W. Sprinkel, "The 'New Economics'–Limitations and Alternatives," a speech presented at the annual meeting of the Illinois Chamber of Commerce Oct. 27, 1967; George Terborgh, *The New Economics* (Washington: Machinery and Allied Products Institute and Council for Technological Advancement, 1968), pp. 166–72. My disagreements with these interpretations are spelled out in *The Political Economy of Prosperity*, pp. 109–15.

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or their main distinctions from the policies of Johnson and Kennedy nearly so well as the "game plan" characteristic.

The three main tenets of the game plan were steadiness in the budget posture, steady growth of the money supply, and consistent nonintervention on the wage-price front. I should like to review the experience in each of these three areas.

II. THE FISCAL RECORD

President Nixon inherited a feverish economy, but he also inherited a reasonably appropriate restrictive fiscal policy, which was in surplus on both the actual and full employment bases for all concepts. That policy was not particularly controversial and it was not altered much within the course of calendar 1969. Of course, there were strong differences of opinion in the nation about the desirability of the extension of the 10 percent income tax surcharge, the repeal of the investment tax credit (a Nixon initiative inconsistent with the thesis of pro-business bias), and the revenue-losing "tax reforms" of 1969. But these controversial issues focused mainly on the proper structure of taxation and the proper size of the public sector rather than on the proper amount of fiscal restraint.

By the end of 1969, the boom was no longer a threat, and additional policy restraint to slow down economic growth was no longer in order. The main argument in favor of maintaining a reasonably restrictive fiscal policy was to leave room for a marked relaxation of monetary policy, which had become extremely restrictive in 1969. From that point of view, the fiscal 1971 budget program, which was presented by the Nixon administration in February, 1970, maintained a degree of restraint that seemed justifiable and reasonable to me.

As I noted then, however, some of the rhetoric accompanying the budget seemed unreasonable.[5] It emphasized the need to achieve an actual surplus in both fiscal 1970 and 1971, and ignored the risk of an economic slump that would make an actual budget surplus undesirable and inappropriate. The first lesson of fiscal economics is to distinguish between what the budget does to the economy and what the economy does to the budget. The concept of the full employment surplus is one way to highlight this distinction, and to remind officials and the public that a surplus in a weak economy represents a much more restrictive fiscal policy than the same surplus in a strong economy: Herbert Stein is the father of the full employment surplus concept, and Paul McCracken has been one of its most ardent and effective exponents through the years. Yet the basic lesson of the full employment surplus was essentially ignored in the initial Nixon budget. Instead, it unveiled a new and short-lived fiscal concept known as the "credible surplus." Conceptually, the fiscal argumentation marked an abrupt return to the era of the 1950s when a target for actual budget balance was vested with economic significance of its own. A little black ink in the budget was treated implicitly as a necessary and sufficient

[5] See statement of Arthur M. Okun in *The 1970 Economic Report of the President*, hearings before the Joint Economic Committee, 91st Congress, Second Session, 1970, Pt. 2, p. 424.

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guarantee against inflation regardless of whether private demand continued to weaken or whether it stepped up again.

That particular policy posture is very hard to understand. Did administration politicians feel that actual budget balance had a strong symbolic value? Was it felt that the public's inflationary expectations would be alleviated to a greater extent if the fiscal position was framed in terms of an actual rather than a full employment surplus? Or was the full employment surplus regarded as too subtle a concept for the Federal Reserve Board, which the administration wished to induce to easing monetary policy? Perhaps some day these questions will be answered by people who were in the huddle.

In any case, actual economic developments pursued a far more recessionary course than had been predicted by the administration (*and* by me) at the beginning of 1970. Nonetheless, when the administration reestimated the budget on May 19, it stuck to a tight fiscal program which called for a large full employment surplus (on the national accounts basis) of $10 billion in the face of a recession.[6] And it advanced two new proposals to increase tax revenues—a speedup of estate and gift taxes and a tax on leaded gasoline. The economic situation had changed enormously between January and May, 1970, but the fiscal posture was not changed. The earlier rhetoric had surely reduced the flexibility of fiscal policy. The steady attachment to the game plan was not shaken by the unsteadiness of economic activity. At that point, fiscal policy became strongly controversial after fifteen months in which it had been basically bipartisan.

