Economic Policy After the 1979 Oil Shock

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Economic Policy After the 1979 Oil Shock

by Allan H. Meltzer

If the President and the press accurately reflect current opinion, we are about to make another in the long series of mistakes in economic policy that have produced high inflation, slow growth and low investment. The press interprets every statistic as support for its view that we are in a recession. The President, and the Congressional Budget Office, agree that we are on the verge of recession. The public guessing game has now shifted from whether and when the recession will strike to how long and how deep the recession will be.

It is a mistake to describe our current or near-term future position as a recession. The consequences of the mistake will be serious and long-lasting if the prognosis of recession is followed by expansive policies to rid the economy of the symptoms of recession. Such policies are not required and are, I believe, counterproductive.

There are some desirable changes in policy that should be taken to reduce the burden of the recent oil shock and to speed the adjustment of employment and real income to the shock. The principal policy change that I recommend in response is a reduction in the real value of government spending and a reduction in tax rates for households and business. Other desirable policy changes include an end to oil price controls and federal oil allocation schemes, a gradual, pre-announced series of reductions in the growth rate of money, and an end to the disruptive controls on interest rates on savings, time and demand deposits. These latter policies were desirable before the 1979 oil shock and remain desirable after the shock. The reduction in the real value of government spending and tax rates
may have been desirable before the oil shock also. If so, the case for reductions in taxes and spending has been strengthened. To understand why, we must distinguish between recession and the oil shock.

Oil Shocks Are Not Recessions

A large permanent increase in the price of oil, or any other imported commodity, permanently reduces the real incomes of residents in the oil importing countries and increases the real incomes of residents of the oil exporting countries. The consumers of oil are forced to transfer a portion of their real incomes to the producers and, if the oil price increase is permanent, there is no way that the transfer of income can be avoided or recovered. It is the inability either to avoid or to recover the loss in real income that distinguishes the oil shock from a recession.

In a recession, real income declines. Sooner or later the economy recovers and real income returns to the level it would have reached if the recession had not occurred. The speed with which the economy recovers from recession depends on the policies that the government pursues and on the incentives it permits. The level of real income to which we return after the recession can be regarded as independent of the policies in a particular recession, even though the level of real income will be affected by the repeated use of policies that crowd out private capital or change incentives to work or to invest. We can, in short, think of the economy as growing at a trend rate of growth of real income, like line A in Figure 1. The recession causes the economy to deviate from the trend line, as shown by the broken line. During the recovery, real income rises until the economy again reaches the long-run trend line.
Suppose that the Federal Reserve increase the growth rate of money during the recession and that the higher growth rate speeds the recovery. The degree to which higher money growth speeds the recovery will depend on a number of factors including the effect on anticipations and the extent to which the timing and magnitude of the change in money growth is unanticipated. Increased money growth will be followed, sooner or later, by a permanently higher rate of inflation if the rate of growth of money remains permanently at the higher level. Or, if the increase in money growth is temporary, there will be a bulge in the rate of inflation, perhaps followed by a renewed recession as the effects of variable money
growth, and other stop-go policies, work their way through the economy. We are now familiar with this sequence. We have suffered the effects of stop-go policies for fifteen years and can readily observe their lasting effects -- the higher average rate of inflation after each cycle and the reduced growth of long-term investment.

Supply shocks, like the 1974 and 1979 increase in oil prices, reduce domestic income permanently. Once adjustment to the shocks is complete, real income rises again along its new growth path. In Figure 2, the trend growth path before the oil shock is again marked A; the trend growth path after the shock is marked B. The transfer of real income from U.S. citizens to oil producers is measured by the distance between A and B when

![Diagram of Real Income vs Time showing two trend growth paths A and B after an oil shock.](attachment:figure2.png)

**FIGURE 2**
A Supply Shock
the shock occurs. As long as the cartel keeps the real price of oil at its present level, we must export more of our real output to pay for our imports of oil. The additional payment of present or future exports is a measure of the real cost to us of the cartel.

The dotted line in Figure 2 shows one hypothetical adjustment. Real income does not move from A to B in a day or a month. Adjustment takes time because there is substantial uncertainty about the future. Will the cartel maintain the current real price by increasing the future market price of oil at the world rate of inflation? Or, will the oil shock be followed by slower growth of incomes, an excess supply of oil and a reduction in the real price of oil as in 1975-77? Will the U.S. government continue price controls and the loss of allocative efficiency caused by misguided energy policy? Or, will the latest increase in oil prices be followed by more rational energy policies than those we have followed? Answers to these, and many other questions, are neither obvious nor readily available. Uncertainty about the future delays adjustment. During the delay unemployment increases and prices accelerate. Inappropriate monetary and fiscal policies can increase the burden by inducing a recession. In 1974, a sudden shift in monetary policy from excessive expansion to contraction increased the burden of adjustment by pushing the economy below B.

The reduction in real income, and the rise in unemployment during the adjustment from A to B has many similarities to a recession. The key difference is that the economy does not return to the trend growth marked A.

Suppose that the Federal Reserve, believing we are in a recession, responds to increased unemployment by increasing the growth rate of money. The higher growth rate, if unanticipated, may stimulate some additional employment.
Ultimately the effect of higher money growth will be a higher rate of domestic inflation, a further decline in the value of the dollar, a further increase in the prices of the goods and services we import, including the market price of oil.

Money does not create oil, and monetary policy cannot replace the real income we pay the oil cartel. Monetary policy can add to the current uncertainty by mixing the effects of higher money growth with the effects of higher prices for energy. This is a disservice to all of us.

