Arthur Burns and Inflation

Robert L. Hetzel

Arthur Burns, Chairman of the Federal Open Market Committee (FOMC) of the Federal Reserve System (the Fed) from February 1970 until December 1977, was fiercely opposed to inflation. For the public, and especially for the business community, Burns embodied opposition to inflation. Nevertheless, during his tenure as head of the Fed, high rates of inflation became a pervasive fact of American life. How could that have happened?

The puzzle is especially striking as Burns became Chairman with an extraordinarily distinguished background as an economist. He had been president of the American Economics Association and had headed the prestigious National Bureau of Economic Research (NBER) since the late 1940s. As head of the NBER, Burns gained worldwide recognition as the leading scholar of the business cycle. Based on his work on the business cycle, he concluded that inflation itself sets in train forces that cause recession. As an economist, how did Burns think? How did he shape the data he studied into a coherent view of the world—a view that could lead him far away from the control of inflation?

1. EXPLAINING MONETARY POLICY

To explain monetary policy, one requires more than an understanding of the views of the Chairman of the FOMC. One must understand the general political and intellectual environment of the time as well. If Burns had been Chairman in another era, say, in the 1950s or 1990s, the environment, and therefore monetary policy, would have been quite different. So to attribute the inflation of the first part of the 1970s solely to Burns's leadership is wrong.

Monetary policy under Burns's FOMC was never as expansionary as vocal congressmen urged and, through 1972, was less expansionary than the Nixon Administration desired. In fact, throughout his tenure, monetary policy

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was consistently less expansionary than desired by Keynesian economists, who represented mainstream economics. Indeed, at the time, Fed economists joked that policy must be on track because it was more expansionary than monetarists desired but more restrictive than Keynesians desired. The inflation of the 1970s represented the failure of an experiment with activist economic policy that enjoyed widespread popular and professional support. Burns was part of a political, intellectual, and popular environment that expected government to control the economy.

In the early 1970s, the political system and the economics profession agreed that 4 percent was a normal rate of unemployment. Both the political system and a majority in the economics profession accepted that the government was responsible for keeping the unemployment rate to 4 percent or less through activist monetary and fiscal policy. Burns accepted this consensus view. And he added a sense of urgency to it. At the time, the United States was riven by the socially divisive issues of race and the Vietnam War. When the unemployment rate rose in 1970 to 6 percent, Burns believed that the country needed a combination of policies that would simultaneously restore price stability and full employment.

In November 1970, the minutes of the Board of Governors show Burns telling the Board (Board *Minutes*, 11/6/70, pp. 3115–17) that

> . . . prospects were dim for any easing of the cost-push inflation generated by union demands. However, the Federal Reserve could not do anything about those influences except to impose monetary restraint, and he did not believe the country was willing to accept for any long period an unemployment rate in the area of 6 percent. Therefore, he believed that the Federal Reserve should not take on the responsibility for attempting to accomplish by itself, under its existing powers, a reduction in the rate of inflation to, say, 2 percent. . . . he did not believe that the Federal Reserve should be expected to cope with inflation single-handedly. The only effective answer, in his opinion, lay in some form of incomes policy.

(The term “incomes policy” is a catchall expression for various forms of direct intervention by the government to control prices.) Those comments reflected a reading of the domestic situation that was particular to the time. Again, a different time would have yielded a different monetary policy.

To blame the inflation of the 1970s on an individual or on a group of individuals is too facile. At the same time, monetary scholars can still learn from the mistakes of individuals—in this case, they can comprehend how Burns understood the world as an economist. By doing so, they can put into place a piece of a larger puzzle, which when completed explains the inflation of the early 1970s.

Attributing policy failures to personal failures is a mistake that keeps one from learning. In this respect, it is helpful to view the high inflation of the 1970s as part of a learning process. The current consensus that central banks are responsible for inflation would have been impossible to establish in the intellectual environment of the 1970s. However, the "learning" view itself is incomplete. It does not explain why inflation was low in the 1950s. Presumably the state of economics was not more enlightened in the '50s than in the '70s. Also, experience in itself does not make people wise. Economists need to examine and learn from historical experience to avoid repetition of mistakes.

Economists use models to learn about the world and to explain how it works. A model imposes a discipline by forcing the economist to explain cause and effect relationships within a framework that yields testable implications. When experience falsifies those implications, the economist must return to the model and examine its failures. The economist cannot "explain" the model's failure to predict by assuming that the world's underlying economic structure changes in an ongoing, unpredictable way. The evidence from Burns's own words shows that he did not use such a model to predict inflation and, consequently, failed to learn from the inflationary experience of the 1960s and 1970s.

How did Burns view macroeconomic policy as an economist? Most generally, Burns had a credit view of monetary policy. That is, monetary policy worked through its influence on the credit market. However, monetary policy was only one factor affecting credit markets. At times, in its influence on inflation, monetary policy could be overwhelmed by other factors. More specifically, Burns had a real or nonmonetary view of inflation. That is, inflation could arise from a variety of sources other than just money. He believed that a central bank could cause inflation by monetizing government deficits but did not attribute inflation to that source in the early 1970s. Instead, he attributed it to the exercise of monopoly power by unions and large corporations.

If conventional monetary policy weapons were powerless to deal with these forces, then perhaps direct controls might work. Accordingly, President Nixon imposed wage and price controls August 15, 1971. The experience with such constraints offered a tailor-made experiment of Burns's views. The controls worked as intended in that they held down wage growth and the price increases of large corporations (see Kosters [1975]). Nevertheless, inflation rose to double digits by the end of 1973. So Burns attributed inflation to special factors, such as increases in food prices due to poor harvests and in oil prices due to the restriction of oil production. However, special factors are by nature one-time events. In 1974, inflation should have fallen as the effect of these one-time events dissipated, but it remained at double-digit levels that year. Burns then blamed inflation on government deficits. Although those deficits were small in 1973 and 1974, Burns was able to make them look larger by adding in the lending of government-sponsored enterprises like the Federal National Mortgage Association.

