

1 A “New Economic Policy”

If you turned on your television set at 9:00 p.m. on Sunday evening, August 15, 1971, as millions of Americans did every week to follow the travails of the Cartwright family in the enormously popular Western *Bonanza*, you might have been surprised to see the somber visage of Richard M. Nixon, the thirty-seventh president of the United States. Nixon had come down from the mountaintop—down from Camp David, the presidential retreat nestled in the Catoctin Mountains of Maryland—to unveil a dramatic and far-reaching set of economic policy changes. His address, entitled “The Challenge of Peace,” was rather short, given its dramatic content. By 9:20, *Bonanza* had resumed without a hitch, but our nation still lives with the aftermath of what Richard Nixon said and did that night.

The policies Nixon announced had been outlined to him a few weeks earlier by his charismatic Treasury secretary John Connally, and the president had already agreed to the essential elements. The details, however, were developed over the previous weekend by his economic advisers, who had been sequestered at Camp David since Friday afternoon. They had been cut off from any communication with the outside world to avoid leaks. The *New York Times* had published the heretofore secret *Pentagon Papers* only a month earlier, and Nixon was determined to keep a tight lid on his plans for the economy. Moreover, as Treasury Undersecretary Paul Volcker told the group, billions might be made with advance knowledge of what the president was about to do. The weekend at Camp David was more than a charade, but considerably less than a decision-making conclave.

Nixon began his speech by suggesting, as he so often had, that a Vietnam peace was at hand. He described his plan as essential “to create a new prosperity without war.” He insisted the nation’s economy was moving from war to peace—anticipating an end to Vietnam, which would not

come for another four years. The “New Economic Policy” Nixon announced that evening was intended to address three pressing problems: rising unemployment, ongoing inflation, and the weakness of the dollar.

The measures to stimulate employment were relatively noncontroversial standard fare: a tax credit for business investments, elimination of an excise tax on automobiles, and a middle-class income tax cut. The wrinkle, if there was one, was Nixon’s call to offset the fiscal costs of these tax cuts by reduced spending in order not to increase the federal government’s deficit. But in classic Nixonian fashion, “reduced spending” was merely a feint. The president called for a postponement in spending that he knew Congress was never going to buy. He also expected Congress to add more tax cuts into his package. The combination of tax cuts and spending restraint he proposed, however, allowed him to describe these proposals as “reordering our budget priorities so as to concentrate more on achieving our goal of full employment.”

The second prong of the New Economic Policy was far more dramatic, catching everyone who heard it by surprise. Even in retrospect, it seems positively unthinkable. A Democratic Congress, anxious to deflect the blame for inflation away from itself and onto the White House, had a year earlier handed Nixon an extraordinary grant of presidential power: to regulate wages and prices throughout the economy. The Democratic congressional leadership was convinced that this Republican president would never use this power. But John Connally had urged Nixon not to reject it, but instead to keep this authority in a closet in case he wanted to use it some day. On this summer Sunday, Nixon opened that closet. He told the country he was ordering a 90-day freeze on all wages and prices in the United States, “backed by government sanctions.” He also announced that he was creating a new federal agency to regulate prices and allocate products, the Cost of Living Council, to maintain price stability after the freeze expired. This freeze came at a time when inflation was at 4 percent. Nixon had pulled out a sledgehammer, not a stick. Perhaps hoping that his audience had not fully comprehended what he had just said, Nixon had the gall to add: “Working together, we will break the back of inflation, and we will do it without the mandatory wage and price controls that crush economic and personal freedom.” But his freeze on wages and prices was hardly voluntary, and price controls would last far longer than anyone expected.

Wage and price controls were a terribly blunt instrument, thought to be appropriate only in extraordinary wartime circumstances. That a Republican president would institute such governmental interference over what Nixon insisted was a peacetime economy was truly remarkable. Ironically, Nixon himself had worked in the Office of Price Administration during World War II, and having seen a price control bureaucracy up close, he knew how difficult such controls were to enforce. He also personally abhorred, for both practical and philosophical reasons, the idea of government trying directly to control wages and prices. So did virtually his entire team of economic advisers.

Nixon had often stated that he would never adopt this kind of an "incomes policy." But he had been tempted to embrace such controls not only by ongoing calls for them from key members of Congress, the public, and the press, but also by Arthur Burns, who had served as President Eisenhower's chairman of the Council of Economic Advisers and was in 1971 chairman of the Federal Reserve. George Shultz, Nixon's director of the Office of Management and Budget (who would subsequently succeed John Connally at the Treasury and serve as secretary of state under Ronald Reagan), had asked the critical question about wage and price controls that weekend at Camp David: "How do you stop it when you start?" An answer to that vexing question, such as it was, would have to wait. For energy prices, the wait would last a decade.