The basic fact is this: We are poorer as a result of the oil shock, and we must adjust to our reduced affluence. Full employment can only be restored at a lower level of real income. Monetary policy can raise or lower the cost of adjusting to the lower level of real income, but it cannot prevent the adjustment.

Appropriate Monetary Policy

The Federal Reserve should announce, and carry out, a medium-term policy to reduce the rate of inflation. Gradual, sustained, pre-announced reductions in the growth rate of money is the policy recommended by the Shadow Open Market Committee for several years and by the unanimous vote of the House Committee on Banking, Currency and Urban Affairs earlier this year. That policy remains appropriate.

Until recently, it was possible to sustain a different view. Inflation could be viewed as a means of reducing the real cost of oil to everyone. The reason is that the price of oil is stated in dollars, and after the 1974 increase of 300%, oil prices rose less than the prices of other commodities. The real price of oil, the price of oil relative to all consumer

prices, declined by 10 to 15% between 1974 and early 1979. The rise in oil prices on July 1 increased the real price of oil above the 1974 level. We now know that we cannot inflate our way out of the problem.

Many observers believe that it is impossible to end inflation. Others believe that the costs of ending inflation are too high. I believe these views are mistaken and that a proper reading of our recent past does not support these pessimistic views.

The average rate of increase in consumer prices for the six months ending September 1973, before the first increase in oil prices, was 9.4%. The six month average reached a peak of 12.2% in September 1974. Thereafter, the rate of inflation fell, and little more than a year later, the average rate of inflation was 4.5% or less -- below the levels achieved in the late 1960's. The economy recovered during this period of declining inflation. Unemployment fell from a peak rate of 9% to 7.5%; interest rates on long- and short-term securities fell, and the economy began to throw off the heritage of a decade of rising inflation.

The benefits of the policy of slower money growth were abandoned in 1976, and the mistaken policies continued in 1977 and 1978. Within a few months of the change, the average rate of price increase rose, and we entered another period of rising interest rates, rising rates of inflation and depreciating currency which is too fresh in our memories to recount.

I urge the committee to adopt a resolution expressing the sense of Congress that gradual, sustained reductions in money growth are to be achieved by the Federal Reserve until the rate of money growth returns to the non-inflationary path of the early 1960's. This resolution, if it
is to be effective, must be accompanied by action that removes interest rate ceilings and other impediments to monetary policy.

A resolution directing the Federal Reserve to produce gradual, sustained reductions in money growth is not a policy of inaction. It is an announcement to the world that at least one part of government has the vision to look beyond current problems. The resolution would make clear that the Congress wants the Federal Reserve to give up the myopic concern with problems that it cannot solve to concentrate on the problem of inflation which will not be solved until the Federal Reserve develops a medium-term strategy and adopts procedures capable of achieving its targets.

Appropriate Fiscal Policy

The income we transfer to the oil producers cannot be restored by changing taxes and government spending -- by fiscal policy -- anymore than by monetary policy. But fiscal policy can be used to shift the burden from one sector of the economy to another. If tax rates and government spending are unchanged, the loss of real income will fall on private spending for consumption and investment. The decline in consumption is a measure of the loss borne by consumers now; the decline in investment is a measure of the loss that falls on future income and consumption.

There is no reason to believe that all of the loss of affluence should be taken from private spending and none from government spending. To share the burden between the public and private spending, we must cut the real value of government spending and tax collections. The reduction in the real value of government spending assures that we have not used the
unforeseen loss of real income, resulting from the cartel's action, to increase the relative size of the public sector.

Cutting taxes, without reducing government spending, does not distribute the burden between the private and public sectors. A tax cut, unaccompanied by a reduction in spending, changes current tax rates relative to future tax rates. The main effect of a tax cut is to redistribute the loss of real income between consumption and investment.

The decline in income cannot be avoided, but the decline does not have to be followed by a decline in the future growth of income. Two decisions of Congress that affect the growth rate are the decision to share the loss of real income between the private and public sectors by reducing government spending and the decision to shift the burden of taxes between consumption and investment.

The rise in oil prices falls most heavily on those individuals, industries and countries that depend most on oil. Countries and industries that produce with more oil using capital and less labor lose relative to those that use less capital and more labor. This is one reason that we have seen, in the years since the 1974 oil shock, relatively faster growth of investment and output in countries like Malaysia, Korea, Brazil and Taiwan and relatively slower growth of investment and real output in the industrialized countries. The recent oil shock will have similar effects unless offset by a reduction in taxes on capital. A reduction in taxes on capital stimulates investment by raising the after-tax return to capital but places more of the burden of adjustment to the oil shock on current consumption.
The decision about how the loss of real income is to be shared should not be left to chance. If the current or prospective decline in real income is mistakenly regarded as a recession and tax cuts are used to stimulate current spending, more of the loss will be shifted to capital, to future consumption and to our children. I do not recommend that course.

Conclusion

The 1979 oil shock presents a problem, albeit a much smaller problem for us and for the world than the 1973-74 oil shock. We have shown that energy policy and economic policy can make a small problem large and can make a problem into a crisis. We misinterpreted the effects of the 1974 shock and seem determined to repeat, or compound, our error.

Events that have already occurred assure that we will experience a decline in real income. Government policies -- fiscal and monetary -- will determine how the loss is borne. Monetary policy will decide whether we move toward higher or lower inflation. Fiscal policy will determine how the loss is distributed between private and public sectors and between consumption and investment. If we misinterpret our current circumstances as a recession, and regard the loss of real income as a gap to be filled, we will assure that investment will remain low. With that error repeated, we will continue to grow slowly and will experience higher inflation and very little increase in income in the early eighties.