

# Dreams Can Be Nightmares

by

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Economic History Association Meeting  
San Jose Hilton Hotel, San Jose, CA  
September 15, 2017

Michael Bordo is a persuasive economist. When we were chatting one day, I was telling him about the bad economy of the 1970s and why it was clearly the result of bad policies, missed judgment about the effectiveness of policies, and the poor performance on the part of the Federal Reserve. I included some stories in our chat, and Michael suggested that I tell some of these stories at a meeting of the Economic History Association. I agreed, so here I am.

Let me start by setting the scene. Real GDP during the 1970s jumped around, looking good in the early 1970s, then dropping precipitously, only to recover but fall to zero growth by the end of the decade. The Consumer Price Index in the same decade ran from an early low to a high of 11 percent in the mid-decade, ending the decade at a high of around 13 percent. Meanwhile, the growth of the monetary aggregates was fluctuating wildly and rising from an average of 6.7 percent in the 1960s to 9.4 percent in the 1970s, as measured by M2. And productivity growth, starting at about three percent at the beginning of the decade, was down close to zero by decade's

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end. You can already see the outlines of the argument. Let me start by giving some of my perspectives from an earlier time.

During the 1960s, I was a faculty member at the University of Chicago and I read about the advocacy of guidelines for wages and prices by the President's Council of Economic Advisors. I worried that these guidelines might be the conceptual precursors of wage and price controls. In collaboration with Robert Aliber, we held a conference on the issue, and many heavy hitters attended. Milton Friedman gave an outstanding address. Robert Solow talked about "The Case against the Case against the Guideposts." The conference was a success; the issues were well identified. So Aliber and I gathered together the papers and transcripts of the discussions and published them in a book titled *Guidelines*. So the subject was on my mind.

Not long afterward, I became Secretary of Labor. There I was preoccupied with settling major strikes, fighting against discrimination in the workplace, and managing for the President the desegregation of schools in seven Southern states, sixteen years after the *Brown v. Board of Education* decision of 1954.

Then, in July 1970, I became the first Director of the Office of Management and Budget. I sensed, after a time, that wage and price controls were, indeed, in the air, so I gave a speech making the case that we had the budget under control and, with a reasonable monetary policy, inflation would be brought under control. All we needed was the patience to see these policies through, so the title of my speech was "Steady as You Go."

But the pace toward controls picked up. In August 1970, Congress gave the president the authority to impose them. In effect, the Congress

said, “We have given you the tools; now it’s up to you to do the job.” The accelerating growth of dollar in foreign hands posed the threat of a run on the bank (Fort Knox), with inflationary implications.

In doing some research in the Hoover archives on this subject, I unearthed a letter dated June 22, 1971, from Arthur Burns, Chairman of the Federal Reserve at the time, to President Nixon. Arthur argued that structural changes in the economy made it difficult to control inflation. He seemed to be particularly concerned about the impact of unions. He said,

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.

So, in this letter to the President and more publicly, Arthur was advocating wage and price controls. Obviously, he thought they would work, giving the Fed a major assist in taming inflation.

Then, dramatically, on Sunday, August 15, 1971, the President simultaneously announced a 90-day wage and price freeze to be followed by more elaborate controls and a surcharge of 10 percent on imported goods and services. On three television networks, he said, “The time has come for a new economic policy for the United States.” Disaster had struck, I thought, but it didn’t look that way. The stock market logged its largest ever one-day increase. The freeze was hugely popular – so much so that I was frightened, as the natural flow of economic variables in the economy was being stifled.

I had some help. A number of economists, published in the *Wall Street Journal* and in *Newsweek*, argued against the freeze. Milton Friedman was quoted in *Newsweek* as saying: “[President Nixon] has a tiger by the tail. Reluctant as he was to grasp it, he will find it hard to let go.”

President Nixon established a “Cost of Living Council” composed of Cabinet members and other senior officials. It met for the first time the next afternoon and daily for two months, chaired with a strong hand by Treasury Secretary John Connally. Interestingly, the implementation of the Phase 1 freeze, as directed by the Cost of Living Council, was actually left to the 300-person Office of Emergency Preparedness. It was an in-place bureaucracy with regional field offices that just happened to be available at the needed time. The Office of Emergency Preparedness later coordinated with the IRS.