The clinching argument in favor of the wage-price freeze was political, not economic, and it had been made privately to the president by the politically savvy Connally, a man whom William Safire, Nixon's chief speechwriter, would later say Nixon had fallen in love with. The nation had first come to know Connally, a lifelong Democrat, when he was seriously wounded in November 1963 while riding as Texas governor in the motorcade during John F. Kennedy's assassination in Dallas. In February 1971, over some serious objections from Republican colleagues, Nixon brought Connally into his cabinet to serve as Treasury secretary and his key economic spokesman. Like Nixon, Connally was a lawyer and a politician, not an economist. Together, he and Nixon focused their attention on the 1972 election. As Herb Stein, chairman of Nixon's Council of Economic Advisers, gently put it later, Nixon "tended to worry exceedingly about his reelection prospects and so felt impelled to extreme measures to assure his reelection." Stein added, "He had a great longing

for the dramatic gesture, for which he found a perfect supporter in John Connally.”

The wage and price controls Nixon imposed on the nation that August night would subsequently prove to be very bad economic policy. By the time the freeze expired 90 days later, a large regulatory system had been created in an attempt to keep prices in check, and nearly two years later, in June 1973, Nixon ordered a repeat price freeze to keep inflation from raging. Prices had been held down to the point that companies lost more by marketing some products than by destroying them. By then, the public had witnessed scenes of chickens being drowned rather than grown for market and had become used to seeing empty grocery shelves. Looking back, Herb Stein confessed, “no one involved in the decision to impose controls foresaw how long they would last or how rigorous they would be.” Except for energy, price controls were generally abolished in April 1974, when the president simply allowed his authority to impose them to expire.

The period of controls was followed by a large price explosion and ultimately contributed to the combination of high unemployment and high inflation—the dread “stagflation”—that would haunt the country later in the 1970s. Even when the controls were in place, they were frequently ineffective. From mid-1971, when the freeze was announced, until the end of 1974, when virtually all controls were eliminated, prices rose by an average annual rate of 6.6 percent, largely due to increases in energy prices. By the end of the decade, inflation was so out of control that short-term interest rates hit 21 percent. And, as we shall see, price controls on oil and gas remained in place long after other controls had expired. Nixon’s New Economic Policy made fashioning sensible energy policy very difficult indeed.

A deep recession coupled with very tight monetary policy in the 1980s would ultimately wring out of the nation’s economy most of the lingering aftermath of Nixon’s wage and price controls—energy policy aside. But the wage–price freeze and the controls that followed, as bad as they proved to be economically, well served their purpose of helping Nixon politically. Congress cheered the wage–price freeze, the press applauded, the electorate was exuberant. On the Monday following the president’s announcement, the Dow-Jones Average enjoyed the biggest one-day increase it had ever had. Polls showed that nearly three-fourths of the American people were

glad to see Nixon institute the freeze. The public welcomed strong and decisive presidential action and was comforted by a faith that if their government would just adopt the right economic policies, they could always enjoy high employment with little or no inflation. It was, after all, a time when the planned economies, especially that of the Soviet Union, appeared to be doing rather well and when the directive "industrial policies" of Japan seemed to offer the best path to prosperity with price stability.

The economic havoc that price controls would ultimately wreak was pushed down the road, past Nixon's 1972 reelection. That election took place—just as Nixon and Connally planned—at a moment when the economy had strengthened and the controls seemed to be holding inflation in check.

The third and equally profound prong of the New Economic Policy that the president described that Sunday night unilaterally extinguished the world's international monetary arrangements. The headlines said that Nixon had "closed the gold window." What this meant was that the United States, which had long stood ready to exchange dollars for gold at the rate of \$35 per ounce, would no longer routinely do so at any price. Exactly what abandoning the gold standard meant for the relationships among the values of the dollar and other currencies was not immediately clear, although it was apparent to anyone who understood the situation that the dollar would be devalued, especially vis-à-vis the Japanese yen and the German mark.

Nixon claimed, in a portion of the August 15 speech he had written himself in the wee hours that Sunday morning at Camp David, that his actions would "lay to rest the bugaboo of what is called devaluation." He insisted that it was necessary to protect the American people from the "international money speculators," who, he claimed, had "been waging an all-out war on the American dollar." As Watergate and its aftermath would subsequently reveal all too clearly, Nixon had a particularly wide streak of paranoia and a perverse ability to identify enemies or villains. So it is difficult to credit this claim—a difficulty magnified by the fact that if anyone had precipitated this crisis, if in fact it was a crisis, that person was a representative of the British national bank, who during the preceding week, according to the Treasury, had asked to convert \$3 billion into gold.