On July 18, 1970, the administration altered its fiscal rhetoric. In conceding that he could not balance the actual budget, the President pointed out that he was balancing the full employment budget and that the resulting actual deficits should not be regarded as inflationary. At that time, he endorsed the principle of full employment budgeting, but established a principle against deficits on the full employment basis. Even with this change in posture, the fiscal 1971 budgetary program was not altered. Indeed, in August, the President vetoed appropriations for education and for housing, calling it "painful" on social grounds to hold down those programs but insisting that the additional funds Congress had provided would be excessively stimulative and inflationary. The unemployment rate had crossed 5 percent by that point, but apparently in the administration's view it was cresting. In fact, the rate reached 6 percent late in 1970 and remained essentially there throughout 1971.

At the beginning of 1971, the administration set an ambitious goal for rapid economic recovery, and stressed that the budget called for bare balance at full employment on the unified basis. Yet that fiscal program was not strongly stimulative. It involved a $7 billion full employment surplus (virtually unchanged from the outcome, as modified by Congress, for calendar 1970) on the national accounts basis, which is the way Herbert Stein had unveiled the concept and the way economics students had learned to measure the full employment surplus for a generation.

[6]See Nancy H. Teeters, "Budgetary Outlook at Mid-Year 1970," *Brookings Papers on Economic Activity* (2: 1970), p. 306.

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III. THE MONETARY RECORD

In the closing months of 1968, private demand displayed more strength and tenacity than had been expected by the economists of the Johnson administration and the Federal Reserve. Additional fiscal-monetary restraint was clearly in order and the extra ingredient had to consist of monetary tightening. In light of developments, the easing of monetary policy undertaken in the spring of 1968 was revealed as a mistake. The views in the Federal Reserve, among outgoing officials, and outside economists, were thus all congenial to the new administration's desire for a more restrictive monetary policy to be reflected in a slower growth of the money stock. By that criterion and every other indicator, monetary policy became restrictive in 1969. Indeed, as measured by the aggregates, it became extremely tight in the second half of 1969, with demand deposits on a plateau and time deposits falling sharply.[7] This was not the slow and steady path that monetarists had recommended, and outside monetarists became sharply critical of the Federal Reserve during the summer for overdoing restraint. It is not clear whether some (or even all) of the Nixon economists shared that concern at that time. During the spring and summer, most Keynesians (including me) viewed Federal Reserve policy as appropriate—though potent—medicine to halt the investment boom and curb excess demand. In the early autumn, however, we joined the monetarists in calling for less restraint, as the task of halting the boom was clearly being accomplished. In retrospect, I would reaffirm the subjective judgment that the error of monetary policy in 1969 was in keeping the brakes on hard late in the year rather than in jamming them on early in the year,[8] but this is a debatable issue. In any case, extreme monetary restraint—rather than adherence to the "game plan" of steady growth—was maintained until the Federal Open Market Committee meeting of January 15, 1970, two months after the nation's fifth postwar recession had begun.

Early in 1970, the Federal Reserve explicitly adopted its game plan with primary focus on the narrowly defined money supply. Initially, the target value for money growth was apparently 4 percent; but, partly because preliminary data understated the growth, the money supply expanded at a 6 percent rate through the first three quarters of 1970. Although month-to-month variations were larger than they had been in periods when steadiness of money growth was not explicitly sought, the Federal Reserve achieved its target of steadiness in money growth on a quarterly basis during that period.[9] This was "game plan" monetary policy. However, through the first half of the year, long-term interest rates failed to decline and basic private short-term rates were very sticky; some traditional indicators of money market conditions—like net free reserves—also showed little easing. By living with the game plan of steady money growth, the Federal Reserve may well have con-

[7] See John H. Kareken, "Monetary Policy in 1969," *Brookings Papers on Economic Activity* (1: 1970), pp. 152–61.

[8] One shred of evidence in support of this view is the character of "money path B" in William Poole, "Gradualism: A Mid-Course View," *Brookings Papers on Economic Activity* (2: 1970), pp. 280–82.

[9] See John H. Kareken, "FOMC Policy: 1970 and Beyond," *Brookings Papers on Economic Activity* (3: 1970), pp. 476–81.

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tributed less to the end of the recession than would have been the case if a traditional antirecession policy of easing money market conditions had been pursued.

Between September, 1970, and January, 1971, divergent signals came from the growth of the money stock, on the one hand, and interest rates and time deposits, on the other. The Federal Reserve maintained a high rate of growth of overall bank reserves; credit conditions eased dramatically; and interest rates fell sharply. The rapid expansion of reserves, however, was reflected in a surge of time deposits while growth of the money stock slowed. Obviously, the Fed could have stuck to the game plan and pushed the growth of money during that interval, but with other indicators easing, it saved its ammunition.

