Helping a Great Economist: Arthur Burns

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It is a tenet of the GEM Project that professional greatness is not limited to making important contributions to economic theory. Economist policymakers whose experience and skill, especially in crisis, have substantially enhanced our collective well-being are included in the Blog's Helping-Hand series. An earlier post featured my friend Ben Bernanke, who was Chairman of the Board of Governors of the Federal Reserve during the extreme instability that was organizing itself in 2008-09. He was the architect of and principal force behind the central bank's bold and creative aggregate-demand policies that prevented a second, and much worse, Great Depression. In that post, I argued that Bernanke ranks with the likes of George Marshall in the pantheon of U.S. civil servants.

Joining Ben is a more surprising selection. I believe that an earlier Chairman of the Federal Reserve also deserves recognition for exceptional skill and experience in a very difficult time. Arthur Burns insightfully managed 1970s stagflation instability, the 20th-century's second most debilitating macro crisis, that seriously risked collapse into a second Great Depression.

<u>Burns's Great Contribution</u>

In the circumstances of the 1970s stagflation, mainstream market-centric general-equilibrium advice to central bankers was then (and remains today) to aggressively pursue the single goal of low, stable product-price inflation, laser-focused on asserting their anti-inflation credibility. In arguing that little else matters, the macro academy implicitly promises that the whatever-it-takes use of tight credit will quickly break any price-wage-price spiral, short-circuiting the damaging macrodynamics experienced during the stagflation decade. The wrong-headiness of that policy prescription reveals a great deal about the fatal flaws in the macro academy's consensus thinking about how highly specialized economies actually work.

How investors assessed the Fed's credibility with respect to its trend full-employment, not low inflation, objective is what worried Arthur Burns in the stagflation crisis. He understood that an all-out credit-tightening war on the structural 1970s price-wage-price spiral unacceptably risked a loss of its real-side credibility and a consequent nonstationary collapse of total spending – the precursor to depression. Instead, he pursued a more measured policy that allowed substantial, albeit gradually decreasing, inflation to coexist with high, but also gradually decreasing, unemployment. Time was needed for the structural consequences of the early 1970s labor-adverse shifts in the terms of trade played out.

I know what Burns was trying to do. I was there, supervising the economists charged with figuring out the economics of stagflation and what the Fed could and should do about it. It says something important that Burns intuitively figured out what the GEM Project rigorously modeled decades later. Perhaps most significant, he understood what the soon-to-become-mainstream neoclassical theorists were advising him to do – quickly achieve the single objective of low, stable price inflation – was dangerously wrong. The 1970's price-wage-price spiral was the product rational behavior that was much more deeply rooted than Lucas and the other neoclassical macro theorists realized. Attempting to stop the spiral in its tracks would have required a huge squeeze on total spending and employment, output, and income, putting the credibility of the Fed's real-side objective at great risk.

<u>GEM Helping Hand</u>

The GEM Project's analysis of nonstationary demand contractions strongly indicates that Burns' much maligned caution helped prevent a 1970s depression. His approach in the face of intense criticism was heroic, although he probably would have admitted that it did not require super smarts to reject policy advice from a general-market-equilibrium model class that cannot accommodate involuntary job loss. What kind of unemployment did the academic critics, with their reliance on job search/match modeling, think was being produced during the stagflation decade? Did they really think that higher joblessness resulted from an onset of millions of voluntary quits from rent-paying jobs?

The GEM Project's extreme-instability model, making sense out of the macrodynamics of nonstationary demand collapse, demonstrates the centrality of investor perceptions of trend real-side credibility of stabilization authorities, denoted by $\acute{C}$. (For elaboration, see the website's e-book, Chapters 4 and 10.) Such perceptions are shown to mediates the relative influence of economic fundamentals and investor confidence in the determination of asset prices and total spending. Burns' extraordinary business-cycle experience, including the 1930s debacle, enabled his intuitive identification of the criticality of $\acute{C}$, fueling his resolve not to push recessions too far. He did not need the GEM rational-behavior model of extreme instability to understand that reducing structural inflation caused by the 1970s price-wage-price spiral was not a short-term problem. The model, however, is critical to correcting the badly off-base mainstream NK assessment of Burns's performance.

Is the Game Worth the Candle?

GEM rational-behavior model of extreme instability, rooted in optimization and equilibrium, rejects the mainstream NK assessment of Burns's policymaking. Farmer (2010b, p.60) can be used to reiterate the today's mainstream explanation of the stagnation decade: "During the 1970s, the U.S. economy experienced high inflation and high unemployment at the same time and the data did not lie anywhere near the [original Keynesian] Phillips curve…. The Phillips curve broke down because firms and workers began to increase wages and prices in an inflationary spiral. Wages went up because workers believed that prices would rise. Prices went up because higher wages were passed on to consumers." Macroeconomists today broadly accept that the engine of the 1970s stagflation was the un-anchoring of workers' anticipations of inflation, implying that the cause of the wage-price spiral and high unemployment was a less-than-credible monetary-authority commitment to low inflation. The NK message is that robust central-bank nominal credibility would have prevented the welfare loss that resulted from stagflation-decade instability. It would then follow that Burns' policy of paying attention to the credibility of the Fed's commitment to trend full employment was then and is today wrong.

That conclusion of NK theorists is not only incorrect but remains today one of the mainstream academy's most serious of decades of errors. The generalized-exchange model class not only rescues Arthur Burns's reputation, providing credit where it is long overdue, it obliterates a mainstream argument for the adequacy of a single (low-inflation) objective for the central bank. Given that context, this game is certainly worth the candle.

The cumulative score of the Helping-Hand game: Worth it: 13 (Lewis, Solow, Harris-Todaro, Bernanke, Lucas, Samuelson, Kerr *et al*, Okun, Hicks, Sraffa, Hayek, Keynes, Burns). Not worth it: 0.

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