At the conclusion of the 90-day freeze period, the Council enacted Phase II of the controls, which would stay in place through the 1972 election, with Donald Rumsfeld installed as the Council’s director and Dick Cheney as his deputy. A seven-member “independent” Price Commission and a fifteen-member “independent” Pay Board were established with members from labor, business, and the public. Under Phase II, corporations were allowed to pass increased costs through to prices but were slowed down by pre-notification and profit margin limitation requirements; for example, companies with sales exceeding \$100 million had to register price increases 30 days in advance, which could then go ahead, barring rejection from the Commission. Price growth was targeted at 2.5 percent. Wages were to be limited to 5.5 percent annual growth. Fed Chairman Burns, who had earlier turned down a seat on the Cost of Living Council, was appointed to head the Committee on Interest and Dividends, which stated that

corporate dividend growth should be limited to just 4 percent. Burns described the committee as, “a new instrument for jawboning.” The complexity of administering the wage and price controls grew.

On June 12, 1972, I moved from OMB to become Treasury Secretary, and the control system reported to me. By January 1973, President Nixon had won reelection in part on the basis of an expanding economy with prices under uneasy control. Working with Rumsfeld and Cheney, and with the President’s support, we designed an effort to ease away from the rigidity of Phase II. Phase III of the wage and price controls was announced by the President on January 11, 1973. The idea was to scale back the institutional complexity of the program and to rely more on voluntary cooperation by the private sector. This was partially in response to concerns from both labor and business. We knew that an initial burst of suppressed inflation was likely but then we expected a more settled period. At the time, the CPI was growing at an annual rate of 3.6 percent. The Price Commission and the Pay Boards were abolished in favor of “self-administration” by obligated parties – firms with sales exceeding \$250 million had to report quarterly profits and price changes to the Council, but advance clearances were no longer required. Price growth was again targeted for 2.5 percent annually, and firms could apply exceptions to themselves as needed to maintain adequate supply. Well-regarded labor relations economist John Dunlop was named director of the Cost of Living Council as Rumsfeld departed to serve as Ambassador to NATO.

Following the announcement, the stock market fell. The CPI annual growth rate began climbing and, during this six-month period, the US dollar depreciated by about 20-25 percent.

The real inflation growth was there all along. Phase III just allowed enough freedom for the published rate to reflect the built-up pressure of one and a half years of controls along with concurrent international inflation, especially in traded energy and food commodities. In August 1971, Milton Friedman had written in *Newsweek*: “How will it end? Sooner or later, and the sooner the better, it will end as all previous attempts to freeze prices and wages have ended, from the time of the Roman emperor Diocletian to the present, in utter failure and the emergence into the open of the suppressed inflation.”

Herb Stein, Chairman of the Council of Economic Advisors, in a press conference on April 23, 1973, said, “The ... danger was that, in the light of this rapid surge of inflation, we would make moves on the policy side which were, in the long run, very undesirable, and I think the main danger there was that we would move to a rigorous and comprehensive form of wage and price controls again.”

A little later, Herb and I were meeting with the President, arguing against returning to a control regime. Herb, remembering the popularity of the initial controls, said, “Mr. President, you can’t walk on water twice.” The President replied, “Herb, you an if it’s frozen.”

Facing public outcry and political pressure, President Nixon re-imposed price controls in June 1973 through a new sixty-day freeze, beginning Phase IV of the program, while simultaneously warning the American public against becoming addicted to the tool. Wages were not frozen.

I told the President that I agreed that the re-imposition of controls was his call but that I was strongly opposed, as he knew. I pointed out that the administration of controls fell to me as Secretary of the Treasury. Under

those circumstances, I told him that he should find himself a new Secretary of the Treasury.