For Burns, the source of inflation changed regularly. He believed this view only reflected the complexity of a changing world. As a consequence, he did not have a model of inflation that could be contradicted by experience. Where did his views as an economist originate? They came most importantly from Wesley Clair Mitchell.

2. WESLEY CLAIR MITCHELL

To understand Arthur Burns, it is necessary to see him as standing astride two worlds in economics: an earlier American institutionalism and the now-dominant neoclassical school. Burns was the protégé of the American institutionalist and founder of the NBER, Wesley Clair Mitchell. While working on his Ph.D. at Columbia in 1930, he attracted Mitchell's attention. Burns became Mitchell's student and, later, his collaborator. In 1946, they published a comprehensive study of the business cycle, *Measuring Business Cycles.* A year before, when Mitchell retired, Burns had become director of research of the NBER. Both achieved worldwide recognition as preeminent scholars of the business cycle. In his thinking about the business cycle, Burns was greatly influenced by Mitchell's views.

As a student at the University of Chicago in the 1890s, Mitchell studied under Thorstein Veblen, John Dewey, and the anti-quantity theorists, J. Laurence Laughlin and Adolph Miller. Miller, who became one of the original members of the Board of Governors of the Federal Reserve System, was the staunchest defender of the real bills doctrine in the 1920s and 1930s. (According to the real bills doctrine, central banks maintain price stability by preventing the speculative extension of credit, not by controlling the quantity of money.)

Mitchell, an anti-quantity theorist himself, attacked the quantity theory in his book *History of the Greenbacks.* He observed that the gold value of greenbacks—the North's paper currency—fluctuated with the military fortunes of the North and concluded that their value depended not on the quantity in circulation, but rather on the probability that the North would redeem them in gold (Burns [1949] 1954). In this work, Mitchell first developed his central idea that business cycle dynamics derive from lags in the adjustment of prices of different classes of goods and factors of production and the effects of those lags on business profits. Goods prices rise faster than wages in economic recoveries but more slowly later on. The temporal lags in the adjustment of prices originate in institutional arrangements.

The resulting rise in profits in economic recoveries spurs investment. Later, a fall in profits depresses investment. Such profit variations cause cyclical fluctuations in economic activity by influencing the psychology of the businessman (Burns [1949] 1954). The business cycle is a self-propelling pattern of economic activity where the imbalances of one stage produce corrective forces that ultimately become the imbalances of the next stage. However, changes in institutional arrangements mean that the nature of the cycle changes over time. Burns (1952, pp. 24–25) wrote of Mitchell's views:

> The "system" rests on the proposition that the ebb and flow of activity depends on the prospects of profits. . . . As prosperity cumulates, costs in many lines of activity encroach upon selling prices, money markets become strained, and numerous investment projects are set aside until costs of financing seem more favorable; these accumulating stresses within the system of business enterprise lead to a recession of activity, which spreads over the economy and for a time gathers force; but the realignment of costs and prices, reduction of inventories, improvements of bank reserves, and other developments gradually pave the way for a renewed expansion of activity. Each phase of the business cycle evolves into its successor, while economic organization itself gradually undergoes cumulative changes. Hence, Mitchell believed, "it is probable that the economists of each generation will see reason to recast the theory of business cycles which they learned in their youth."

Mitchell assumed that government intervention is at times necessary to keep the imbalances of the business cycle from cumulating into a major depression or inflation. Burns wrote that Mitchell "repeatedly pointed to the shortcomings of our economic organization," a system which he found "defective" because it had "no effective means of checking depressions." Mitchell, he noted, eagerly followed "our own modest efforts at economic planning" under the aegis of the Council of Economic Advisers (Burns 1952, p. 48).

Burns praised Mitchell's description of the business cycle as having, better than all rival descriptions, passed "the practical test of accounting for actual business experience." He cited Mitchell's unsurpassed skill in tracing "the interlacing and readjustment of economic activities" as "one stage of the business cycle gradually evolves into the next" (Burns [1949] 1954, p. 81).

3. BURNS AS BOARD DIRECTOR AND POLICY ADVISER

Burns's position as head of the NBER supplied him with a name recognition that led to appointments on numerous corporate boards of directors. "As director [of the NBER], Burns . . . was thrust into close contact with the business tycoons, the labor leaders and the foundation chairmen who served on the Bureau's board of directors. . . . He was now not only an eminent scholar, but a friend of people who had access to high places" (Viorst 1969, p. 126). Burns believed that his insights into the psychology of the businessman endowed him with an ability to understand the dynamic behind the business cycle.

After President Eisenhower took office in 1953, he made Burns head of the Council of Economic Advisers (CEA), which had fallen into disrepute as a consequence of the partisanship and advocacy of central planning by Truman's chairman, Leon Keyserling. Burns saved the CEA from extinction by a Congress which could have ended its funding. Burns, who took naturally to the role of counselor to the President, said "he could feel himself coming down with 'Potomac fever,' becoming attached to the bustle of government crisis, being infected with a sense of his own importance" (Viorst 1969, p. 32).

Burns characterized his relationship with Eisenhower as "an extraordinary personal as well as professional friendship" (Hargrove and Morley 1984, p. 95). In their first meeting, Burns showed Eisenhower a set of graphs tracing the growth of government over time. Burns commented later that the President was so deeply interested that he arranged to give Burns a weekly appointment of a full hour with him (Hargrove and Morley 1984, p. 98).