It subsequently used the ammunition during the period from January, through July, 1971, when the money stock was allowed to expand at a rate of 12 percent. Even so, the Federal Reserve did not accommodate the full upsurge in monetary demand during the first half of 1971; indeed, it permitted a marked rebound in the Treasury bill rate and in short-term private interest rates. From July, to September, 1971, money growth was exceedingly slow once again, while interest rates have moved down sharply. As in the closing months of 1970, the Federal Reserve seemed to be saving its ammunition for when it was needed. From September 1970 to September 1971, the record of the various interest rate and quantity indicators would suggest that the Federal Reserve focused eclectically on several criteria and indicators. Money supply growth was 7.0 percent—close to target—but large variations were permitted over substantial intervals in order to cushion interest rate movements. Meanwhile, the published Federal Reserve official directives have seemed to stress the money stock target. Whenever extremely high or low rates of money growth emerged in the statistics, the Federal Reserve has appeared apologetic. I suspect that if it had been possible to provide additional reserves in a way that would not enter the statistics, the Federal Reserve would have been more generous during the first half of 1971.

In retrospect, the surge in demand for money during the first half of 1971 probably reflected (a) a lagged response to the 1970 drop in interest rates; (b) the general syndrome of caution by the American consumer; and (c) international uncertainties. Apparently, circumstantial evidence from data on the distribution of demand deposits points to a spurt in the personal checking accounts of individuals. The same uncertainties that led households to save at an unusually rapid rate also may have led them to stockpile savings in liquid form—including even demand deposits—rather than in equities or other high-risk assets. According to these possible explanations, the surge in the demand for money reflected a lagged response and/or an upward shift of liquidity preference—a sign of weakness rather than of strength in aggregate demand. If that is the correct interpretation, the spurt in money demand should have been fully accommodated; nonetheless, the Federal Reserve deserves a good grade for accommodating as much of it as it did.

It is perhaps an historical accident that this first major upsurge of money demand under a policy geared to monetary aggregates consisted of a strengthening of liquidity preference rather than an expansion of transactions demand. Perversely,

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the last upsurge, during the summer of 1968, under a monetary policy geared to interest rates represented an increased desire for money to spend rather than for money to hold.

All in all, the game plan of steady money growth clearly influenced Federal Reserve policy in 1970–71, but did not entirely determine the actions of the monetary authority. In terms of the performance of the economy, I cannot see how a case could be made that deviations from the game plan during that period represented serious errors of policy. On the contrary, the mistakes seem to lie in the attachment in word to the steady course and in the hesitation in deed about departing from it.

IV. THE WAGE-PRICE POSTURE

A corollary of the reliance on the fundamentals of fiscal and monetary policy to influence inflation and economic activity was the policy of nonintervention on business and labor decisions with respect to prices and wages. On January 27, 1969, in his first postinaugural news conference, President Nixon stated, "I do not go along with the suggestion that inflation can be effectively controlled by exhorting labor and management and industry to follow certain guidelines. . . . The leaders of labor and the leaders of management, much as they might personally want to do what is in the best interests of the nation, have to be guided by the interests of the organizations that they represent."

The President's unequivocal statement was widely read as an invitation to business and labor to eschew self-restraint. Price increases accelerated most for those industries that had cooperated with the Johnson administration in response to "jawboning" activities during 1966–68. For nineteen industries that had been responsive to the Johnson administration's request for restraint, prices rose 6 percent during the course of 1969 in sharp contrast with the average 1.7 percent increase during the preceding three years. For the remainder of industrial wholesale prices, the acceleration from 1966–68 to 1969 was much more moderate—from 2.3 to 3.5 percent. These nineteen industries represented roughly a quarter of the industrial wholesale price index, and their extraordinary spurt relative to the rest of the index added somewhere between a half a percent and a full percent to the 1969 increase, as I calculated at the time.[10] The experience of 1969 made me feel a good deal more confident that the ad hoc efforts to talk down prices and wages during 1966–68 had had a distinct and beneficial effect. But administration economists did not read the evidence this way, and my calculations were criticized in detail by George Shultz.[11]

[10] Arthur M. Okun, "Inflation: The Problems and Prospects before Us," in Arthur M. Okun, Henry H. Fowler, and Milton Gilbert, *Inflation: The Problems It Creates and Policies It Requires* (New York: New York University Press, 1970), pp. 43–53.

[11] George P. Shultz, in the National Bureau's Fiftieth Anniversary Dinner: Transcript of Proceedings, pp. 11–20 (Supplement to National Bureau Report #6, 1970); and George P. Shultz, statement before the Joint Economic Committee, *The 1970 Economic Report of the President*, Hearings, Pt. 1, pp. 263–69.

