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Cancel the Council?

Regardless of its members' professional views, and no matter how economically wrongheaded, the prescriptions of the Council of Economic Advisors throughout its 50-year history have mirrored the preferences of the President. If it cannot dispense genuinely independent advice, the CEA deserves to go.

Next year marks the 50th anniversary of the Council of Economic Advisors (CEA). This group of economists (three members and a staff of two dozen or so) was established under the Employment Act of 1946. This legislation made it the express responsibility of the Federal Government to maximize nationwide employment, economic growth, and purchasing power. Many members of the current Congress want the CEA eliminated, not just to save money (the CEA costs "only" about $4 million), but to abolish a useless relic of an age of overweening government, central planning, and the belief that politicians and bureaucrats somehow know what is best for every one else.

The prospect of terminating the CEA has sparked a curious debate. Iowa Rep. Jim Ross Lightfoot, who voted to kill the CEA, quipped that the White House "can subscribe to the *Kiplinger Letter*."[1] But the CEA's possible demise has been no laughing matter for most Democrats or the "mainstream" economic establishment. Murray Weidenbaum, a past chairman of the CEA, intoned, "you need someone at the table to advise the president from a viewpoint that is not parochial."[2] Michael Boskin, CEA head under Bush, believes CEA economists "bring a freshness that is free of institutional bias."[3] And former CEA head under Clinton, Laura Tyson (now head of the National Economic Council), says "eliminating the CEA is a short-sighted and ill-advised blow to good government."[4] The notion seems to be that the CEA's demise would place the Republic at risk.

The most vigorous defense of the CEA has come from Harvard professor Martin Feldstein. It is worth investigating his assertions in the light of experience. His defense is based in part on the belief that government finances are too important to be left to the politicians. "Economists inside government and out," Feldstein argues, "have been among the leaders in recognizing the adverse effects of budget deficits and in advocating deficit reduction …"[5] But the national debt quadrupled under Ronald Reagan, the president Feldstein served when he headed the CEA.

With regard to regulation, Feldstein asserts that "the CEA is an important barrier to bad legislation" and "killing the CEA would eliminate a strong voice for deregulation." Yet regulatory spending by Federal agencies increased from $4 billion in 1970 to $16 billion in 1994.[6] Over the same period, the number of pages of regulations in the *Federal Register* more than tripled from about 20,000 to 70,000.[7] Thomas Hopkins, an economist at Rochester Institute of Technology, calculates that the cost to business of regulations on health, safety, and the environment alone have skyrocketed from $40 billion in the late 1970s to over $200 billion today.[8] Despite this cascade of controls, some commentators insist that "Council economists, liberal and conservative, have manned the battlements against ill-justified interference with free markets."[9]

In short, experience has shown that the CEA either has favored these controls or has been powerless to stop them. Once the controls were in place, the CEA's principal role has been to referee disputes between regulatory agencies. Michael Boskin, for example, now defends the CEA as a vehicle for settling differences between the Energy Department and the EPA — two agencies that did not even exist before 1970 — and that were established, as far as we are aware, without any opposition from the CEA.

The Heirs of Adam Smith?

More sweepingly, Feldstein contends that "economists are generally intellectual descendants of Adam Smith who embrace his view that free markets are the best way to organize economic activity. Economists instinctively dislike government regulation and price controls."

Oh, that it were so. Feldstein's characterization is more apt for economists of an earlier time, when government simply was not interfering with the range and depth of economic activity that it is today. For example, the President did not need to be advised on how to "fine tune" monetary or fiscal policy when there was no central bank and government taxing and spending was a small portion of output. There was little need to appraise the effects of regulations when executive cabinet agencies were limited to Treasury, Defense, State, and Justice. Yet the United States enjoyed rapid growth in personal income, as well as in savings and business investment, with a sound financial system and no budget deficits (except during war).

Instead of trying to understand how the United States could have flourished without leviathan government for so long, many economic historians today prefer to deny that it did so. The sad fact is that most economists today have been heavily influenced by John Maynard Keynes, and others who focus on the "failures" of the market process rather than its successes.

Such analysts seldom recommend addressing the fundamental causes of the problems they identify, they prescribe various palliatives instead. For example, chronic price inflation, which is the result of officially sponsored inflating of fiat currency, has been attributed to greedy producers or to "shocks" (such as crop failures or oil embargoes) — with wage and price controls as the cure. Problems such as unemployment or low farm incomes are addressed with "income maintenance" programs that perpetuate the condition instead of allowing markets to clear. Inadequate savings and investment are to be boosted with "targeted" tax breaks that make otherwise uneconomic projects attractive at the expense of more useful alternatives and leave intact oppressive regulations and punitive taxation of thrift that curtail capital formation (*e.g.*, taxing the portion of interest income that merely compensates for the degradation of the dollar, taxing inflation-induced capital gains, and taxing corporate profits as they are earned and again when paid out as dividends).

