1

Think Long

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The effort to think long, to think ahead, to consider future consequences, is especially important at a time of crisis when attention is understandably focused on the immediate. Further, I believe that the effectiveness of immediate measures is substantially improved when people can see that long-term issues are being kept in mind and dealt with sensibly. My plan here is to say a few words about one of the problems and one of the possibilities that come to mind when you think long.

History doesn't repeat itself in any precise way, but it is nevertheless worthwhile to take a look back to see what sort of trends and what sort of relationships seem to assert themselves. When you're thinking about the Fed, the best way to start is to consult Volume 1 of Allan Meltzer's magisterial *History of the Federal Reserve*, which takes us up to 1951. (I eagerly await his forthcoming Volume 2.) That was the year of the Accord, and the history of the prior ten years is instructive.

During World War II, the country was mobilized and motivated to win the war. Federal spending and the federal deficit soared. The Federal Reserve had the job of seeing to it that all Treasury issues succeeded at the pegged 2.5 percent rate and that they stayed successful. To put it another way, the Fed helped the Treasury finance the war by creating the money necessary to see that the Treasury could sell its bonds. The inflationary impact was presumably dealt with by very high marginal rates of taxation (over 90 percent) and wage and price controls. So here we see the interplay of inflation, tax rates, and controls as a consequence of persistent high deficits, with the Fed acting as the Treasury's financier.

After the war, the controls were dropped, but the Fed continued its role as maintainer of the 2.5 percent peg. As the economy expanded vigorously, members of the Federal Reserve Board became restive. President Harry Truman felt that it was wrong to let interest rates rise and reduce the value of bonds purchased during the war. Secretary of the Treasury John Snyder apparently thought that changes in interest rates would, in any case, be ineffective in controlling inflation and advocated a return to wage, price, and credit controls. Differences over policy and other issues led to a January 17, 1951, meeting of Chairman of the Fed Thomas McCabe, Secretary of the Treasury Snyder, and President Truman, after which Snyder gave a speech reaffirming the 2.5 percent peg. This was not the position of many Federal Reserve members, and even supporters of the peg grew uncomfortable with the Treasury's overbearance. Feelings apparently ran high. Here is one commentary printed by the *New York Times* and quoted in Meltzer's book:

> In the opinion of this writer, last Thursday constituted the first occasion in history on which the head of the Exchequer of a great nation had either the effrontery or the ineptitude, or both, to deliver a public address in which he has so far usurped the function of the central bank as to tell the country what kind of monetary policy it was going to be subjected to. For the moment at least, the fact that the policy enunciated by Mr. Snyder was, as usual, thoroughly unsound and inflationary, was overshadowed by the historical dimensions of his impertinence.

All this led to an unprecedented January 31 meeting of the full Fed Open Market Committee with the president in the White House. Although the outcome of the meeting was apparently ambiguous, the Treasury reported that the "Federal Reserve Board has pledged its support to President Truman to maintain the stability of government securities as long as the emergency lasts," which was later clarified by the Treasury as maintaining the 2.5 percent peg.

As Meltzer explains the tensions of the times, "These efforts to force the system to remain subservient accomplished in a few days what most of the members had been unwilling to consider in the previous five and a half years. The Treasury had lied publicly. In the words of Allan Sproul, president of the Federal Reserve Bank from 1941 to 1956, 'publicity concerning yesterday's meeting with the President . . . doesn't accord with the facts.'"

So acrimony put backbone into the Fed, and William McChesney Martin, then in the Treasury and soon to be chairman of the Fed, took over the Treasury end of the negotiations. The eventual result was the Accord, announced on March 4, 1951.

The Fed would withdraw support for the pegged rate and regain control of an independent monetary policy.

Or at least so it seemed. Little noticed was an apparent agreement—the Even Keel—for the Fed to support the Treasury market for a few weeks before and after any Treasury issue. This apparently soft understanding was firmed up by President Lyndon Johnson when financial pressures once again rose as he confronted the necessity to fund simultaneously the Vietnam War and the Great Society programs.

