Mitchell's Musings 9-10-12: The Lull Before the Storm?

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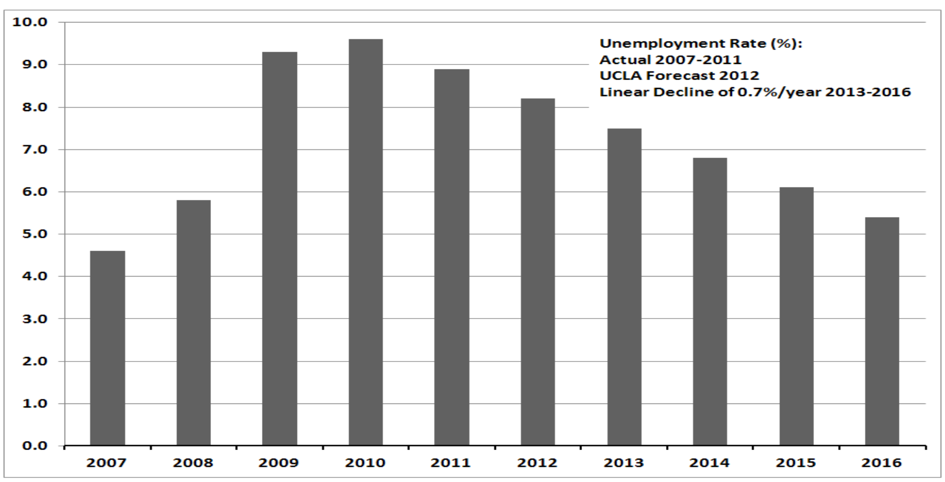
My August 20th musing featured a look back at the decision taken by President Nixon forty-one years ago to impose wage-price controls.[1] I noted in that musing that the economic world of 1971 was a different place from today. But sometimes there are contemporary lessons, even in the distant past. And sometimes history is of interest in and of itself. You can view this musing and its conclusion in that spirit.

The current presidential campaign is shaping up to be about the economy and the labor market. So far, the recovery has been a slow process. Let's put aside the question of whether it could have been otherwise and assume that the current pace of declining unemployment will continue into the future. If that happens, the next presidential term would see a return by its close to something approximating full employment.[2] The chart below represents a simple unemployment projection to 2016.

President Obama is campaigning on a four-more-years-to-finish-the-job platform so the chart can be taken to represent something approximating the projections of his economic advisors. The administration actually had the chart's final unemployment rate somewhat above the rate shown on the chart in its February 2012 *Economic Report of the President*.[3] But it might be assuming a faster recovery now. Candidate Romney is campaigning on the promise that he would do it better - but exactly what he would do is not clear. Neither candidate seems likely to have a free hand in any case to implement drastic changes in policy if elected or re-elected, given Washington's current state of political gridlock.



[1] http://www.employmentpolicy.org/sites/www.employmentpolicy.org/files/field-content-file/pdf/Daniel%20J.B.%20Mitchell/MitchellMusings%208-20-12.pdf.

[2] The 2012 unemployment rate on the chart is from the UCLA Anderson Forecast made in June 2012. There will be a new forecast by UCLA in a few weeks but it should not be much different than what is shown on the chart, given the eight months of 2012 on which we already have data. I then projected the decline from 2011 to 2012 to the remaining years. The actual UCLA June forecast was for a slower pace, ending with a rate a bit over 6%.

[3] The administration gives the projected unemployment rate on a fiscal year basis. For fiscal year 2016, it projected a rate of 6.5%. See page 75 of the *Report.*

That observation takes us back to the Nixon era, a period in which the President had a great deal more authority over economic matters than is the case nowadays. As noted, President Nixon instituted wage-price controls in August 1971. [http://www.youtube.com/watch?v=Wv4gpyfLF3s] At the same time, he ended the Bretton Woods fixed exchange rate system, temporarily going to floating rates. [http://www.youtube.com/watch?v=iRzr1QU6K1o] To push other countries into negotiations on a new exchange rate system, he imposed a 10% tariff on all imports, to be removed when the U.S. obtained a favorable deal. By December 1971, a new system of fixed rates with a devalued dollar was under negotiation and was then put in place. It became known as the Smithsonian system. [http://www.youtube.com/watch?v=8cNGeScxJNw] The import tariff was lifted and the new regime of exchange rates was supposed to last indefinitely.