Since it was first established, the CEA's advice has been decidedly interventionist. While Feldstein believes that the CEA is needed to address such problems as slow

growth of personal income, budget deficits, a low rate of saving and business investment, a falling dollar, and a shaky financial system, etc., such problems can best be attributed to the prevailing Keynesian and interventionist advice of our time.

Nevertheless, Professor Feldstein is essentially correct in one regard: economists in general *are* more likely to appreciate the market process than noneconomists. The problem lies with the politicians. Herbert Hoover, with his background as a mining engineer and Secretary of Commerce, was one of the few Presidents to claim an understanding of economics. But he rejected the pleas of the profession (expressed in a public letter signed by more than 100 top economists) to veto the Smoot-Hawley tariff. During the depression that followed, Presidents Hoover and Roosevelt followed policies designed to keep wages elevated (thereby exacerbating unemployment) and devaluing the dollar (thereby stoking inflation).

Ever since the 1930s, a growing retinue of Keynesian advisors who speak of "market-failure" and government "fine-tuning" have been well-received by the politicians, but for statist, not scientific, reasons. According to one former CEA head, "Keynes provided an explanation for the persistence of a long depression," but "whether the particular assumptions he made were true in the 1930s, or were ever likely to be true, was not demonstrated then or since. This did not diminish the appeal of the theory. Keynes had advanced a theory which, if correct, would fill the logical holes in the most naive view of what was causing the depression.… It provided a rationalization for what the government was doing and found easiest to do — namely to spend more money. It had its attractions even for some conservatives …"[10]

Since then, Keynesian theory and policy have been adopted in some form by Republicans and Democrats alike. The problem, in short, is not that economists have nothing useful to say, but that the politicians will only listen to what they want to hear. They did so long before there was a CEA, and afterwards as well.

Having a CEA appointed by the President does little to ensure that the President will receive the "up-to-date professional expertise," and "independent analysis" that Feldstein seems to think he will. Advice that goes against the politicians' proclivities is most likely to be ignored. The alternative is to tailor the advice to suit the President. For example, Herbert Stein has written and said many sensible things before and after the 5 years that he served on Richard Nixon's CEA. But while he was on the CEA, the United States defaulted on the international gold exchange standard (1971), imposed mandatory wage and price controls (1971-74), and formed an array of new regulatory agencies. Stein was on hand to endorse such moves, to an extent that would hardly have been expected from an economist following Adam Smith. In fact, Stein agreed with Nixon, who said, "We are all Keynesians now."

In other words, there is scant evidence to support Feldstein's notion that the CEA is an island of detached impartiality amidst a turbulent political sea. "Eliminating the CEA," Feldstein insists, "would deny the current and future presidents the impartial and professional advice that can contribute to better economic policies and avoid bad ones." CEA economists, he argues, "are more likely to give the right advice than the bureaucrats, political advisors, and amateur economists that would fill the void if the CEA were eliminated."

When Feldstein himself was head of the CEA under Reagan and publicly criticized the deficits, he was asked to resign. Another presidential advisor interprets Feldstein's experience to mean that impartiality that ends in disagreement with the president "can only limit the influence of an economist and assure a premature exit from government service. Economists must recognize that in joining the senior ranks of an administration, they must sacrifice some of their freedom of action in their public pronouncements.… You must be prepared to support decisions with which you voiced your opposition during private deliberations or at least remain silent."[11] In short, presidential economists must endorse the plan of the man they serve, or remain silent (thereby implicitly endorsing the plan), or else leave office.

As one survey of policy advice concludes, "economists tend to view their proper professional role in the governing process as that of experts separate from politics, value judgments, and other subjective and normative factors. However, this view has not held up well in the light of experience."[12]

Jobs for the Boys and Girls

The CEA also has been defended as a kind of field laboratory for academic economists. According to Feldstein, "the economic staffers [at the CEA] are generally bright young academics who come to Washington for one or two years on leave from their universities. This is … a source of fresh ideas, of up-to-date professional expertise, and of independent analysis." To others, the CEA helps a profession that "accords its highest honors to theorists or ideologies and disdains hands-on experience" in economics. Without government service, it is said, theorists "would have much less of value to say, for example, about ways to contain inflation.…" Thus the CEA permits academics to "get their hands dirty" with on-the-job training in a laboratory where American producers, savers, and investors are guinea pigs. But if the theorists are ignorant of basics like inflation, how will the advisors advise?

