Project Syndicate

Is the Fed Getting Burned Again?

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STANFORD – Fifty years ago, on June 22, 1971, US Federal Reserve Chair Arthur Burns wrote a memorandum to President Richard Nixon that will long live in infamy. Inflation was picking up, and Burns wanted the White House to understand that the price surge was not due to monetary policy or to any action that the Fed had taken under his leadership. The issue, rather, was that "the structure of the economy [had] changed profoundly." Accordingly, Burns was writing to recommend "a strong wage and price policy":
"I have already outlined to you a possible path for such a policy – emphatic and pointed jawboning, followed by a wage and price review board (preferably through the instrumentality of the Cabinet Committee on Economic Policy); and in the event of insufficient success (which is now more probable than it would have been a year or two ago), followed – perhaps no later than next January – by a six-month wage and price freeze."

Perhaps owing to Burns's reputation as a renowned scholar (he was Milton Friedman's teacher) and his long experience as a policymaker, the memo convinced Nixon to proceed with a wage and price freeze, and to follow that up with a policy of wage and price controls and guidelines for the entire economy. For a time after the freeze was implemented, the controls and guidelines seemed to be working. They were even politically popular for a brief period. Inflation inched down, and the freeze was followed by more compulsory controls requiring firms to get permission from a commission to change wages and prices.

But the intrusive nature of the system began to wear on people and the economy because every price increase had to be approved by a federal government bureaucracy. Moreover, it soon became obvious that the government controls and interventions were making matters worse.

Ignoring its responsibility to keep inflation low, the Fed had started letting the money supply increase faster, with the annual growth rate of M2 (a measure of cash, deposits, and highly liquid assets) averaging 10% in the 1970s, up from 7% in the 1960s. This compounded the impact of the decade's oil shocks on the price level, and the inflation rate shot into double digits – rising above 12% three times (first in 1974 and then again in 1979 and 1980) – while the unemployment rate rose from 5.9% in June 1971 to 9% in 1975.

As we know now, the US economy's performance in the 1970s was very poor owing at least partly to that era's monetary policies. This was when the word "stagflation" was coined to describe a strange mix of rising inflation and stagnant economic growth. As James A. Dorn of the Cato Institute recently recounted, Nixon's "price controls went on to distort market prices" and are rightly remembered as a cautionary tale. "We should not forget that the *loss of economic freedom* is a high price to pay for a false promise to end inflation by suppressing market forces" (emphasis mine).
As it happens, *Choose Economic Freedom*is the title of a book that I published last year with George P. Shultz, who passed away in February at the age of 100. Schultz had gained decades of wisdom and experience as both a diplomat and economic policymaker, serving as the Nixon administration's budget director when Burns wrote his audacious memo. In an appendix to our book, we included the full text of that document, because it had only recently been discovered in the Hoover Institution archives. It should now be recognized as required reading for anyone seeking to understand the recent history of US economic policymaking.

The Burns memo is a perfect example of how bad ideas lead to bad policies, which in turn lead to bad economic outcomes. Despite Burns's extraordinary reputation, his memo conveyed a set of terrible policy recommendations. By blaming everything on putative structural defects supposedly afflicting the entire economy, the memo's worst effect was to shun the Fed's responsibility for controlling inflation, even though it was clearly responsible for the rising price level.

By the same token, good ideas lead to good policy and good economic performance. As Schultz and I showed, this was certainly the case in the 1980s. The Fed reasserted itself as part of a broader economic reform, and the economy duly boomed.

The message from this historical experience – and many other examples in the United States and elsewhere – should be abundantly clear. And while history never repeats itself, it often rhymes, so consider where we are midway through 2021: inflation is picking up, and the Fed is once again claiming that it is not responsible for that development. Instead, Fed officials argue that today's surge in prices merely reflects the bounce back from the low inflation of the last year.

Worse, the Fed's policy is even more interventionist now than it was in Burns's day. Its balance sheet has exploded from massive purchases of Treasury bonds and mortgage-backed securities, and the growth rate of M2 has risen sharply over the past year. The federal funds interest rate is now lower than virtually any tested monetary policy rule or strategy suggests it should be, including those listed on page 48 of the Fed's own February 2021 *Monetary Policy Report*.

It is not too late to learn from past mistakes and turn monetary policy into the handmaiden of a sustained recovery from the pandemic. But time is running out.

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