While the President was busy making international monetary policy, he also ended his initial "Phase I" wage-price freeze and created a more elaborate and flexible set of wage-price controls, Phase II. In January 1973, a process of decontrol was begun with implementation of Phase III, a more relaxed and less extensive controls regime. In short, the President in the Nixon era – given the substantial authority he exercised – could be seen by the electorate as responsible for their economic fate, good or bad. During 1972, unemployment was generally at moderate levels as was inflation. Not surprisingly, the President was handily re-elected.

Thanks to the Watergate affair and the disclosure of the White House tapes, we have an historic record of economic policy making during the Nixon period. So are there lessons to be learned from the tapes? Tapes from the Nixon era are gradually being digitized, indexed, and put online by the National Archives. As yet, the indexing is cumbersome. However, I came across one taped discussion between the President and his advisor John D. Ehrlichman that took place on February 5, 2012. The two men go over matters other than economics in their discussion but economic policy was the topic for about twelve minutes. You can listen to the discussion at http://www.youtube.com/watch?v=GbHpXykXNfM.

Initially, the discussion seems similar to what might occur today. There is grumbling in Congress that economic growth is inadequate and the administration is being blamed for the slow pace. Nixon is looking for a response. But the recording is of interest as much for what isn't discussed as for what is. Shortly before the date of the recording, the President had scrapped Phase II wage-price controls for what was to be the start of a process of decontrol with Phase III. On the recording, however, he seems to be having second thoughts about the wisdom of the change. Ehrlichman is also uncertain as to whether scrapping Phase II was a good idea. He says he had become accustomed to the Phase II controls.

Both Ehrlichman and Nixon believe that business – despite being ideologically in favor of freedom from government regulation – actually liked the controls program which was perceived as helping firms hold down wages. Notions of wage-push inflation were in the air at the time (in an era of strong labor unions) and the wage-push idea is explicitly mentioned on the tape. Business was also said to like keeping taxes down and having expansionary spending on the Vietnam War – a war which was in a temporarily quiescent stage. So budget balancing was not actually a priority of the business community.

What is surprising in hindsight is that the international monetary system is barely mentioned. The only reference is a brief remark that the dollar is under pressure. However, the President characterizes the idea that such international developments are important to the domestic economy as "bullshit," although the chair of the Federal Reserve thinks otherwise. Yet at the time the recording was made, the Smithsonian system was just days away from collapsing. The unforeseen collapse was less dramatic than the end of Bretton Woods and took place over several weeks with the U.S. simply deciding not to support the dollar against other major currencies. Congress seemed also to want to drop any alternative fixed exchange rate regime and leave the dollar to float. In short, what was to be a major shift in U.S. and world economic policy is almost completely absent from the meeting.

When we view the Nixon administration in historical perspective, Watergate – which was already beginning to gather momentum at the time of the recording – comes to mind along with the eventual resulting resignation of the President. But there were a variety of economic events that began to unfold soon after the February meeting, even apart from the unraveling of the Smithsonian agreement. Wage-price decontrol did not go smoothly as it turned out. There was another price freeze to come. And there were shortages of meat and spot shortages of gasoline - a foreshadowing of the much more major gasoline shortages during the Carter administration.[4] There was the Yom Kippur War in the Middle East later in 1973, with its impact on world oil prices. Finally, there was a major recession in 1974-75 during which the word "stagflation" was born.

We know about all of these developments now but there was no inkling of them in the February 1973 discussion of economic policy. One is reminded of the supposed response of former British Prime Minister Harold Macmillan when asked about the greatest challenges that he had faced as UK leader. "Events, dear boy, events," he is said to have replied.[5] So coming back to the chart with which we started, we surely can make one observation based on the past. The nice smooth projection for the future course of the labor market on that chart – and in projections by forecasters and by the administration (whichever administration it turns out to be) – could easily be disrupted by "events."

Harold Macmillan

[4] When economy-wide wage-price controls finally ended in 1974, the controls on oil prices remained.
[5] Like many great and witty quotes, no one is quite sure he actually said it.