On the other hand, some critics of the CEA deny that the agency is very harmful, because they believe it is simply irrelevant. In one study, Harvard economist Robert Barro finds no link between the academic stature of CEA chairmen and the economy's performance under their reign. But he did find that the economy improved most during the 13 or so months when the CEA position was left vacant, the most lengthy period being July 1984 to April 1985.[13] Economist Robert Lucas went further, suggesting that, because it legitimizes central planning, the CEA is actually harmful. "The Employment Act of 1946 placed heavy demands on the ability of economists to guide executive authority," he argues. "[Policymakers] have turned to a wide variety of complex, selective interventions in individual markets … simply reacting, sometimes well, sometimes badly, to current difficulties … They are accepting as given the entirely unproved hypothesis that the fine-tuning exercise called for by the Employment Act is a desirable and feasible one."[14]

Therein lies the best reason for canceling the council — not to save money, but to stop the on-the-job training of academic planners and to make a statement that the age of planning is officially dead.

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[1] Quoted in "House GOP Seeks Deep Cuts in Labor, Education, Threatening Clinton's Gains," *The Wall Street Journal*, July 12, 1995.

[2] Quoted in "House Panel Recommends Eliminating President's Team of Economic Advisors," *The Wall Street Journal*, June 2, 1995.

[3] Quoted in Peter Passell, "Will Presidents Miss a Few Economic Aides? Some Say Yes," *The New York Times*, June 29, 1995.

[4] Quoted in *The Wall Street Journal*, June 2, 1995, *op. cit.*

[5] Martin Feldstein, "Don't Shoot the Economic Messenger," *The Wall Street Journal*, June 28, 1995.

[6] "How (Not) to Cut Red Tape," *The Economist*, July 29, 1995.

[7] Milton Friedman, "Getting Back to Real Growth," *The Wall Street Journal*, August 1, 1995.

[8] "Can Republicans Fix It?," *The Economist*, March 11, 1995.

[9] Peter Passell, *op. cit.*

[10] Herbert Stein, *Presidential Economics: The Making of Economic Policy from Roosevelt to Reagan and Beyond*, 1984, p. 44.

[11] Stuart Eizenstat, "Economists and White House Decisions," *Journal of Economic Perspectives*, Summer 1992, p. 69.

[12] Robert H. Nelson, "The Economics Profession and the Making of Public Policy," *Journal of Economic Literature*, March 1987, pp. 49-50.

[13] Robert Barro, "Council of Economic Irrelevance," *The Wall Street Journal*, January 12, 1993.

[14] Robert Lucas, "Rules, Discretion, and the Role of the Economic Advisor," in *Studies in Business Cycle Theory*, 1981, pp. 258-259.

BUSINESS-CYCLE CONDITIONS

The economy is not out of the woods yet according to the latest batch of economic data. Although the deterioration among the leaders has slowed, a clear reversal in their downward trend is not yet evident. The economy may be past the point of maximum risk, but the potential for a recession still remains.

In our latest review of business-cycle conditions, two of the 12 primary leading indicators reached new cyclical highs, *contracts and orders for plant and equipment* and the *index of common stock prices*. Both reached new historical highs as well, and both are appraised as clearly expanding (these series and all other dollar denominated series are reported in constant dollars).

Due in part to increases in the amount of money flowing into money market mutual funds and small CDs, the *M2 money supply* is beginning to recover from its lackluster performance over the current expansion. We judged the recent increase, now 2 months in duration, sufficient to upgrade the series' cyclical status from probably contracting to indeterminate.

The base data for *new orders for consumer goods* increased in May and June, but the increases were slight and not indicative of a trend. *Initial claims for state unemployment insurance* (inverted) increased this month after declining for 5 consecutive months, but the 3-month moving average remains below its level 6 months ago. The base data for the *change in consumer installment debt* decreased in June, reversing the increase in May. The recent moves in these three series, which were appraised as cyclically indeterminate last month, were not sufficient to reveal identifiable trends, thus they remain appraised as indeterminate.

The 3-month moving average of the *average workweek in manufacturing*, appraised as indeterminate last month, decreased sharply in July. Thus, we changed the status of the series to probably contracting. This series is the only leader we downgraded this month — one indication that the recent deterioration in the leaders has slowed, if not yet reversed.

