The economic troubles of Richard Nixon and Donald Trump (second part)

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Last week I published the first part of this note comparing the international dimensions of the Nixon and Trump administrations, arguing that Nixon calling off the Bretton Woods system via dollar devaluation may be seen as equivalent to the Trump administration potentially ending the Great Moderation.

This second part focuses on some policy issues related to the fact that in both cases a key policymaker, John Connally (Secretary of the Treasury under Nixon) and Janet Yellen (Fed chairwoman under Trump), is a Democrat, whereas the incumbent president is of Republican affiliation.

Beyond the obvious fact that this division in partisanship adds to the confusion about the overall direction of policy (right-wing pro-finance versus left-wing pro-employment, in an overly-simplistic framework), this may create or further exacerbate conflicts when it comes to policy objectives.

Indeed if their policy objectives differ, the two key macroeconomic policy-making bodies (the Fed and the Treasury) may enter in a power struggle and the objectives of the dominant body prevails over those of the weaker one. This clearly has important consequences for employment, growth, exchange rate parities and the world economic order.

Janet Yellen's first term comes to an end early next year. For those of us who understand the social and economic consequences of unemployment, an important concern is the fact that, if she is not reappointed, this could mean the end of the recovery from the anti-inflationary regime we are getting out of. Moreover, if her replacement is hawkish and partisan (as for instance Alan Greenspan), the recovery may be rather short-lived and unemployment may again be a problem after 2017.

The Treasury and the Fed, some elements of their ~~long term~~ history together

The U.S. Treasury is one of the oldest policy-making bodies of that country. Created in 1789, "the Secretary is responsible for recommending and implementing U.S. domestic and international economic and fiscal policy; governing the fiscal operations of the U.S. government; maintaining foreign assets control; managing the federal debt; collecting income and excise taxes;

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representing the United States on international monetary, trade, and investment issues; overseeing Departmental overseas operations; and directing the manufacture of coins, currency, and other products for customer agencies and the public" (Department of the Treasury, 2015 p. 55).

Moreover, its mission is to "[m]aintain a strong economy and create economic and job opportunities by promoting conditions that enable economic growth and stability at home and abroad; strengthen national security by combating threats and protecting the integrity of the financial system; and manage the U.S. government's finances and resources effectively" (*ibid*).

To summarize, the Treasury is globally in charge of conducting *fiscal policy* and its main objective is to promote economic growth and guarantee maximum employment with the aid of other government bodies whose leaders are often elected officials.

Banking in the United States dates back to the late eighteenth century. Despite a first attempt in 1791 by then secretary of the Treasury Alexander Hamilton to create a Central Bank, a second attempt in the early nineteenth century sabotaged by Andrew Jackson's administration, a National Banking Act in plain Civil War, and several panics and crashes, the Federal Reserve system was created 1913 (124 years after the Treasury).

The Federal Reserve (who is in charge of conducting *monetary policy* along with the FOMC) has a dual mandate of guaranteeing price stability and maximum sustainable employment. However, price stability (often *mis*understood as low stable inflation) is hardly achievable simultaneously with low unemployment. This inflation-unemployment trade-off is known as the Phillips curve.

Over time, some Fed chairs have been more successful than others at achieving price stability (their main goal nowadays), but this depends rather on whether the corresponding chair has a realistic view of how the economy works. This is the main thrust of Christina and Paul Romer, who argue that "[w]hen a realistic model of how the economy works and what monetary policy can accomplish prevailed within the FOMC, as in the 1950s and the 1980s and beyond, policy was appropriate and macroeconomic outcomes were desirable" (Romer and Romer, 2004, p. 158).

This statement is strong for at least two reasons[1]. First, by placing too much weight on the authority in charge of monetary policy (particularly on the incumbent Fed chair) it ignores the role and importance of the fiscal authority. Second, the article does not give any weight whatsoever to the international economic context for each Fed chair tenure. Thus, by giving importance *mainly* to the model of the Fed chair, it undermines other factors that may have played an important role in determining the Phillips curve and the power struggle for policy objectives between the Fed (price stability) and the Treasury (employment and growth).

[1] A third reason why this statement is strong is because the authors consider that since the 1980s macroeconomic outcomes were desirable. I have argued otherwise on a previous note.

Some conflicts of interest between fiscal and monetary policymakers

In 1945 a Full Employment Bill was passed, in which it was specifically specified that "All Americans ... are entitled to an opportunity for useful, remunerative, regular and full-time employment ... To that end, the Federal Government shall ... provide such volume of Federal investment and expenditure as may be needed" (Santoni, 1986, p. 12).

This bill was amended and passed the next year as the Employment Act of 1946. In it, it was specified that "[t]he Congress hereby declares that it is the continuing policy and responsibility of the Federal Government ... to promote maximum employment, production and purchasing power" (*ibid*), thereby constraining the Government's ability to spend at will and, as a consequence, limiting the Treasury's capacity to run budget deficits to promote employment.

This power constraint in itself is not bad. On the contrary, as long as the ability of a government body to do anything it pleases is limited, democracy may still work properly. This was the logic, thirty years later, of James Buchanan's Nobel lecture, that reminded economists and policymakers of the dangers of excessive deficit-financed public expenditure. Buchanan's message seems to legitimize the small government doctrine (also encouraged by the Reagan administration), but certainly other ideas complementary to this doctrine made their way decades before.

In the late 1970s there was a period of stagflation: the theoretical inflation-unemployment trade-off didn't occur, and there was both high inflation and high unemployment. Alan Blinder and Jeremy Rudd (2008) argue that the Great Stagflation of this period may be explained as a supply shock, therefore suggesting that if no drastic measures taken by the Fed and the FOMC in late 1979 were taken, inflation would have gone away 'by itself'.

Nonetheless, inflation did not go away by itself. It was ended abruptly by Fed chairman Paul Volcker[2]. But this would not have been possible if Congress hadn't given more weight to the inflationary pressures of the period than to the unemployment problem. With this green light granted, the inflation dragon was slain... and the Fed's main policy objective prevailed over that of the Treasury. Even more, the Fed's independence was enhanced since then.

By the time the Nixon administration was planning on closing the gold window, Richard Nixon appointed John Connally (former governor of Texas) Secretary of the Treasury. In the words of then undersecretary Paul Volcker (also a Democrat, at least back then) "[n]one of us in the Treasury knew Connally ... He was a Democrat but plainly not a despised Establishment liberal, and the president was attracted by his vibrant, forceful personality, as many of us were later" (Volcker and Gyohten, 1992, p. 71-72).

Connally's job back then may have been one of the toughest ones in political negotiations, for it mainly consisted in reassuring financial markets in times of strong financial distress (due to the devaluation of the dollar). Moreover, despite Nixon's rather standard "small government" campaign in 1968, financial markets weren't reassured. Neither Nixon nor Connally were solely

[2]Of course, a single person is incapable of achieving such a gigantic task by her/himself or simply with actions; an ideological mindset had to back up the then new economic policies. This issue will be dealt with in another note.

responsible for this. What mattered most back then was the international economic context (i.e. Bretton Woods).

Now that the balance of power between fiscal and monetary policy is on the monetary side, the Fed's dual mandate is apparently turning away from favoring low inflation and now seems to be giving more weight to employment. This long disinflation cycle is apparently reaching its end, but such end does not happen overnight. The unemployment rate has been consistently falling since 2010, and this was thanks in part to Bernanke's Fed, which was given continuation by Janet Yellen. However, if she is not reappointed next year (and the aggressiveness of the Trump administration suggests this will not happen) a full recovery may not take place in the years to come.

References

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