President Nixon accepted that reality but asked me to stay on for a while longer since I was managing the US-Soviet Union economic relationship and the realignment of the exchange rate system that had been disrupted by closing the gold window. The leader of the Soviet Union, Leonid Brezhnev, was due to visit soon and the President said he needed my help on the economic side. He said that he also needed time to find a successor. I agreed to stay on to work on these fascinating areas of international work, and I finally resigned on May 8, 1974.

Meanwhile, the controls went on. Under Phase IV, the Cost of Living Council's administrative focus was on trying to induce supply expansion despite the price freeze and limits on exports, especially for food items. Agricultural goods were once again exempted, while wholesale and retail food prices were controlled, resulting in shortages. The price of oil was capped at \$4.25 per barrel (those were the days!) and scheduled to gradually rise over six months towards the world price (a plan disrupted by the Arab oil boycott, which sent up global prices faster than the US domestic oil prices were rising to meet them). Faced with these disruptions, and poor public reaction, this second freeze was ended early by the President after just 35 days. Further price controls were gradually scaled back from covering 44 percent of CPI prices in August 1973 to just 12 percent of CPI prices by their end in April 1974.

But the controls – or the threat of their re-imposition – never stopped. Not six months after allowing the Cost of Living Council to dissolve in the spring of 1974, Congress reversed itself in August by granting a request from President Ford to establish a Council on Wage and Price Stability,

which lasted until President Reagan took office. Also, remember President Jimmy Carter's lines at the gas stations! What you control, you get less of.

I returned to government with Ronald Reagan in January 1981. I served as Chairman of the Economic Advisory Panels during the primaries, the campaign, and the Reagan administration before I became Secretary of State in July of 1982.

When I returned to government, I found high inflation, an economy going nowhere, and the Cold War as cold as it could get. The President and I knew that you couldn't have a decent economy without getting control of inflation. Paul Volcker was Chairman of the Federal Reserve. I knew him well and admired him. He had been my Under Secretary when I was Secretary of the Treasury. He was doing what needed to be done by controlling the money supply. People kept running into the Oval Office saying, "Mr. President, he is going to cause a recession, and we're going to lose in the mid-term elections," but the President smiled and put a political umbrella over Volcker so he could do what needed to be done.

By the end of 1982, inflation was under control and everyone could see it was going to stay that way. The marginal rate of taxation, having been reduced by Presidents Kennedy and Johnson from 90 percent to 70 percent, was brought down to 50 percent by Reagan. He killed off the last remnants of the controls. In 1983, the economy took off like a bird. So, economic expansion without inflation took place through orthodox methods. Control the money supply, get inflation, regulation, and taxation under control, and you can have a good economy. Reagan had been part of a needed strategic view that took a short-term hit to gain long-term health in the American economy. He, in effect, implemented "Steady as You Go." I have always



felt this was his finest hour in domestic policy and it contributed to my high estimation of the way he understood the presidency.

What can we learn from this extraordinary episode in the 1970s? First, the political process can easily create a demand to “do something” about important problems. The ability to stay the course on a strategic policy comes under great pressure. You might say that the politician’s dream is the economist’s nightmare.

Second, you learn that the heavy regulatory process, as in wage and price controls, can stifle these movements for a time, but what is stifled bursts back. In the meantime, the controls lay a heavy hand on the economy, despite an expansionary monetary policy.

Third, an easy monetary policy will produce inflation, so the Federal Reserve must not be misled into thinking that wage and price controls can relieve the Fed of its duty to fight inflation.

Fourth, all this means that orthodox commonsense policies, that are known to have worked, need support. For the Fed, that means, it seems to me, that they need a public statement of their strategy (call it a rule – even a Taylor Rule) from which they deviate only after a full explanation of why. The burden of proof should be on the deviation.

I emerged from this trial scarred but optimistic that the lessons learned from it would help avoid mistakes in the future. Remember: you get less of what you control. As Milton Friedman (himself quoting Edmund Burke) said of wage and price controls, “That is one of those ‘very plausible schemes ... with very pleasing commencements [that] have often shameful and lamentable conclusions.’” Indeed, dreams can be nightmares.