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The administration maintained its noninterventionist posture consistently with only a few deviations. In one instance, the President indicated that he was not enthusiastic about a huge increase in the price of steel, and he did impose a tripartite organization for wage restraint on the construction industry in the spring of 1971. Economists within the administration were not unanimous on the issue of nonintervention. Arthur Burns was reported to have advocated an incomes policy in 1969 while still a White House adviser to the President; and as chairman of the Federal Reserve he subsequently became a public advocate of a wage-price policy. Indeed, he was roundly criticized by some administration spokesmen during the early summer of 1971 when he strongly and publicly urged action to restrain wages and prices. Murray Weidenbaum, Assistant Secretary of the Treasury, and Maurice Mann, Assistant Budget Director, seemed to share that view, but they returned to private life before it triumphed within the administration. As late as August 4, the President's attachment to nonintervention in wages and prices seemed unswerving.

V. OBITUARY OF THE GAME PLAN

In my judgment, the seeds of destruction of the game plan were planted by the ambitious goal for rapid economic recovery set by the administration at the start of 1971 and epitomized in the forecast of a GNP of $1,065 billion. That figure startled and puzzled the profession. It was not clear whether the administration was taking an exceedingly optimistic jack-in-the-box view of private demand or, alternatively, whether it was handing a large and open-ended assignment to the Federal Reserve to do whatever was necessary to create a rapid rebound. No economist I know outside the administration had a GNP forecast higher than $1,057 billion, and only a few monetarists significantly topped $1,050 billion. Experts who covered a broad ideological and methodological spectrum had numbers just below $1,050 billion. There was basic agreement on the outlook among economists as wide apart in their orientation as Alan Greenspan and Otto Eckstein, Walter Hoadley and Walter Heller. 1971 happened to be a year in which the standard economic forecast turned out to be remarkably correct. As generally predicted, output grew at a rate below 3 percent and prices rose at a rate above 4 percent. The annual rate of real GNP as 1971 drew to a close ran about 3 percent below the administration forecast.

I cannot hope to explain why the world looked so different to the economists in the Executive Office Building from the way it did to their professional fraternity brothers elsewhere. The Laffer model probably contributed somewhat to that bullish economic forecast, particularly by helping to convince Budget Director Shultz of the feasibility of a rapid recovery. Mechanical extrapolations of previous patterns of business cycle recoveries also probably led some officials astray.

Quite apart from how they arrived at the $1,065 billion figure, administration economists could not have lived with a forecast of $1,050 billion because it represented an unsatisfactory outcome. After suffering through a recession in 1970, they could not publicly envision—or, I would suggest, privately let themselves

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believe—that 1971 would record the most sluggish recovery from recession in postwar history. They wanted a more vigorous recovery than that, and yet they were unwilling or unable to provide a sufficiently stimulative policy to convert that desire into a realistic prospect. The modest character of the policy stimulus may have reflected the constraint of the principle of a balanced full employment budget, the fear of unleashing inflationary expectations by an active display of government stimulation, or, perhaps, the verdict of political officials.

Despite its failure as a forecast, the "1065 episode" had extremely important beneficial effects on subsequent policy. It offered a long, loud cheer for brisk economic expansion and, although it expressed the hope and bet that nature would do the job, it implicitly pledged support for nature if that should prove necessary. The majority of the bond and banking community and part of the economics profession would have favored a year of slow growth as "convalescence" from inflation before the renewal of strong expansion. The administration's explicit dissent from that view was significant; its preferences on the unemployment-inflation tradeoff gave more weight to unemployment.

As I interpreted the official position in February 1971,

> That forecast represents a binding commitment to get the economy moving again toward full employment. . . . Administration economists really do want a vigorous recovery and a reduction in unemployment during 1971, and they will be disappointed if that doesn't happen. They will react to convincing evidence of an inadequate and weak recovery with further stimulative policy measures. In the mid-year environment of say a second quarter GNP of $1,040 billion, Federal Reserve policy simply has to be easy. . . . Fiscal policy will also have to supply additional fuel for the economic engine. . . . Some mid-year little budget is bound to emerge from our scenario.[12]

Against the background of these expectations, I was surprised by Secretary Connally's statement at mid-year that the game plan would not be altered in 1971. The nation was told that the administration was now doing nothing decisively rather than indecisively; no actions or recommendations were forthcoming for tax reductions, expenditure increases, or wage-price policies. Secretary Connally underlined an optimistic assessment of the outlook, although he did not quantify his views. The adverse reaction of informed business, financial, and political opinion was fortunately torrential. Opinion surveys registered new lows of confidence by the American public in the President and in the Republican Party for the management of prosperity. Significantly, twelve Republican senators, before leaving for home at the recess early in August, issued a manifesto explicitly disassociating themselves from the economic policies of the administration. The plea for patience and fortitude was no longer credible. There was no sign of strengthening in the recovery; deceleration in prices and wages was visible only under a microscope; and overly optimistic forecasts and diagnoses of developments had outworn any usefulness in placating public opinion. When the inaction decision on the economy was

[12] Arthur M. Okun, "The Game Plan of Stop and Go," *Business Economics* (May, 1971), pp. 16–17.