Burns obviously relished the battles he won as head of the CEA through his personal influence with the President (Hargrove and Morley 1984, pp. 108–09):

> I stayed in the office till 8:00 or so, then came home, had a late dinner, rested for an hour, and by 10:00 or 11:00 I would start working on the text of the [Economic Report of the President]. I stayed at it until around 3:00, 4:00 or 5:00 in the morning. . . . I got a phone call from George Humphrey [Secretary of the Treasury], who called the report "socialistic" and wanted it scrapped. . . . Finally the day arrived . . . when I was to submit the Economic Report for review by the Cabinet. . . . After I had summarized the report to the Cabinet, he [Nixon] spoke up and said, "It is a beautiful report. It gives the Republican administration a philosophy that it has lacked." . . . Then Eisenhower thanked me for the report and said, "Arthur, what you presented here is of course a summary. . . . I want to read the report in its entirety. . . ." I got one of the most beautiful letters I have ever had from anyone, from Eisenhower . . . praising the report. . . . I made no effort to conceal my feelings, and for a time—when I saw Humphrey—I just looked the other way. . . . The trouble with Humphrey was that he didn't know where his knowledge stopped and his opinions began.

Burns's influence was significant in Washington, mostly because of his work on leading indicators done at the NBER and his ability to use them to predict economic activity, especially recessions (Hargrove and Morley 1984, p. 116):

> I had warned Eisenhower, back in 1953, that a recession was developing. Once it became a matter of serious governmental concern, he said to me, "Arthur, you are my chief of staff in handling the recession. You are to report every week at a Cabinet meeting on where we are going and what we ought to be doing." I remember him saying with enthusiasm . . . "Arthur, what a chief of staff you would have made during the war." To Eisenhower, that was probably the highest compliment he could pay—he was a military man.

Fifteen years later, Nixon, who, like Eisenhower, recognized Burns's expertise, asked him to become an adviser during Nixon's 1968 presidential campaign. Upon assuming the presidency, Nixon put Burns in charge of development of the agenda for domestic legislation.

4. BURNS'S VIEW OF THE BUSINESS CYCLE

As a microeconomist, Burns employed the tools of neoclassical price theory. As a macroeconomist, he largely ignored the working of the price system as a coordinating mechanism. Instead, he relied on the empirical regularities he derived from examining the cyclical behavior of a large number of statistical series. Burns believed he could integrate a vast variety of empirical observations about the business cycle using his knowledge of human psychology, while retaining an awareness of what is unique about each cycle (Viorst 1969, p. 123):

> I suspect that some of my colleagues are unduly fascinated by economic instruments and have given insufficient attention to the workings of the business mind of America. I weigh that heavily in questions of policy. . . . before I judge whether some proposal is good or bad, I ask how the businessman is going to react. I've studied the businessman of America. He has his strengths and he has his weaknesses, but it is within the framework of his psychology that the economist in America must operate. . . . The well-being of the country . . . depends upon the favorable expectations of the investing class. . . . As I see it, the role of Government must be to shape policy to improve these expectations.

Like most other economists who came of age in the Depression, Burns held conventional views about the need to manage the economy (Burns 1973, pp. 792–93, and Burns [1946] 1954, p. 4, respectively):

> Our economy is inherently unstable. . . . experience has demonstrated repeatedly that blind reliance on the self-correcting properties of our economic system can lead to serious trouble. . . . Flexible fiscal and monetary policies, therefore, are often needed to cope with undesirable economic developments.

> The principal practical problem of our generation is the maintenance of employment, and it has now become—as it long should have been—the principal problem of economic theory.

Although Burns's views on the need to manage the economy were conventional, his views on *how* to manage it were unconventional, stressing the confidence of the businessman.

Burns organized his explanation of cyclical movements in economic activity around an extraordinarily detailed knowledge of the interrelationships among economic time series. He knew an overwhelming amount of detail about the business cycle. Such detail he had gleaned from his examination of the timing relationships between specific cycles of individual sectors and the general reference cycle. In his words, the business cycle is a "consensus of specific cycles" (Burns [1950] 1954, p. 111). Burns explained the cycle as a natural accumulation of imbalances that cause economic recoveries to turn into recessions. Those imbalances develop from the way costs overtake prices and depress profits (Burns [1950] 1954, pp. 127–28):

> . . . as prosperity cumulates, unit costs tend to mount for business firms generally; and since in many instances selling prices cannot be raised, profit margins here and there will narrow. . . . Errors pile up as mounting optimism warps the judgment of an increasing number of businessmen concerning the sales that can be made at profitable prices.

Burns gave life to his factual descriptions of timing relationships over the cycle with descriptions of the subjective state of mind of key groups in the economy—consumers, workers, and businessmen. Alternating mood swings of the consumer and businessman drive the process of moving from recovery to recession. During expansion phases "firms will find their profit margins rising handsomely" and "people [have] a feeling of confidence about the economic future—a mood that may gradually change from optimism to exuberance. . . . The new spirit of enterprise fosters more new projects" (Burns 1969, pp. 27–28). However, rising costs erode profit margins and eventually turn expansion into contraction. Also, "overstocking and overbuilding . . . are likely to be bunched when enthusiasm has infected a large and widening circle of businessmen." [then] "The stubborn human trait of optimism begins to give way. . . . Once many men begin to lose faith in themselves or in the institutions of their society, full recovery may need to wait on substantial innovations or an actual reduction in the stock of fixed capital" (Burns 1969, pp. 33, 41).

Generally, in recessions, the reversal of imbalances leads to a recovery. However, if such imbalances are not corrected, the economy may enter into a downward spiral leading to a depression. One could gain some idea of how eclectic Burns's (1969, p. 36) explanation for business cycles is from his discussion of how such a spiral develops:

> As a decline in one sector reacts on another, the economy may begin spiraling downward. . . . The likelihood that a depression will develop depends on numerous factors—among them, the scale of speculation during the preceding phase of prosperity, the extent to which credit was permitted to grow, whether or not the quality of credit suffered significant deterioration, whether any markets became temporarily saturated, how much excess capacity had been created before the recession started. . . .