This bit of history shows, among other things, how difficult it is for the Fed to disengage, to be in fact an independent monetary authority, once the Fed has become thoroughly entangled in Treasury operations.

Enter Richard Nixon, Arthur Burns, and John Connally in a drama in which I had a bit part and a ringside seat. There had been a drumbeat of talk in the latter years of the Johnson administration of guidelines for wage and price changes. Conceptually, this was a clear precursor to wage and price controls. With a colleague at The University of Chicago, Robert Aliber, I put together a conference on the subject of informal controls in the marketplace. We had many great papers and lots of good discussion. Milton Friedman led off on the price of guideposts, and Bob Solow followed with "The Case against the Case against the Guideposts." Gardner Ackley weighed in, as did many others, including Allan Meltzer. In a fascinating comment, Milton Friedman said,

> In my opinion, the most serious logical fallacy underlying the analysis of cost-push inflation in the guideposts is the confusion of nominal magnitudes with real magnitudes—of dollars with real quantities or what a dollar will buy. This fallacy is

> very deep and affects a great many current views. The basic fallacy is to suppose that there is a trade-off between inflation and employment; that is, to suppose that, by inflating more over any long period of time, you can have on the average a lower level of unemployment. This is the notion underlying the desire to maintain a great deal of pressure on aggregate demand and, when you want to avoid the symptoms of inflation, to try to suppress them by guideposts, guidelines, and the like.

That was Milton's first written exposition of his famous devastating critique of the Phillips curve, later delivered as his presidential address to the American Economic Association.

Against the background of this work at the university, I found myself, as the director of the newly formed Office of Management and Budget, worried about possible reactions to potential inflation and arguing with my friend, the awesome Arthur Burns. He was a great fan of guideposts. I gave a talk entitled "Steady as You Go," arguing that we had the budget under control and that with sensible monetary policies and a little patience, inflation would recede. (In light of subsequent events, I later coined the phrase, "An economist's lag is a politician's nightmare.") In fact, inflation was starting to drift down from a high of around 6 percent. In came John Connally, the handsome Texas activist who said, "I can sell it round or I can sell it flat." The business community weighed in with its fear of wage-price inflation caused by wage increases demanded by strong unions. Somehow, many business leaders seemed to feel that they could have wage controls without price controls. Can you believe that? Only when you hear it yourself.

Along came the collapse of a main pillar of the Bretton Woods system, as the United States could not maintain the promise to exchange gold for dollars at $35 an ounce. With a run on Fort Knox in prospect, the gold window was closed, which had inflationary implications, though overrated since our imports at that time were only 5.4 percent of GDP. The Democratic Congress had passed legislation authorizing—practically daring—President Richard Nixon to impose wage and price controls. Secretary Connally, under those circumstances, easily sold the president on wage and price controls as necessary to deal with the threat of inflation. Once again, as in World War II, the belief was that inflation could be contained by controls, so monetary policy could be eased. And it was, laying the basis for the inflation of the latter part of the 1970s. So once again, we saw the interplay of easy money, inflation, and controls.

With heroic efforts by Paul Volcker as chairman of the Fed operating under the umbrella of Ronald Reagan's political protection, inflation was brought under control by 1982 but with the cost of a tough recession. Reagan ended controls on the price of crude oil immediately on taking office. The marginal rate of taxation was brought down from 70 percent to 50 percent and then, in the bipartisan 1986 Tax Act, to 28 percent. Alan Greenspan, Volcker's successor as chairman of the Fed, effectively reinforced Volcker's heroic efforts. There ensued a quarter century of reasonable economic growth without inflation.