Three series remain appraised as probably contracting. The *change in sensitive materials prices* decreased in June, as the prices of metal scrap and other raw materials continue to fall or to increase less rapidly than a few months ago. Wastepaper prices continue to rise, corrugated wastepaper being the only exception. There was an uptick in the *index of new housing permits* in June, but it was not enough to warrant changing the series' status. The *ratio of manufacturing and trade sales to inventories* increased as both sales and inventories increased last month, but the increase in sales was slightly larger. Despite this increase, the 3-month moving average decreased for the fourth consecutive month and, based on past performance, it seems more probable that the series will continue to contract rather than recover.

Of the 12 primary leading indicators, two series have clear negative trends. The *M1 money supply* and *vendor performance* (the percentage of purchasing managers reporting slower deliveries from their suppliers), both appraised last month with clearly negative trends, decreased and remain appraised as clearly contracting this month.

Overall, because one series' appraisal was upgraded and another was downgraded, while all the rest remain the same, the percent of leaders expanding is unchanged from last month and remains at 25 (2 out of 8). The cyclical score, AIER's alternative measure of the leaders, fell this month from the 66 reported last month to 64. Despite the decrease, the cyclical score indicates that continued expansion still is statistically more probable than contraction. As with previous months, we are paying close attention to this series — before asserting the next recession is imminent, we will wait to see if it falls below the critical 50 point level.

The appraisals for all six of the primary roughly coincident indicators are unchanged from last month. Both *nonagricultural employment* and *gross domestic product* (GDP, quarterly) reached new cyclical highs and both remain appraised as clearly expanding. According to the Commerce Department's advance estimate, GDP growth slowed to an annual rate of half a percentage point in the second quarter. As revised data become available, this estimate is likely to change.

The base data and the moving average of the *index of industrial production* increased in June, but the series has yet to return to the peak it reached in February. Therefore, an upgrade in its status is not yet warranted and the series remains appraised as probably expanding.

Personal income in manufacturing, *manufacturing and trade sales*, and the *ratio of civilian employment to population* continue to show no apparent trend. Although the most recent monthly base data for all three series increased, only

Statistical Indicators of Business-Cycle Changes

Change in Base Data					Cyclical Status		
Apr.	*May*	*Jun.*	*Jul.*	***Primary Leading Indicators***	*Jun.*	*Jul.*	*Aug.*
–	–	–		M1 money supply	–	–	–
–	+	+		M2 money supply	–	?–?	?
–	+	–		Change in sensitive materials prices	?–?	?–?	?–?
–	+	+		New orders for consumer goods	?	?	?
–	+	+		Contracts and orders for plant and equipment	+	+	+
+	nc	+		Index of new housing permits	?–?	?–?	?–?
–	+			Ratio of manufacturing and trade sales to inventories	?	?–?	?–?
–	–	–	–	Vendor performance	?–?	–	–
+	+	+	+	Index of common stock prices (constant purchasing power)	+	+	+
–	–	+	–	Average workweek in manufacturing	?	?	?–?
–	–	+		Initial claims for unemployment insurance (inverted)	?	?	?
–	+	–		Change in consumer installment debt	?–?	?	?
				Percentage expanding cyclically	*25*	*25*	*25*
				Primary Roughly Coincident Indicators			
+	–	+	+	Nonagricultural employment	?+?	+	+
–	–	+		Index of industrial production	+	?+?	?+?
–	–	+		Personal income in manufacturing	?+?	?	?
–	+			Manufacturing and trade sales	+	?	?
–	–	+	+	Civilian employment to population ratio	?+?	?	?
+	+	+		Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	*100*	*100*	*100*
				Primary Lagging Indicators			
–	+	+	–	Average duration of unemployment (inverted)	?+?	+	+
+	+			Manufacturing and trade inventories	+	+	+
+	–	+		Commercial and industrial loans	+	+	+
+	+	+		Ratio of consumer installment debt to personal income	+	+	+
r+r	–	nc		Change in labor cost per unit of output, manufacturing	?+?	?+?	?
–	–	–	–	Composite of short-term interest rates	?	?	?–?
nc No change.		r Revised.		*Percentage expanding cyclically*	*100*	*100*	*80*

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

the moving average of the employment ratio increased. All three series are appraised as indeterminate.

Overall, 100 percent (3 out of 3) of the coinciders with an apparent cyclical trend are expanding. The most recent base data for all six series increased, indicating that the economy continued to expand going into the third quarter.

Four of the six primary lagging indicators posted new cyclical highs: the *average duration of unemployment* (inverted), *manufacturing and trade inventories*, *commercial and industrial loans*, and the *ratio of consumer installment debt to personal income*. Of these four series, only the average duration of unemployment decreased. All four are appraised as clearly expanding.