Nevertheless, in a few short paragraphs President Nixon swept away the international monetary arrangements that had been agreed to nearly three

decades earlier in July 1944 by delegates from 44 Allied nations at Bretton Woods, New Hampshire. The Bretton Woods agreements had set up a system that required each country to maintain the exchange rate of its currency within one percent of a specified value of gold. There was no consensus at Camp David about what would happen to the dollar after the president's announcement. Not that such a consensus would have mattered.

The underlying economic problem Nixon faced had been caused by large U.S. trade deficits, which had sent billions of dollars abroad in exchange for foreign goods. Our accumulated trade deficits had become so large that there were more than enough dollars in circulation around the world to empty all the gold from Fort Knox. The outflow of dollars in exchange for foreign goods had resulted in foreigners' exchanging an unprecedented number of dollars for gold. To address the trade issue directly, Nixon also announced that he was temporarily imposing a 10 percent tax—a tariff—on all goods imported into the United States.

After several months of hurried international diplomacy attempting to assuage hurt feelings, especially in European capitals and Japan, and to relieve the shock from Nixon's actions, a multilateral agreement about exchange rates, devaluing the dollar against other major world currencies, was reached in a meeting of the so-called Group of Ten nations in December 1971 at the Smithsonian Institution in Washington, D.C. In that agreement, there was some effort to maintain fixed currency exchange rates, albeit with a wider band of values, 2.25 percent. But this agreement was not to last: by the mid-1970s, the values of most of the currencies of the world would be allowed to float against one another. On December 18, 1971, when the "temporary" Smithsonian agreement was announced, the price of gold was said to be only \$38 an ounce; a few weeks later it reached \$44 an ounce. In 1972, it hit more than \$70 an ounce and was still climbing.

Taken together, the dramatic policy changes Nixon announced on August 15, 1971—the wage and price freezes, the 10 percent import surcharge, and the revamping of worldwide currency arrangements—would profoundly affect U.S. energy policy. Herb Stein would later call the impact on energy the most "irksome legacy of the Nixon price-wage controls." Yet at Camp David that weekend there had been no mention of energy. Nor did Nixon mention it in his speech. Even John Connally, the former

governor of Texas—then America's greatest oil-producing state—had managed to ignore it in the development of his plan for the president.

The fact was that in August 1971 the United States was complacent about energy policy. The president and his advisors, giving no particular thought to the effect of price controls on oil, expected the freeze to last only 90 days and only a short thawing period to follow. But that is not the way things turned out—especially for oil and gas: it took a 118-page Cost of Living Council report simply to describe the four phases of rules and regulations and some of the effects of price controls on petroleum products from the August 1971 freeze through 1974—nearly seven years before the controls would actually be lifted. The government's effort to supersede the market's allocation of oil and gas prices was byzantine and perverse. There were numerous tiers of prices for oil and petroleum products, including thirty-two different prices for natural gas. Buyers scrambled to qualify for the lowest possible prices, sellers for the highest. Producers turned their oil and gas spigots on or off depending on what prices they would receive. The Cost of Living Council's rules and regulations determined who got which supplies and at what price. Virtually all the prices were in some sense inappropriately low. Local product shortages became common. Price controls contributed to shortages of home heating oil; reduced production of domestic oil, coal, and natural gas; inspired hoarding and black market transactions; produced uncertainty throughout the energy industry and among energy users; and bestowed favorable and unfavorable treatment on categories of buyers and sellers completely unrelated to considerations of fairness or efficiency—to name just a few of its unfortunate and unintended consequences.

Energy policy complacency had settled in because for decades oil prices had been remarkably stable or even declining. Inflation in energy products had been lower than inflation generally. From the end of World War II through the late 1960s, the United States not only had produced the vast bulk of oil consumed domestically, but had also been able to play the role of emergency supplier to the rest of the free world. Large U.S. and British oil companies had long maintained control over vast oil reserves in the Middle East. Before the 1970s, our nation's policy struggle over oil had been over how to respond to abundant supplies.

