Mitchell's Musings 11-5-12: Political Economy, 1971

Daniel J.B. Mitchell

Note: With both presidential candidates' campaigns getting ready to pounce on the November 2 media release by the Bureau of Labor Statistics on the employment situation (unemployment rate, etc.), I thought I would put out this edition of the Mitchell musings early (Oct. 31), even though it is technically dated Nov. 5. In a sense, it is timely because it deals with presidential re-election concerns about the state of the economy. But the musing is also "untimely" in that it refers to events of 1971. Still, as a Halloween offering, the musing does point to the fact that nothing is scarier than not knowing for sure what is about to happen.

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This musing comes just as the nation is about to vote in a presidential election. One factor that has been much discussed in that context is the role of economic trends – often the trend in the unemployment rate - in shaping the election outcome. Those researchers who model the impact of economic trends on presidential elections seem to focus on *direction* (expansion or contraction) rather than on the *absolute condition* of the economy or labor market. Republican nominee Mitt Romney has tended in the 2012 campaign to point to the absolute level of the economy, the sluggishness of the recovery, and the fact that administration economists, early on, had been too optimistic in their projections. Incumbent President Barack Obama points to the fact that recovery is underway and promises that recovery will continue under a second term.

Earlier musings have been based on now-available Nixon "White House tapes" and their revelations about policy making.[1] It's quite clear from the tapes that President Nixon was very much interested in economic trends, particularly as he looked towards his 1972 re-election campaign. In this musing, I focus on a June 1, 1971 taped telephone conversation on the economic outlook and on economic policy, both monetary and fiscal. The participants are the President and George Shultz. It can be heard at http://www.youtube.com/watch?v=M6DtzjVJM-w.

The economy the President inherited in 1969 had been heating up during the late 1960s under pressures of the Vietnam War. Concerns about inflation led the Federal Reserve to take actions to slow the expansion, hopefully producing a "soft landing," i.e., a growth pause that would not technically be a recession. As it turned out, however, a recession did occur which the National Bureau of Economic Research dates as starting in December 1969 and ending in November 1970. By June 1971, it appeared clear that the economy was expanding again. But the question was how solid and rapid the expansion would be and what would economic conditions be in the coming election year.

[1] As has been noted in earlier musings, not all of the tapes were of conversations in the White House. Some conversations took place in other locations or on the telephone.

At the time, the economics profession was split between monetarists, led by Milton Friedman of the University of Chicago, and Keynesians, led by (among others) Paul Samuelson of MIT. Friedman's position was that the Fed should simply keep the "money supply" growing at around 2% per annum and not attempt to fine tune the economy. I put "money supply" in quotes because there are various definitions of what one might mean by "money" and Friedman focused on a particular narrow definition that he favored. When deregulation of the financial sector began to occur (later in the 1970s), and different financial assets became more interchangeable with narrowly-defined money, the definition issue became more important. But in 1971, there was less concern about the definition than subsequently arose.

The Keynesian perspective put more emphasis on fiscal policy than the monetarist view. Keynesians were more inclined to approach monetary policy as the setting of interest rates by the Fed – which had been the traditional approach. As many observers have pointed out, at any moment the Fed can target the growth of money (somehow defined) *or* interest rates. But it cannot do both. In any event, Keynesians tended to be activists and did not go along with the idea that the Fed should passively increase the money supply at 2% (or any other pace) without regard to economic conditions. Rather they thought that the Fed should cut interest rates when the economy slowed and raise them when it overheated. Although it was not so evident in 1971, the Fed during the later 1970s and into the 1980s became monetarist - in the sense of focusing on the money supply – but remained activist in the sense of varying its monetary targets with the condition of the economy.[2]

George Shultz, who had been Nixon's Secretary of Labor initially, was - by June 1971 - his Director of the Office of Management and Budget. It is evident from various Nixon-Shultz phone conversations, including the one of June 1, 1971, that the President regarded Shultz as a key economic advisor and probably *the* key economic advisor. There was an economic policy group, referred to at the time as the "triad," consisting of Shultz, John Connally (Secretary of the Treasury), and Paul McCracken (Chair of the Council of Economic Advisors). During the phone conversation with Shultz, there is reference to the "quadriad" - which was White House-speak for the triad plus Arthur Burns, chair of the (independent) Federal Reserve. It might be noted that including the Fed chair in such a group as if he were a member of the administration was unusual. Burns seemed closer to the administration than other Fed chairs have been.[3]

In the phone conversation, President Nixon is concerned that Milton Friedman has been consulted by the Fed and Burns. He knows that Friedman favors the constant 2% policy which Nixon fears would not

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[2] As the Fed later became more monetarist, it faced a problem with defining the money supply that came along with financial deregulation. It tried to set targets with various definitions simultaneously, but that approach proved difficult since the relationship between the different versions of money kept changing. By the 1990s, the Fed had returned to the interest rate approach.