5. MICROECONOMIC MANAGEMENT OF THE BUSINESS CYCLE

Burns believed that as CEA chairman in the first Eisenhower term he had kept the economy out of a serious recession by mobilizing a whole arsenal of special measures to stabilize the economy. For Burns, the most important ingredient of successful countercyclical policy was to act early to maintain the optimistic psychology of businessmen. Burns ([1950] 1954, pp. 132–33) wrote:

> To glimpse economic catastrophe when it is imminent may prevent its occurrence: this is the challenge facing business cycle theory and policy. . . . the crucial problem of our times is the prevention of severe depressions. . . . developments during "prosperity"—which may cumulate over one or more expansions—shape the character of a depression.

Burns (1957, pp. 30–31 and 69) recited a list of measures the Eisenhower Administration had taken under his leadership to forestall recession and wrote:

> When economic clouds began to gather in the late spring of 1953, the government was alert to the possible danger of depression. . . . In its new role of responsibility for the maintenance of the nation's prosperity, the federal government deliberately took speedy and massive actions to build confidence and pave the way for renewed economic growth. . . . This unequivocal declaration of tax policy, like the earlier moves in the credit sphere, was made when the unemployment rate was 2 1/2 percent. . . . The President recommended a broad program of legislation. . . . whenever the economy shows signs of faltering, the government must honor by its actions the broad principles of combatting recession which served us so well during the decline of 1953–54.

Burns's understanding of the business cycle caused him to emphasize microeconomic tools to control unemployment and inflation. For example, Burns recommended the creation of productivity councils to lower inflation (U.S. Congress, 2/20/73, p. 409):

> I have long believed that productivity councils working at the local level—community by community, establishment by establishment—can be very constructive. We tried them during World War II, and we achieved extraordinary success. I would like to see that effort carried out now on a comprehensive scale. There is enough good will in this country which, if mobilized, could produce significant results. It has not yet been mobilized.

Burns also recommended forced savings as a means of dealing with inflation (U.S. Congress, 6/27/73, p. 179):

> I would look with some favor on a fiscal measure that does not quite fall in the tax category. This would be a plan for compulsory savings, but again of a flexible type. Let us say corporations would be required to put aside 10 percent of the amount of their corporate taxes. That sum would be locked up in the Federal Reserve in such a way that it could be released in the event of a downturn in the economy. In other words, my concept is that we ought to try to siphon off some purchasing power but we ought to do it in such fashion that we could reverse gears and do so rather quickly if the economic need arose.

Because Burns attached so much importance to fluctuations in investment, he campaigned regularly for a variable investment tax credit (Burns [6/6/73] 1978, pp. 157–58):

> Throughout business cycle history, the major force making for economic instability has been the rather large fluctuations characteristic of business investment. . . . we must persist in the search for new and more refined tools of stabilization policy. Ideally, these measures should be of the kind that can be introduced or removed quickly and that will affect private spending decisions rather promptly. . . . I continue to believe that the concept of a variable tax incentive to business investment has merit.

Finally, after becoming FOMC Chairman, Burns wanted direct government intervention to hold down prices and wages (Burns [6/6/73] 1978, p. 156):

> The persistence of rapid advances of wages and prices in the United States and other countries, even during periods of recession, has led me to conclude that governmental power to restrain directly the advance of prices and money incomes constitutes a necessary addition to our arsenal of economic stabilization weapons, to be used occasionally—but nevertheless vigorously—when needed.

Consistent with Burns's emphasis on using microeconomic tools was his de-emphasis of the direct, aggregate demand effects of macroeconomic (monetary and fiscal) policy. His 1957 book *Prosperity Without Inflation* conveys this theme, emphasizing as it does the near impotence of monetary policy. Burns held the conventional view of monetary policy as working through the cost and availability of credit. Moreover, according to Burns, the cost of credit has only a minimal effect on the decisions of businessmen, and financial innovation makes it hard for the Fed to control the availability of credit. Burns (1957, p. 46) wrote, "Many business firms are able to finance their requirements without any borrowing. . . . Interest charges are rarely a large element in business costs, and their practical importance has tended to become smaller as a result of high taxes."

Burns testified (U.S. Congress, 2/20/73, p. 400):

> The proper role of monetary policy in the achievement of our national economic objectives is a comparatively modest one. Monetary policy can help to establish a financial climate in which prosperity and stable prices are attainable. But it cannot guarantee the desired outcome: the task is much too large.

Burns shared the conventional business and Keynesian view that monetary policy was an unduly blunt instrument for controlling inflation. Almost from the beginning of his tenure as Fed Chairman, he pushed for government intervention to restrain prices and wages (Burns [5/18/70] 1978, pp. 95, 98, and 99):

> Another deficiency in the formulation of stabilization policies in the United States has been our tendency to rely too heavily on monetary restriction as a device to curb inflation. . . . severely restrictive monetary policies distort

> the structure of production. General monetary controls . . . have highly uneven effects on different sectors of the economy. On the one hand, monetary restraint has relatively slight impact on consumer spending or on the investments of large businesses. On the other hand, the homebuilding industry, State and local construction, real estate firms, and other small businesses are likely to be seriously handicapped in their operations. When restrictive monetary policies are pursued vigorously over a prolonged period, these sectors may be so adversely affected that the consequences become socially and economically intolerable.
>
> We are in the transitional period of cost-push inflation, and we therefore need to adjust our policies to the special character of the inflationary pressures that we are now experiencing. An effort to offset, through monetary and fiscal restraints, all of the upward push that rising costs are now exerting on prices would be most unwise. Such an effort would restrict aggregate demand so severely as to increase greatly the risks of a very serious business recession. . . . There may be a useful . . . role for an incomes policy to play in shortening the period between suppression of excess demand and restoration of reasonable price stability.

While Burns de-emphasized the direct effects of monetary and fiscal policy, he emphasized their psychological effects, especially on the confidence of the businessman and his willingness to invest. Likewise, Burns attached great importance to the psychological impact of the government deficit on these same two variables.