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followed by the initiative on China, some political observers inferred that the President had adopted a strategy of stressing foreign policy issues and downplaying the domestic scene. One financial executive summarized these concerns privately, "The President is too busy reading the thoughts of Chairman Mao to pay any attention to the economic mess at home."

VI. THE BIG BOLD INITIATIVE

When Secretary Connally's mid-year plea for patience and fortitude fell on wisely unreceptive ears, the game plan had to be changed. International pressures on the dollar undoubtedly catalyzed the decision and made it come on August 15th, rather than later, such as perhaps when Congress reassembled after Labor Day. Given the decision to do something, the President had the option of presenting a modest program, including such fiscal measures as he did in fact propose, and the appointment of a wage-price review board accompanied by a plea for voluntary restraint in private decision-making. Such domestic measures could have been advanced as evidence that the United States would correct the fundamental problems plaguing our international accounts, and they probably would have bought time and sympathy from our trading partners. But—whether it would have been better or worse substantively—a moderate and limited program would probably have been regarded by public opinion as a shabby retreat from the game plan; and the President could have anticipated such a reaction. Given the alternative of a shabby retreat, a big, bold, new initiative was clearly more attractive to a wise and pragmatic political official.

The strong and lasting attachment to do nothing thus led directly to exceedingly dramatic action once it was decided that something had to be done. A crisis was convenient, even necessary. The bigger and bolder the package, the more likely it was to capture public support as a brand new initiative, a comprehensive attack on fundamental problems, and a display of leadership. The President had locked himself into a position from which he could escape only by breaking down the door. And he did!

Although defense cutbacks, international speculators, and unfair trade practices abroad were mentioned as sources of our economic problems, it is remarkable how little effort was devoted to defending the old policy or to explaining its failure. Indeed, some officials stressed that this was the biggest economic policy package in nearly forty years—as though that was a triumph rather than a declaration of bankruptcy. It seems revealing that the previous "biggest economic program" was unveiled when Roosevelt took over from Hoover.

As a political strategy, the President's decision scored a victory. The public responded warmly to the display of leadership and initiative and apparently took in stride the confession of error. To the political official, a dramatic and effective goal-line stand may be even better than a defense that keeps the opponent from crossing mid-field. The trouble is that the analogy with football is not consistently applicable. In the football game, nothing may be lost if the opponents are kept

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from scoring, while in public policy a delay in correcting economic ills necessarily imposes a very large cost.

In short, political officials get rewarded or penalized for results. They are bound to be pragmatic and to change course at some point when their policies are not producing results. In contrast, the academic economist—including the academic economist temporarily occupying public office—is paid for being right, for proving that he is right, and for being right for the right reasons. And so he is bound to be extremely reluctant to change his mind while any shred of possibility remains that events will confirm the validity of his original thinking. The economists who had gone out on the limb insisting that inflation could be cured by fundamentals without recourse to wage and price policies had everything to lose and nothing to gain personally and professionally from the adoption of controls.

The economic profession was sharply divided about the desirability of wage-price efforts by the government in 1969, and it remains divided today. Indeed, I know of no economist who has changed his mind in either direction during that period. Both advocates and opponents of incomes policy were represented among the advisers to the President and undoubtedly gave him conflicting advice throughout the period.

Similar persistence was displayed in appraisals of the outlook for 1971. Those who had held the jack-in-the-box view early in the year dug in their heels. As late as July, the St. Louis Federal Reserve Bank was forecasting a GNP of $1,061 billion and the First National City Bank was issuing warnings about the impending boom. As in the wage-price case, various economists within the administration must have been offering the President differing views about the desirability of additional fiscal stimulus to pep up the lagging expansion. The same kind of battle occurred in 1961–62 when the economic and financial advisers to President Kennedy differed, some insisting that more stimulus was necessary and others warning that it would be inflationary. After a disappointing slowdown in the pace of recovery during 1962, President Kennedy cast his lot with those who advocated additional fiscal stimulus. Again, none of the experts changed his mind, but the President did and ultimately came down on the right side.