But dramatic change was afoot. Due principally to strong economic growth and rising incomes, total world energy consumption more than

tripled between 1949 and 1972 as Europe shifted from a coal-based economy to one fueled by cheap oil from the Middle East. Worldwide oil demand more than quintupled during this postwar period. But because of vast new discoveries and production of oil, especially in the Middle East, prices had remained remarkably stable. The public in both the United States and Europe regarded abundant, inexpensive oil as a birthright. Through the end of the 1960s, the problem, if there was one, was how to limit excess production. In the United States, stable prices were achieved largely through allocations of production and supply by state regulatory commissions, the most important among them the Texas Railroad Commission. Indeed, from the mid-1950s through the mid-1960s there was such a glut of oil that prices actually declined. To keep their revenues growing, the oil-producing nations of the Middle East were constantly increasing their oil output. Henry Kissinger later reflected, "In 1969, when I came to Washington, I remember a study on the energy problem that proceeded from the assumption that there would always be an energy surplus. It wasn't conceivable that there would be a shortage of energy."

In August 1971, a barrel of oil (42 gallons) in the United States cost only about \$3, and even this price was about \$1 higher than the worldwide market price due to a mandatory quota on imported oil imposed by the United States to encourage domestic exploration. Domestic U.S. oil production had peaked in 1970, but domestic demand continued to rise at a rate of about 5 percent a year. At the beginning of that decade, only about one-fifth of U.S. oil consumption was supplied by imports. A presidential task force convened by Nixon to study the import quota predicted in a 1970 report that by 1980 the United States would be importing only 27 percent of its oil and that prices would remain stable for the next decade. As it turned out, by 1980 we were importing about half of our oil and at a price more than ten times that of 1970. Today, imports account for nearly two-thirds of the oil we consume.

In the 1950s and 1960s, however, when domestic production was robust and protected from foreign competition by the quota as well as allocated by state regulatory systems, U.S. oil prices had remained remarkably stable: \$2.90 a barrel in 1959 and \$2.94 in 1968, 60 to 70 percent higher than the price of Middle East imports at East Coast ports. Due to increasing demand, domestic oil production was nearly 30 percent higher at the end of the 1960s than in the 1950s. Prices were considerably lower elsewhere,

reaching, for example, a low of \$1.20 to \$1.30 per barrel for Iranian oil in Europe in 1967. Along with the U.S. economy, the European and Japanese economies were becoming ever more dependent on cheap foreign oil—mostly from the Middle East.

Our unwavering belief that plentiful, cheap oil was a permanent fact of life became abundantly clear in May 1969 when the shah of Iran visited the United States to attend President Dwight Eisenhower's funeral. While here, he offered to sell the United States one million barrels of oil a day for 10 years at a price of \$1 per barrel. He also proposed that we establish a petroleum stockpile to protect us against any supply interruption. After short study, our nation's oil experts rejected the shah's offer. That October a second offer by the shah to sell us cheap oil was also turned away. In May 1971, when Saudi Arabia's King Faisal visited Nixon, oil was not even discussed. These decisions we would soon come to regret.

Nixon's price freeze and the energy price controls that followed it were imposed just as oil markets were undergoing a dramatic transformation. By the end of 1973, oil shortages would become obvious to every American. Insisting on keeping oil and gas prices from rising as surpluses turned into shortages would prove a fool's errand.

Dramatic upward pressure on worldwide prices resulting from upheaval in the Middle East would be felt in the United States first in the fall of 1973. But even before that Richard Nixon's New Economic Policy caused substantial disruptions. The original problem resulted from the president's timing and the freeze's inflexibility. His policy went into effect a couple of weeks before Labor Day, toward summer's end when gasoline prices always hit their seasonal peak. Home heating oil prices were then seasonably low. Refiners, stripped of their usual ability to adjust the relative prices of these products, in the fall of 1971 kept making gasoline long after they normally would have shifted to producing more heating oil. The unsurprising result was that when a harsh winter came in 1971–1972 to the Northeast, so did shortages of heating oil. Natural gas for heating was unfortunately also in short supply that winter. Many midwestern factories closed, as did some schools. Thermostats were lowered everywhere.

During the next decade, the U.S. government would struggle—with limited success—to keep U.S. energy prices low in the face of a rising tide of worldwide prices. Nixon's devaluation of the dollar ironically made this task considerably more difficult. Oil-producing nations lost purchasing

power throughout the world as the value of the dollar fell because their oil prices were set in dollars. In September 1971, a month after Nixon's speech, at an OPEC meeting in Beirut, its member states increased oil prices by nearly 9 percent explicitly to compensate for the devaluation of the U.S. currency. And the value of the dollar continued to decline for several more years. By mid-1973, the dollar price of gold had risen to more than \$90 an ounce; by the end of the decade, it exceeded \$450. By the mid-1970s, the dollar had declined by more than 30 percent relative to the German mark and the Swiss franc and by more than 20 percent against other European currencies and the Japanese yen. Middle East oil producers, having embarked on ambitious long-range plans for spending their oil revenues, naturally reacted to offset this ongoing decline in their purchasing power by raising prices. To accomplish this goal they ultimately had to make sure that they—and not U.S. or British oil companies—had control over both the price and quantity of their oil output.