6. BURNS AS FOMC CHAIRMAN

A variety of beliefs shaped Burns's actions as Fed Chairman: his self-confidence in his forecasting ability; his concern for the fragility of economic recovery; and his fear of the adverse effect on business confidence of sharp increases in interest rates. Burns stressed the President's ability to influence the psychological mood of the public. He likewise stressed the role of the deficit in influencing the willingness of businessmen to invest. To make these views manifest, Burns wanted to remain widely influential within the administration.

Burns was confident of his ability to predict near-term economic activity. After all, he and Mitchell had developed the idea of leading indicators. Leonard Silk (1976, p. 31) wrote:

> Arthur Burns's finest hour was the 1955 recovery. He forecast higher than all his staff. I asked one of his staff "How come?" and he said, "Well Burns has reasons we will never know." But [Paul] Samuelson thinks Burns's real reason was that the General Motors cars of that period had met a resonant response: "You could tell it from the cigarette smoke in the salesroom early in the autumn of '54."

In a similar way, Burns also predicted in 1976 that the contemporaneous economic recovery would be stronger than almost anyone else was predicting.

Burns believed that economic recoveries are fragile and must be nursed along by government policies. He wrote of the mix of strong and weak economic series that turns a recession into an economic recovery (Burns [1950] 1954, p. 113):

> The substitution of one of these majorities for the other takes place gradually, and indeed follows a definite cyclical course. . . . Rising series are only a thin majority at the beginning of a business cycle expansion. Their number swells as aggregate activity increases, though expansion reaches its widest scope not when aggregate activity is at a peak, but perhaps six months or a year earlier. In the neighborhood of a peak, crosscurrents are the outstanding feature of the business situation.

For Burns, monetary policy influenced the state of the business cycle through the effect of interest rates on the psychology of the businessman. For that reason, he was not willing to raise interest rates sharply during economic recovery. Burns testified (U.S. Congress, 7/20/71, p. 256):

> This March and April, the Federal Reserve System faced a dilemma. Information available at that time suggested that high rates of monetary growth might well persist under existing conditions in the money market. Interest rates, however, were already displaying a tendency to rise, and vigorous action to restrain monetary growth might have raised them sharply further. In view of the delicate state of the economic recovery, which was just getting under way, it seemed desirable to prevent the possible adverse effects of sharply higher interest rates on expenditure plans and public psychology.

Burns ([1947] 1954, p. 230) wrote that "Economics is a very serious subject when the economist assumes the role of counselor to nations." With his long experience in government, as head of the CEA and later as informal adviser to Nixon, Burns took very seriously his role as "counselor." He believed he had the knowledge that would aid the government when it intervened in the economy to prevent economic imbalances from cumulating in a destabilizing way and producing either prolonged recession or inflation. He could show how to control inflation without a prolonged recession. For Burns, the problem was that monetary policy constituted only one part of the arsenal of weapons he needed. He also wanted to influence another weapon in the arsenal, namely fiscal policy. Furthermore, he wanted aggressive special intervention by the President into the price and wage decisions of the private sector.

Burns's penchant for government intervention reflected the importance he attached to strong leadership. He exercised a commanding presence. A magazine article on Burns commented that "Where Arthur sits, there is the head of the table." By personality, Burns was a leader, and he wanted to inspire the President to be the kind of leader Burns believed the country needed. Although the incomes policy Burns advocated in 1970 and the first half of 1971 lacked the legal sanctions of controls, it would, Burns believed, allow the President to lead. With leadership, the country could avoid a painful choice between inflation and unemployment.

Burns saw himself as playing a key role in prodding the government into leadership. A small, but telling, example is the reinstitution at Burns's initiative of sterilized foreign exchange intervention in the summer of 1972. Sterilized foreign exchange intervention changes neither the money stock nor interest rates but, for Burns, government action could have a galvanizing effect on markets. Burns told the FOMC (FOMC *Minutes*, 7/18/72, pp. 734–35):

> . . . despite the atmosphere of unease that had prevailed in the international financial world for a good many months, the United States—the only nation capable of exerting effective leadership—had appeared to be playing a passive role, with no clear-cut policy or program. . . . he [Burns] had outlined certain principles of world monetary reform in his speech at the International Monetary Conference in Montreal last May. He had made that address reluctantly, since he would have preferred to have such a statement come from the Treasury Department. It had seemed necessary for him to speak out, however, because a certain hopelessness and despair had settled on international financial markets. His remarks had received world-wide acclaim, not because of their intrinsic merit, but because of the widespread hunger for leadership; they represented the first outgoing, constructive statement by a senior U.S. official indicating a willingness on this country's part to help in reestablishing monetary order. . . . There were times for blowing a trumpet within the halls of Government, and this was one of them. Those efforts had now produced results. . . . By demonstrating that the United States was prepared to cooperate with other nations in defending the Smithsonian parities, such operations could have a major impact on market psychology.

7. INFLATION AS A NONMONETARY PHENOMENON

Burns had an eclectic view of the causes of inflation. His earliest comprehensive treatment of inflation is *Prosperity Without Inflation.* Burns (1957, p. 7) stated that "There is . . . not one cause of the post-war inflation but many." However, among the many factors, the most important was a wage-price spiral caused by expectations of inflation. "One of the main factors in the inflation that we have had since the end of World War II is that many consumers, businessmen, and trade union leaders expected prices to rise and therefore acted in ways that helped to bring about this result" (Burns 1957, p. 71).

Throughout his life Burns returned to the theme of a wage-price spiral driven by the expectation of inflation. The expectation of inflation arose from the public's belief that government would shield individual groups from competition. Shortly after he became Fed Chairman, Burns ([5/18/70] 1978, pp. 91–102) gave a speech to the American Bankers Association, where he stated:

> . . . the root of the difficulty [inflationary bias] seems to be the broadening of the social aspirations that have been shaping our national economic policies, and especially the commitment to maintain high levels of employment and rapid economic growth. . . . Another source of inflationary pressure in recent years has been the rise of governmental expenditures for social welfare. . . . The present world-wide inflationary trend may thus be ascribed to the humanitarian impulses that have reached such full expression in our times.