By the time any expert professional adviser reaches a position close to the ear of the President, he has developed a professional reputation, a respected record for making correct analyses and predictions, and a point of view. That point of view—indeed, that element of dogmatism—makes him useful to the President. But it makes him useful as an adviser rather than as a decision maker.

The American people are well served by having a democracy rather than a technocracy. Presidents need professional advisers who battle for their minds, but the American public needs a president who understands how to make decisions and how to choose among divergent considerations and conflicting pieces of advice. When I have met economists who have not served a hitch in Washington, the question I have been most often asked is how much economics President Johnson "really understands." The question itself reveals much about the expert professional mind. For the answer is not a significant indicator of the qualifications of a

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president or his likelihood of success in the field of economic policy. The far more important question is whether he understands how to listen to experts and how to make his own decisions in light of the information and advice that they give him.

VII. SOME LESSONS FOR THE FUTURE

The fact that President Nixon did break down the door on August 15, 1971, is a tribute to his pragmatism. The fact that he got locked into a position for so long raises questions about how our economic policymaking institutions and procedures can be made more conducive to small and more continuous adjustments of policy. The most important lesson is to avoid placing a premium on decisive inaction. That means eschewing policy positions that are dignified as game plans and elevated into false principles, like the non-negative full employment surplus, the steady growth of the money supply, or total nonintervention in the wage-price process. The way to ensure that policy need not lurch is to make sure that it can move gently and smoothly.

International

The best example of a policy-making institution that impedes rational political economy by putting a premium on decisive inaction is the system of pegged exchange rates. Under that system, whenever a currency showed a tendency to weaken, it became incumbent on the Chief Executive to discourage speculation by insisting that the basic strength of his nation's currency had never been greater and that devaluation was inconceivable under any set of circumstances. The system made honest men compromise their integrity to promote the immediate welfare goal of avoiding a currency crisis. The British have developed a rather neat device for minimizing the evil consequences of this arrangement. The Prime Minister subcontracts the task of boasting and vowing to the Chancellor of the Exchequer so that the latter can be the scapegoat whenever devaluation becomes required.

The need for flexibility of exchange rates should be a prime consideration in the construction of the new international monetary system. Since most countries still seem determined to maintain some form of pegged exchange rates, I suppose, realistically but regretfully, that the resolution of the current international financial crisis will involve the adoption of some set of tentatively pegged rates. The only confident forecast I can make about those rates is that they will turn out to be wrong. They will not maintain equilibrium in 1972 or 1973 or any other year. Further adjustments will be required. The success of the new system will depend heavily upon whether it introduces some degree of automaticity, some mechanism for smoother and smaller realignments of exchange rates that prevents any currency from getting as far from equilibrium as the U.S. dollar did in recent years.

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Price-Wage Policies

Although the total price-wage-rent freeze President Nixon adopted on August 15, went far beyond any measures that I would have recommended, I am convinced that some direct action was required on the price-wage front. First, if a policy of substantial fiscal-monetary stimulus had been undertaken without some restraint on prices and wages, it would have been read by the private sector as compelling evidence that the government had given up any effort to curb inflation; the initiative would have intensified inflationary habits, attitudes, and expectations.

Second, the price-wage record remained a miserable disappointment as of August 15. On a careful and comprehensive look at our various price and wage indices, one must agree with Arthur Burns' judgment of July that substantial progress had not been made in checking inflation.[13] The deceleration of rises in the consumer price index from a 6 percent annual rate during 1969-70 to 4.5 percent by mid-1971 greatly overstates the fundamental improvement. Nearly 1 point of the 1.5 point swing in that index reflects the 10 percent rise in mortgage interest rates during 1969-70 and their subsequent sharp decline of 11 percent by mid-1971. Commodities excluding food did not slow down; their 4.0 percent rate of increase between mid-1970 and mid-1971 essentially repeated the 4.1 percent advance from 1969 to 1970. The rise in the deflator for the consumption component of GNP (which excludes interest rates) edged down merely from 4.8 percent in 1969–70 to 4.4 percent from spring 1970 to spring 1971; food prices accounted for most of that total slowdown. Consumer services in the GNP actually accelerated as did the prices of consumer durable goods. The wholesale price index, which had registered a 3.7 percent increase from 1969 to 1970, continued to move up at a 3.5 percent rate from mid-1970 to mid-1971. The best comprehensive index of quarterly price movements, in my judgment, is the chain price index for gross private product: Its 4.8 percent annual rate of increase during the second quarter of 1971 was actually a shade higher than the rise during 1969 and 1970.