Thus, entirely unwittingly, Nixon's New Economic Policy exerted upward pressure on foreign oil prices and put a ceiling on domestic energy prices just as our nation was becoming more and more dependent on foreign oil. Regulators wrestled with the question of how to control prices and continue to encourage domestic production. In August 1973, they adopted a complicated two-tier pricing scheme, which allowed higher prices for "new" domestic oil than for "old" domestic oil. Refiners, wholesalers, and retailers all stood to profit if they could buy the old stuff, for old and new oil looked and worked the same. Imported oil had its own price based on worldwide market conditions. A small army of Internal Revenue Service (IRS) agents was deployed to enforce cumbersome rules that attempted to ensure a "fair" allocation of the cheap and more expensive oil. This is what passed for energy policy in the United States in the early 1970s.

Some version of the oil price controls instituted in August 1971 stayed in place until 1981, when they eventually expired—many years after other price controls had terminated. This policy was disastrous. Throughout that crucial period, the controls would keep U.S. prices generally below worldwide market prices, thereby inhibiting the downward pressure on demand that would otherwise have accompanied the dramatic worldwide price increases of the 1970s. Keeping the price of oil artificially low not only decreased incentives to conserve energy, but also diminished the likelihood of successfully developing and marketing alternative energy sources.

Unfortunately, Richard Nixon was far from the only U.S. politician to elevate short-term political expediency over sound economic and energy policies. The political struggle over whether to decontrol the price of oil would prove to be the most dominant and contentious issue of U.S. energy policy throughout the decade, inhibiting policymakers' ability to respond to a brand-new set of energy conditions. In August 1971, however, U.S. policymakers were oblivious to the fact that the long postwar era of abundant oil at low prices was ending.

As subsequent chapters detail, Richard Nixon's price controls proved surprisingly resilient. It would be September 1981 before price controls on oil were finally gone—more than a decade after they first came into place. Then they disappeared quietly when the authority to impose such controls simply expired. During their time, oil price controls decreased the effectiveness of conservation efforts and held down both domestic production of oil and domestic development of alternatives to oil. Perhaps even more important, they dominated the legislative efforts regarding energy policy and tied our political process in knots. Once Nixon had put them in place, finding a congressional majority to lift the controls became impossible.

Following his August 1971 speech, Richard Nixon returned his main focus to foreign-policy issues: ending the war in Vietnam, *détente* with the Soviet Union, and his forthcoming trip to China. Meanwhile, Britain's prime minister Edward Heath was making a major foreign-policy decision of his own. Despite some misgivings, his conservative government was in the process of fulfilling a promise made in 1968 by his predecessor, the Labour Party prime minister Harold Wilson, to withdraw all British troops from the Persian Gulf by the end of 1971.

Since early in the nineteenth century, Britain had played a key role in securing the peace and prosperity of the gulf region. The gulf, after all, was a very important pathway to India. And for much of this time, many observers had described the gulf states, including Iraq, as part of Britain's informal empire. Once oil was discovered in the Middle East, Britain had important commercial as well as political interests to protect. Following World War II, however, Britain decolonized, and by the late 1960s its own economic problems had led it to diminish significantly its military presence around the world. When Harold Wilson announced his plan to withdraw all British troops from the Middle East, the sheiks of the region

were shocked. They begged the British not to leave and even offered to fund the troops' continuing presence.

It is difficult even now to know whether Britain's decision to leave the gulf was a mistaken short-sighted cost-benefit calculation or the region's growing nationalism had properly persuaded the British government that maintaining any military presence there was simply too risky to continue. In either event, when Britain abandoned the Persian Gulf in November 1971, the geopolitics of oil changed. A great power vacuum emerged east of the Suez, a vacuum that the Soviet Union, Iraq, Libya, and Iran were anxious to fill.

In the Middle East, a new future was under way. Richard Nixon, who had longstanding and cordial relations with the shah, favored Iran as the most important new regional power. Always seeking a power balance, he wanted a strong counterpoint to Iraq's ambitions, which were being promoted by the Soviet Union's ongoing shipments of arms. In 1971, these developments in the gulf region were unsettling but not alarming. Just two years later, in October 1973, the alarm bells would go off.