After leaving the Fed, Burns gave a speech in 1979 called “The Anguish of Central Banking.” He said (Burns 1979, pp. 12, 13, and 21):

> Once it was established that the key function of government was to solve problems and relieve hardships—not only for society at large but also for troubled industries, regions, occupations, or social groups—a great and growing body of problems and hardships became candidates for governmental solution. . . . Their [government programs] cumulative effect . . . was to impart a strong inflationary bias to the American economy. . . . The pursuit of costly social reforms often went hand in hand with the pursuit of full employment. . . . This weighting of the scales of government policy inevitably gave an inflationary twist to the economy, and so did the expanding role of government regulation. . . . My conclusion that it is illusory to expect central banks to put an end to the inflation that now afflicts the industrial economies does not mean that central banks are incapable of stabilizing actions; it simply means that their practical capacity for curbing an inflation that is driven by political forces is very limited.

Burns did not consider money to be a major independent influence on economic activity or inflation. For Burns, the fundamental determinant of economic activity was the confidence of businessmen. As a result, Burns emphasized not the rate of growth of money but its short-run velocity, which he believed reflected that confidence. At the December 1974 FOMC meeting, Burns stated (FOMC *Minutes*, 12/17/74, pp. 1312–14 and 1338):

> The willingness to use money—that is, the rate at which money turned over, or its velocity—underwent tremendous fluctuations; velocity was a much more dynamic variable than the stock of money, and when no account was taken of it, any judgment about the growth rate of M1 was likely to be highly incomplete. . . . Fundamentally, velocity depended on confidence in economic prospects. When confidence was weak, a large addition to the money stock might lie idle, but when confidence strengthened, the existing stock of money could finance an enormous expansion in economic activity.

Money was important, but only as it affected interest rates. Burns saw monetary policy through the optic of credit markets. With interest rates being the measure of monetary ease or tightness, monetary policy could be restrictive even if money growth was rapid. Burns testified to Congress (U.S. Congress, 6/27/73, p. 185):

> We began applying monetary restraint as early as March of 1972. This is reflected in interest rates. . . . I do not want to leave you with the impression that . . . we went much too far in the growth of the aggregates [in 1972]. I do not think we did.

In 1973 and 1974, as inflation rose sharply, Burns became sensitive to monetarist criticism of the Fed for allowing high rates of M1 growth. In 1973 and the first half of 1974, the FOMC, with Burns's encouragement, moderated the M1 growth. However, while acknowledging that inflation could not continue without rapid money growth, Burns challenged the monetarists by arguing that rapid money growth had followed inflation, rather than preceding it. Burns testified (U.S. Congress, 7/30/74, p. 257):

> The current inflationary problem emerged in the middle 1960s when our government was pursuing a dangerously expansive fiscal policy. Massive tax reductions occurred in 1964 and the first half of 1965, and they were immediately followed by an explosion of Federal spending. . . . Our underlying inflationary problem, I believe, stems in very large part from loose fiscal policies, but it has been greatly aggravated during the past year or two by . . . special factors. . . . From a purely theoretical point of view, it would have been possible for monetary policy to offset the influence that lax fiscal policies and the special factors have exerted on the general level of prices. One may, therefore, argue that relatively high rates of monetary expansion may have been a permissive factor in the accelerated pace of inflation. I have no quarrel with this view. But an effort to use harsh policies of monetary restraint to offset the exceptionally powerful inflationary forces of recent years would have caused serious financial disorder and dislocation.

When Burns became Chairman of the FOMC in February 1970, economic activity had fallen for two months from its December 1969 cyclical peak. During the recession of 1970, inflation failed to decline. Burns drew the conclusion that the contemporaneous inflation arose primarily from a rise in wages due to the exercise of monopoly power by labor unions. In a speech before the American Economics Association, Burns ([12/29/72] 1978, pp. 143–54) stated:

> The hard fact is that market forces no longer can be counted on to check the upward course of wages and prices even when the aggregate demand for goods and services declines in the course of a business recession. During the recession of 1970 and the weak recovery of early 1971, the pace of wage increases did not at all abate as unemployment rose. . . . The rate of inflation was almost as high in the first half of 1971, when unemployment averaged 6 percent of the labor force, as it was in 1969, when the unemployment rate averaged 3 1/2 percent. . . . Cost-push inflation, while a comparatively new phenomenon on the American scene, has been altering the economic environment in fundamental ways. . . . If some form of effective control over wages and prices were not retained in 1973, major collective bargaining settlements and business efforts to increase profits could reinforce the pressures on costs and prices that normally come into play when the economy is advancing

> briskly, and thus generate a new wave of inflation. If monetary and fiscal policy became sufficiently restrictive to deal with the situation by choking off growth in aggregate demand, the cost in terms of rising unemployment, lost output, and shattered confidence would be enormous.

The Nixon Administration designed the wage and price controls program that began August 15, 1971, on the assumption that the monopoly power of labor unions was producing a cost-push inflation. Wage guidelines of 5.5 percent, along with strong productivity growth, did in fact restrain the growth of unit labor costs of corporations. The controls program allowed corporations to increase prices in line with increases in costs, but those prices were subject to strict limitations. Corporations had to pass a profits test before they could raise prices in response to higher costs. Large corporations had to receive explicit permission from the Cost of Living Council before raising prices. In fact, the controls program did keep the corporate price increases to a moderate pace (see Kosters [1975]). Controls did everything they were supposed to do, except prevent a rise in inflation. In 1973, the prices of commodities traded on world markets began to soar. Those prices were uncontrollable without strict export controls and rigid price ceilings accompanied by mandatory allocation schemes—measures that were unacceptable to the Nixon Administration.