[3] Members of the Fed's Board of Governors, including the chair, are appointed by the President for fixed terms. But the Fed is viewed as an independent agency and is supposed to be insulated from politics.

aid the pace of the post-1970 recession expansion. Shultz tells Nixon that in fact Friedman, given the sluggish economy, supports temporary 4% money supply growth. On the other hand, Paul Samuelson is pushing the Fed for a more expansive policy which Shultz terms "let 'er rip." Shultz reports that Connally and McCracken are on the side of more expansion. Shultz, however, defines himself as a moderate. He is concerned that too much expansion in 1971 could lead to an overheated economy in 1972.

The President says that the problem with Friedman is that he doesn't have a sense of politics. Congress will act if the administration doesn't take an expansive stance by adding to federal spending (fiscal stimulus). It is noted, however, that some of the pressure for more spending comes from the Nixon administration's policy of shifting to a volunteer military and away from the draft. If the military has to depend on labor-market recruitment rather than compulsion, a large pay raise is needed. Toward the end of the conversation, there is mention of a proposal by Commerce Secretary Maurice Stans to have a mid-decade census. Shultz thinks whatever such a census could accomplish could be done with some cheaper sample surveys. And Nixon doesn't want to spend money on a mid-decade census, apparently because it would signal laxness in constraining the federal budget.[4]

With hindsight, we know that in two-and-a-half months an international dollar/gold crisis will cause the President to declare a dramatic change in economic policy. The remnants of the gold standard will be ended, the dollar will be allowed to float temporarily while a new international monetary system is planned, and wage-price controls will be imposed. But international downward pressure on the dollar in currency markets is not mentioned explicitly in the conversation. Shultz tells the President that Burns wants to talk with him (Nixon) about the international situation. Burns probably wanted to alert the President to what was already occurring in currency markets. But Nixon is not anxious to have a meeting alone with Burns on that subject. He indicates that whatever Burns has to say should be aired in the quadriad. Was this decision a missed opportunity to look into the economic future? We will never know.

So what do we learn from this conversation? First, the more things change, the more they remain the same. Presidents worry about the economic conditions that will surround their re-election campaigns. Although the more recent studies that indicate that the *direction* of change is very important hadn't been done yet, there seemed to be a political sense back in 1971 that the pace of expansion would be important. Second, the economic circumstance that would turn out to be the most important with regard to actual policy in election year 1972 – the downward pressure in world currency markets on the U.S. dollar - was not understood (or at least not appreciated) by the President or his key advisor. Third, the gap between political economy and academic views of economic policy was apparent, particularly in President Nixon's complaint about Milton Friedman's advice. It also shows up in the position of the

[4] I have truncated the conversation at that point to meet YouTube length requirements. The omitted material, however, does not add to the content of the conversation.

academically-oriented Council of Economic Advisors (CEA) and its chair, Paul McCracken. It's pretty clear that McCracken as the official advisor is nevertheless not the key advisor.[5]

Apart from the general concern about the economy in an election year, are there other parallels with 2012? There is no contemporary direct parallel with the unforeseen dollar crisis of 1971 that would soon upend economic policy in 1971-72. But the Obama administration faced a different kind of unknown when it came into office. Economic forecasting relies heavily on past experience, nowadays in the form of econometric models based on historical empirical data. When the economy is functioning outside the normal range in which most of those data arose, forecasting models are unlikely to be highly accurate.

To the extent there is an analogy with 1971, it is that what would happen to the U.S. economy and labor market - even in the few months after the Obama administration came into office - was not foreseen. As is well known in hindsight, unemployment quickly exceeded forecasts and expectations. In political terms, however, Nixon was able to react to the unforeseen events once they occurred. But it was much harder for the Obama administration to chart a new course, particularly once the House of Representatives changed hands in 2010, an event itself that was conditioned by economic conditions and the lagging labor market. There is the apocryphal quote of movie mogul Sam Goldwyn, "Never forecast, especially about the future." But it's a luxury presidents don't have. Even when they can't get the forecast right, they have to forecast and then live with the political consequences.

[5] Both Shultz and McCracken came from academia. But President Nixon seems to have regarded Shultz as having a political sense, perhaps because of his earlier role as Secretary of Labor.