Nor did wages slow down perceptibly: The year-over-year increase in compensation per man hour for both the private economy and the nonfarm sector was 7.5 percent in the second quarter, one of the highest figures attained in the current inflation. In adjusted hourly earnings for the private nonfarm sector, a 7.4 percent increase over a year earlier similarly set a new high for that measure in the second quarter.

I cannot fully explain the puzzling stubbornness of wage and price inflation in the face of recession and a maintained 6 percent rate of unemployment. I know that it cannot be explained as the result of a competitive determination of wages and prices by the balance of supply and demand. That view of the economy cannot account for wages continuing to rise rapidly—much less for their continuing to accelerate—when the omnipresence of excess supplies was reflected in every indicator of labor market conditions. I suspect, although I cannot prove, that large and highly

[13] See Arthur F. Burns, "Statement" before Joint Economic Committee (July, 1971).

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visible wage settlements that made newspaper headlines contributed to norms or habits of wage inflation that pervaded the atomistic sectors of the economy.[14] Small, unorganized employers want the good will of their workers for the long run, and they felt obliged to provide equitable wage increases (that is, to approach the big visible union settlements) even when there was no danger that existing workers would quit or that additional workers would need to be recruited.

I also suspect, although I cannot prove, that "target-profit" pricing rules in large firms kept the spiral in orbit. In the years of inflationary boom, the profits of industrial giants were doing well, and they felt no urgency to increase prices at a rapid rate. When profits fell sharply during the slowdown and recession, pressures mounted to pass on cost increases with a markup in order to keep profit margins from dropping way below target. That supposition is consistent with the seemingly inexorable recent prefreeze of prices in durable goods industries, which are dominated by large firms with market power.

My conjectural diagnosis would not support the prescription of a comprehensive system of wage and price controls. It would suggest that the nation would be much better off if the Nixon administration had tiptoed into the wage-price area back in 1969 with an informal and unenforced program, focused on the key price-wage decision-makers who do not respond passively to the will of the marketplace and who do set the visible norms for much of the economy. By tiptoeing into this sensitive area, the government might have determined how far it was necessary and feasible to go, whether any legal sanctions seemed necessary and appropriate, how an influence on the average increase of wages and prices could be consistent with efficient allocation of resources and with the maintenance of a basic social consensus among interest groups. A strategy of tiptoeing in early rather than plunging in late could have avoided the spectacle of high government officials occupied in fixing the compensation of professional football players and drawing dividing lines between pickles and cucumbers. It would have avoided other difficult problems that confront us today when a thaw on controls is in order. The maintenance of comprehensive federal controls on rents and retail prices would be a nightmare, in my judgment; yet it may be extremely difficult politically to decontrol rents after the freeze, and it may be impossible to convince the housewife that the typical retailer is merely the bearer of sad tidings on prices and not the cause of the inflation that she experiences.

Nonetheless, I am hopeful that Phase Two price and wage restraints will not be unduly severe, that they will hold together, and that they will make some contribution to breaking the momentum of the wage-price spiral. Phase Two can and should move us 90 percent of the distance from freeze to free markets. And a further movement in that direction should be made during 1972. But there should remain a mechanism for incomes policy in the federal government. I cannot imagine any president in my lifetime again declaring that wage and price decisions are of no interest to the federal government, exposing himself to the risk of another big turn-

[14] See the discussion, George L. Perry, "After the Freeze," *Brookings Papers on Economic Activity* (2: 1971), pp. 445–49.

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around. Rather, I should expect us to move to a situation like that of 1962-65, in which the government expresses a point of view and uses its influence to break inflationary habits in the private sector—but without frequent confrontations or widespread legal sanctions.

In my view, institutions such as the Price Commission and the Pay Board should be maintained for the long run. I believe they can be a useful forum for discussing and influencing key aspects of the wage and price process that may contribute to the inflationary biases so evident in our economy's performance throughout the postwar period. If they have no serious problems, the members can make speeches heralding the success of the nation in reconciling price stability and prosperity. With such an institutional mechanism, we can gradually create a means for the federal government to express the public interest in wage and price restraint in ways consistent with the market system.

Fiscal Policy

As I read the lessons of recent experience, they stress the need for institutional changes and policy strategies that facilitate small and frequent adjustments in fiscal policy as a matter of routine. One important improvement could be made simply by having the executive cease and desist its practice of acting as cheerleader in interpreting economic news. In the early postwar years, the Truman and Eisenhower administrations reacted on occasion to soggy economic news by denying its significance and insisting that no recession was imminent. When it became clear that a recession had begun, the previous statements of reassurance made it harder for the administration to take antirecessionary measures. The official interpretations of unemployment figures and price statistics during 1970-71 reveal that federal candor has not improved much over the past generation.