Burns attributed the inflation that began in 1973 to a variety of special factors (U.S. Congress, 2/1/74, pp. 669–70):

> In retrospect, it might be argued that monetary and fiscal policies should have been somewhat less expansive during 1972, but it is my considered judgment that possible excesses of this sort were swamped by powerful special factors that added a new dimension to our inflationary problem. . . . A major source of the inflationary problem last year was the coincidence of booming economic activity in the United States and in other countries. . . . Another complicating factor was the devaluation of the dollar. . . . disappointing harvests in 1972—both here and abroad—caused a sharp run-up in prices. . . . In short, the character of inflation in 1973 was very different from the inflation that troubled us in different years. A worldwide boom was in process; the dollar was again devalued; agricultural products, basic industrial materials, and oil were all in short supply.

Both Burns and the economists in the Nixon Administration believed that the special factors that were exacerbating inflation in 1973 would dissipate in 1974 and, consequently, inflation would decline. Nevertheless, inflation remained in the low double digits throughout 1974. For that reason, Burns remained a strong advocate of incomes policies to control inflation (U.S. Congress, 7/30/74, p. 258). However, on April 30, 1974, the President's authority to impose wage and price controls expired. The Cost of Living Council, which had administered the controls, disappeared at the same time. Even though Burns lobbied hard for reestablishment of an incomes policy, the price-controls program had become discredited in Congress. Also, the key economic policymakers in the incoming Ford Administration, in particular CEA chairman Alan Greenspan and Treasury Secretary William Simon, opposed incomes policies.

In the last half of 1974, with an incomes policy no longer viable and with inflation continuing unabated, Burns returned to the themes of government spending and deficits as the primary cause of inflation. He testified to Congress (8/21/74, p. 213), “The current inflation began in the middle 1960s when our government embarked on a highly expansive fiscal policy.” And again, Burns testified (U.S. Congress, 9/25/74, p. 119):

> . . . special factors have played a prominent role of late, but they do not account for all of our inflation. For many years, our economy and that of most other nations has been subject to an underlying inflationary bias. . . . The roots of that bias . . . lie in the rising expectations of people everywhere. . . . individuals and business firms have in recent times come to depend more and more on government, and less and less on their own initiative, to achieve their economic objectives. In responding to the insistent demands for economic and social improvement, governments have often lost control of their budgets, and deficit spending has become a habitual practice. Deficit spending . . . becomes a source of economic instability . . . during a period of exuberant activity.

Burns told the FOMC, “While the U.S. inflation was attributable to many causes, a large share of the responsibility could be assigned to the loose fiscal policy of recent years” (FOMC *Minutes,* 5/21/74, p. 669).

The problem with Burns’s argument that the government’s fiscal laxness had caused inflation was that government deficits had not been especially large. As a percentage of GNP, the government (federal, state, and local) surplus or deficit (−) was 1.1 in 1969, −1.0 in 1970, −1.7 in 1971, −0.3 in 1972, 0.5 in 1973, and 0.2 in 1974. The deficits of 1970 and 1971 reflected the recession. Burns augmented the magnitude of the conventionally measured deficit by adding the borrowing of government-sponsored agencies like the Federal National Mortgage Association. However, economists challenged Burns on this point (see Walter Heller in U.S. Congress, 8/6/74, p. 248).

Ultimately, Burns attributed the effect of the deficit on inflation to its influence on the psychology of businessmen. Because the deficit symbolized a lack of government discipline, it lessened the willingness of businessmen to exert the discipline required to hold down wages and, as a consequence, prices. The importance that Burns placed on the psychological effects of the deficit are evident in his comments both at FOMC meetings and at congressional hearings. At one FOMC meeting, Burns made his point by taking a shot at the Keynesianism of the Board staff (Board *Minutes,* 12/16/74, p. 1261):

> The Chairman then asked what the staff thought the net effect would be of a simultaneous decrease of, say, $20 billion in both Federal expenditures and business taxes. In response, Mr. Pierce said the econometric model would indicate that such a policy was deflationary, on balance, because it would

> result in a rise in savings. Chairman Burns observed that in his opinion the effects would be strongly expansionary rather than deflationary; a $20 billion tax cut would create a wholly new environment for business enterprise, and businessmen would react by putting their brains, their resources, and the credit facilities to work. His disagreement with the staff on that point reflected a basic difference in interpretation of how the economy functioned and how fiscal stimulants and deterrents worked their way through the system.

According to Burns, a reduction in the deficit would both stimulate economic activity and reduce inflation. He testified to Congress (8/6/74, pp. 225–26 and 229):

> If the Congress . . . proceeded to cut the budget . . . then confidence of business people, and of heads of our households, that the inflation problem will be brought under control would be greatly enhanced. In this new psychological environment, our trade unions may not push quite so hard for a large increase in wage rates, since they would no longer be anticipating a higher inflation rate. And in this new psychological environment, our business people would not agree to large wage increases quite so quickly. Therefore, these indirect effects of a cut in the Federal budget of $5 [billion] or $10 billion can in such an environment be vastly larger than what the mathematical models . . . suggest. . . . If this Congress were to vote this day . . . a cut of $10 billion in spending, the stock market would revive promptly, the bond market would revive promptly, and short-term interest rates would move down promptly. . . . Forces . . . would be released within the private sector that would in time make more jobs for our people.

8. WAGE AND PRICE CONTROLS

Burns (1966, p. 61) had opposed wage and price controls in the 1960s as "a grim expedient that would indeed suppress inflation for a time, but at the cost of impairing efficiency as well as crushing economic freedom." Why did he later change his views?

Burns believed that as chairman of the CEA under Eisenhower he had shown how to prevent a serious cyclical downturn. Having solved that problem, he wanted next to show how to lower inflation while maintaining economic expansion. Burns never viewed as inevitable the need for monetary policy to trade off between reducing inflation and maintaining growth. He saw himself as pursuing with equal vigor both the objectives of lowering inflation and of promoting economic growth. Burns used the expression "There is no need to be afraid of prosperity" to rally the FOMC to expansionary policies (FOMC *Minutes*, 8/15/72, p. 803). The same expression also surfaced in his congressional testimony (U.S. Congress, 2/20/73, pp. 402, 416):

> We live in troubled times, and memories are still fresh of the damage produced by inflation during the later years of the 1960s. But there is no need to be

> afraid of prosperity. . . . the objective of our monetary policy is, in the first instance, to sustain high levels of production and employment and, in the second place, not to contribute to inflationary pressures.