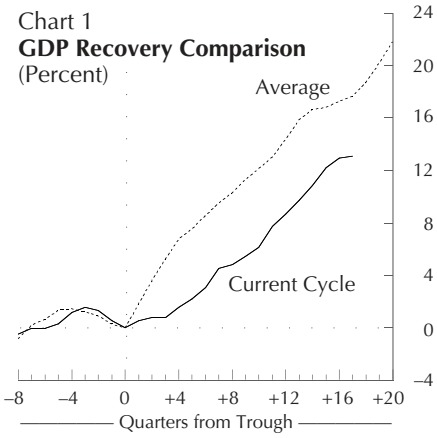
The statuses of the remaining two laggers were both downgraded this month. The *change in labor cost per unit of manufacturing output* decreased slightly. The accompanying decrease in the 2-month moving average raised enough doubt to warrant the downgrade of the series' appraisal to indeterminate. The *composite of short-term interest rates* — which appears to be behaving more like a leader than a lagger — decreased again in July, to 5.77 percent from 5.93 percent in June, and now is appraised as probably contracting.

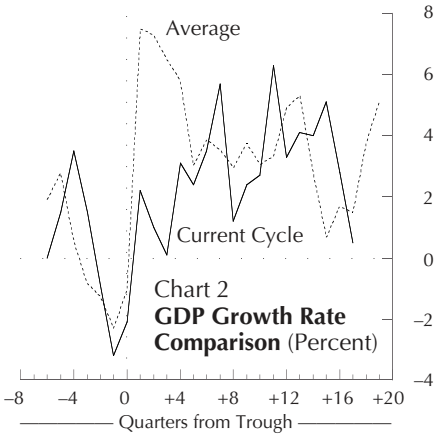
Despite the four new highs, only 80 percent (4 out of 5) of laggers with apparent cyclical trends now are expanding — a decrease from last month's 100 percent (5 out of 5). That four of the laggers hit new highs indicates that bottlenecks continue to form in the economy. Lending further evidence of bottlenecks, the Commerce Department's ratio of coincident indicators to lagging indicators decreased in June. This is the sixth consecutive month this ratio has declined.

Whether or not the economy will avoid a recession in the near future still is not clear from the indicators. The current wisdom seems to be that the worst is behind us and a recession is possible but unlikely. Although the latest data are more encouraging than those of the past few months, the improvement is not yet sufficient to eliminate our concern that a recession might yet occur.

Growth During the Current Expansion

Following the 1991 business-cycle trough, the economy did not grow as rapidly at the beginning of the expansion as many analysts expected. At that time, the recession itself was perceived by many to have been both longer and deeper than revised data later indicated. Chart 1 compares the percent increase in constant-dollar GDP from the trough in the first quarter of 1991 with the average recovery in the eight other postwar expansions.* As the chart indicates, the rebound from the beginning of the current expansion was extremely slow by historical standards. It was not until a year after the recession ended that GDP began to grow at rates approaching those typically observed at similar stages of prior recoveries.





Source of data for Charts 1-3: Department of Commerce.

These growth rates are better seen and compared in Chart 2, which plots the annualized quarterly percent changes in GDP in the current expansion with the average growth rates in the eight previous expansions. Again, the below-average experience in the early stages of this expansion is apparent — the economy usually rebounds quickly after a trough. The average growth rate during the first quarter of previous recoveries is 7.5 percent — but GDP increased only 2.2 percent in the first quarter of the current expansion.

Chart 3 compares GDP, in constant 1987 dollars, with its 25-year trend (calculated as a simple regression of the data for the period). As shown, GDP remained below this long-term trend line for most of the current expansion. In 1994, 3 years into the expansion, it surpassed the trend line. The slowdown in the first half of 1995, however, is bringing GDP back towards the long-term trend line.

Analyzed together, these charts illustrate the unusually weak growth in the beginning of this expansion, and the exceptionally strong growth last year compared with similar stages in previous business cycles — at least, according to the data currently available. In December, the Commerce Department will rewrite U.S. economic history (again). It is scheduled to release new GDP figures based on a comprehensive revision and a new method of estimation. Among other things, constant-dollar GDP will be rebased from 1987 to 1992 dollars. The revised data are expected to show that recent growth in GDP has been slower than the previously reported figures indicate; the rebound from the 1991 cyclical trough may look even more sluggish. It remains to be seen whether these new data will significantly change economists' and the public's perceptions about the current expansion.

* The averages for the cycles were calculated from the first eight completed postwar recessionary periods, which excludes the most recent cycle.

PRICE OF GOLD

	1993	*1994*	*—— 1995 ——*	
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