The task of implementing changes in fiscal policy through our legislative process must be eased in the years ahead. Presidents will not make proposals that have no chance of enactment. And if they will not ask for change, they will feel obliged to insist no change is needed. Again, bad institutions encourage public officials to dig in their heels and compromise their integrity in order to promote the public welfare.

Finally, we must avoid entrenched doctrines and locked-in positions that inhibit needed adjustments. The only proper game plan for fiscal policy is to adjust the budget to the state of the economy. The steadiness of the policy instruments is no criterion of success or failure in stabilization policy. The meaningful goal and meaningful test is the stability of the growth performance of the economy. The profession knows enough to contribute to greater stability of that performance. For all the limitations of economists, our professional judgment beats the agnosticism of nondiscretionary rules.[15]

If every fiscal program of the President has a distinct, definite, and warranted

[15] See the discussion in Arthur M. Okun, "Rules and Roles for Fiscal and Monetary Policy," in James J. Diamond (ed.), *Issues in Fiscal and Monetary Policy: The Eclectic Economist Views the Controversy* (DePaul University, 1971), pp. 65-69.

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change in its full employment surplus from that of the previous budget, no big deal will be made of it. Small variations should be accepted and implemented as a matter of course. In contrast to the rule for steady full employment surpluses, I would argue that almost never will two consecutive years call for exactly the same fiscal policy. In particular, the amount of fiscal shove needed to get our economy out of the mud will surely be excessive once the economy gets rolling. I believe we are about to begin a long, slow movement back to prosperity. Our prospects for restoring full prosperity in a reasonably short period of, say, two years are inhibited by the fear of overdoing stimulus. And there is a genuine danger that providing strong fiscal and monetary stimulation now will lead to excess demand inflation later. That danger argues most strongly for temporary and self-liquidating fiscal measures—like temporary tax cuts—rather than in favor of timidity. It argues for a readiness and a willingness to moderate the amount of fiscal stimulation once the economy gets rolling. If we are willing to turn the wheel routinely and adjust to the existing situation and the reasonably predictable near-term future, we can hope to avoid another round of stop and go.

Monetary Policy

Recent years have given us a diversity of experience on the money and credit front. At times, aggregate quantities and interest rates have moved in remarkably divergent ways; at times, growth rates of the various aggregates have been spectacularly far apart; at times, the money supply has been a good predictor of economic activity, and during 1971 it was a terrible predictor of activity. These experiences should shake the conviction of any mortal man that he has a reliable formula or a trustworthy guide for action by the Federal Reserve. To me, the experience argues in favor of small, flexible, and unpresumptuous adjustments of monetary policy. The Federal Reserve must face reality by asking itself why interest rates move as they do, and why the money demand curve shifts at a particular time. Sometimes, it will give the wrong answers and make mistakes, but it is more likely to be right than wrong on a careful, dispassionate analysis of these issues. And it is more likely to support and promote our social goals by taking some risks and making its judgments than by following rigid rules. During 1970-1971 in particular, the Federal Reserve has acted best when its deeds have deviated from its game-plan words.

VIII. CONCLUSION

In short, the only way to get the activism we need when we need it is to avoid making a virtue out of an inactive and entrenched policy strategy. This is a key argument in favor of what some people denounce as fine tuning and what I endorse as sensible steering. The flexibility I recommend will surely not keep us on a precise and narrow path, but it should help keep us from getting very far off track and

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it will avoid occasional enormous shifts in government policy. Those who favor complete inactivism and a thoroughgoing self-denial of discretionary economic policy have lost the battle in the democratic process. The events of 1971 demonstrate that the American people want and expect their government to deal with important national problems, and that the government will be responsive, sooner or later.

The relevant choice is between acting sooner and acting later—between small flexible adjustments made promptly and frequently, and enormous lurching shifts made belatedly and infrequently. The dangers of the latter course are enormous: the costs of delay, the loss of predictability and confidence in government, the likelihood of overdoing the correction in a crisis atmosphere. Academic economists have long been trying to convince international bankers that the costs of small day-to-day fluctuations in exchange rates on currencies would be trivial, far smaller than the uncertainties associated with the threat of enormous financial crisis and occasional huge shifts in parities. That same argument applies to domestic economic policy. The case in favor of a steady course argues against crisis economics. And the only genuine alternative to crisis economics is flexible, sensible-steering economics that develops institutions and procedures conducive to small and timely adjustments. That is the way to buy insurance against the need for another massive program. If we learn our lessons well, the Nixon package of August 15, 1971, will retain its championship as the biggest and boldest economic program for the rest of the century, and political economy will have taken a major step forward.

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