Now here we are again. We have a recession on our hands. Fiscal and monetary policies starting in the last months of the Bush administration and accelerating with the Obama administration have been moving into unprecedented terrain. Federal government spending has moved from a recent history of around 20 percent of GDP to an estimated 28.5 percent in fiscal 2009. The deficit, even as optimistically forecast by the administration in the out-years, is in unsustainable territory, and federal spending remains well in excess of the historic 20 percent level. The Federal Reserve has brought the federal funds rate down to zero and has been extending credit in unprecedented ways. By this time, the Fed has expanded the monetary base by 80 percent in the last six months, an astronomical yearly rate of increase. And its portfolio is increasingly made up of privately generated assets, acquired because their unknown and questionable value made them a drag on the operations of the private organizations that generated them in the first place.

On February 10, Secretary of the Treasury Timothy Geithner announced that

> Working jointly with the Federal Reserve, we are prepared to commit up to a trillion dollars to support a Consumer and Business Lending Initiative. This initiative will kick start the secondary lending markets to bring down borrowing costs and to help get credit flowing again . . .This lending program will be built on the Federal Reserve's Term Asset Backed Securities Loan Facility, announced last November, with capital from the Treasury and financing from the Federal Reserve.

This looks like a Treasury initiative to commit the Fed to a trillion dollars of federal spending, or perhaps the Treasury will put up one-tenth of the money from the Troubled Asset Relief Program.

The authorities seem to be a little uneasy about their legal authority; in a press release on March 3, the Board of Governors of the Federal Reserve System announced that "Treasury and the Federal Reserve will seek legislation to give the Federal Reserve the additional tools it will need to enable it to manage the level of reserves while providing the funding necessary for the TALF and for other key credit-easing programs."

And then comes the announcement on March 18 that the Fed will purchase up to $300 billion in long-term Treasury securities. As observed by Krishna Guha in the March 19 *Financial Times*, "Once this scheme is fully implemented, its [the Fed's] balance sheet could approach $4,000 billion—nearly a third of the size of the U.S. economy. A swollen Fed balance sheet runs the risk that the U.S. central bank may find it difficult to manage down the money supply when the economy turns, raising the possibility of inflation."

Observing this process, the question comes forcefully at you: Has the Accord gone down the drain? And remember how difficult it was for the Fed to disentangle itself from the Treasury in the post-World War II period.

If you're trying to think ahead and worry about consequences, you have to be concerned about the potential for inflation generated by these huge changes in the money supply and the imbalance in the federal budget. Marginal tax rates are now scheduled to rise, as are rates of taxation on dividends and capital gains.

Will controls be in our future? Who knows? We have a start with executive compensation and with prices and pay in the health industry. But I'm struck by a phrase used by my friend Allan Meltzer in a recent phone conversation. He said, "It's a race between the inflation rate, the tax rate, and controls, and all three are going to win."

The purpose of thinking long is, among other things, to identify potential undesirable consequences and focus on the positive possibilities.

So here is one positive possibility. Much has been made for some years now about the potential problems created by the large international imbalances in trade and payments. As is well known, we have seen a period where high-savings countries have maintained their economies by a large surplus of exports over imports. Meanwhile, other economies, principally the United States, have not saved enough to finance their own investments, so savings have come from abroad, with a counterpart of large excesses in imports over exports. The current economic downturn has shown the validity of the worries about these large, insistent imbalances. Suddenly, in particular the countries that have counted on large exports find their economies hard hit when that possibility diminishes.

Right now, household saving rates in the United States are finally on the rise, having recently gotten up to around 5 percent (the feel of the situation suggests that the number is now higher). This is still one-half or so the rate of saving as recently as the early 1980s. At some point, the world will come out of the current gloomy phase; when that happens, I believe it will be desirable to have greater balance in the new picture. When the United States saves enough to finance its own investment, a more or less balanced trade account will result. Obviously, this means major adjustments elsewhere. That, to my way of thinking, should be a principal item of substance on the international agenda. What it implies for the United States is to welcome the rise in the rate of saving and to match it by drawing down the high degree of dissaving now in prospect in the federal budget.

So, once again, the purpose of thinking long is, among other things, to identify potential undesirable consequences and to think about positive possibilities. I have tried to identify one of each. That is my job here. The job of the rest of this book is to figure out how to avoid the undesirable consequences and capitalize on the positive possibilities.