Burns rejected the idea of a tradeoff between inflation and unemployment because, he believed, inflation caused high unemployment. If, through presidential leadership, the United States were to mitigate the inflationary psychology that propelled inflation, economic activity would advance as inflation fell. At Burns's nomination hearings for the post of Fed Chairman, Senator Proxmire questioned Burns (U.S. Congress, 12/18/69, pp. 23–24):

> **Proxmire:** Let me ask you about your views on the Phillips curve. . . . Many economists argue the only way to reduce inflation is to follow a policy which is going to result in some unemployment.
>
> **Burns:** I think even for the short run the Phillips curve can be changed. I think we ought to be able in the years ahead to pursue when we need to a restrictive financial policy without significantly increasing unemployment.

(The Phillips curve expresses the relationship between inflation and measures of real economic activity such as real growth or the unemployment rate.)

Burns (1957, p. 17) believed that normal cyclical behavior entailed a rise of prices during expansions and a subsequent fall in contractions: "Experience both before and after 1933 suggests . . . that when expansions are long or vigorous, the price level tends to rise substantially, and that when contractions are brief and mild, the decline in the price level tends to be small." Inflation and deflation were a characteristic of the cyclical behavior of economic activity, not monetary policy. When inflation failed to decline during the 1970 recession, Burns blamed the continued inflation on the aggressive exercise of monopoly power by unions.

Burns laid out his philosophy of managing the economy in a speech at Pepperdine College. He emphasized the importance of confidence for maintaining economic recovery, the way that inflation undermined that confidence, and the role that leadership from Washington could play in reducing inflation by altering the expectation that inflation was self-perpetuating. Burns believed that an incomes policy would engender a reduction in inflationary psychology, or expectations, as well as inflation itself. Such reduction would spur a vigorous economic recovery. Burns ([12/7/70] 1978, pp. 103–05 and 113–15) argued:

> The role that confidence plays as a cornerstone of the foundation for prosperity cannot, I think, be overstressed. . . . If we ask what tasks still lie ahead, the answer I believe must be: full restoration of confidence among consumers and businessmen that inflationary pressures will continue to moderate.
>
> [Inflation first arose because of] the imprudent policies and practices pursued by the business and financial community during the latter half of the 1960s [and because of the] mood of speculative exuberance. [More recently] the inflation that we are still experiencing is no longer due to excess demand. It

> rests rather on the upward push of costs—mainly, sharply rising wage rates. Wage increases have not moderated.
>
> In a society such as ours, which rightly values full employment, monetary and fiscal tools are inadequate for dealing with sources of price inflation such as are plaguing us now—that is, pressures on costs arising from excessive wage increases. . . . We should consider the scope of an incomes policy quite broadly. . . . We are dealing . . . with a new problem—namely, persistent inflation in the face of substantial unemployment—and . . . the classical remedies may not work well enough or fast enough in this case. Monetary and fiscal policies can readily cope with inflation alone or with recession alone; but, within the limits of our national patience, they cannot by themselves now be counted on to restore full employment, without at the same time releasing a new wave of inflation.

Burns campaigned publicly for an incomes policy because he believed that monetary and fiscal policy could not by themselves achieve his goal of a combined economic recovery and return to price stability. Shortly before the imposition of price controls, he testified before Congress (U.S. Congress, 7/20/71, p. 259):

> . . . the present inflation in the midst of substantial unemployment poses a problem that traditional monetary and fiscal policy remedies cannot solve as quickly as the national interest demands. That is what has led me . . . to urge additional governmental actions involving wages and prices. . . . The problem of cost-push inflation, in which escalating wages lead to escalating prices in a never-ending circle, is the most difficult economic issue of our time.

Burns believed that the labor unions, through their exercise of monopoly power to push up wages, were blocking his attempt to lower inflation and stimulate economic activity. He attacked the monopoly power of corporations and unions (U.S. Congress, 2/20/73, p. 414, and 8/21/74, p. 219, respectively):

> As for excessive power on the part of some of our corporations and our trade unions, I think it is high time we talked about that in a candid way. We will have to step on some toes in the process. But I think the problem is too serious to be handled quietly and politely.
>
> . . . we live in a time when there are abuses of economic power by private groups, and abuses by some of our corporations, and abuses by some of our trade unions.

More than anyone else, Burns had created widespread public support for the wage and price controls imposed on August 15, 1971. For Burns, controls were the prerequisite for the expansionary monetary policy desired by the political system—both Congress and the Nixon Administration. Given the imposition of the controls that he had promoted, Burns was effectively committed to an expansionary monetary policy. Moreover, with controls, he did not believe that expansionary monetary policy in 1972 would be inflationary.

In 1957 Milton Friedman wrote Burns a nine-page letter that criticized Burns's manuscript *Prosperity Without Inflation* for confusing monetary policy with credit policy. (Burns did not alter the manuscript.) Friedman (1957) argued that one should consider the effect of the money stock on nominal expenditure and prices independently of the operation of the credit market:

> . . . it is striking that changes in the stock of money have had very similar effects under widely different institutional arrangements for bringing about changes in it, some under which the credit market was of minor importance. . . . the evidence persuades me that this old fashioned, fairly direct linkage between the stock of money and flows of outlays is empirically more important than the Keynesian linkage between investment and other outlay flows that underlies the credit policy approach you adopt—though I was almost reconciled to seeing Keynes conquer central bankers I now feel like saying "et tu, Brute!" . . . Where . . . these lectures can do a great deal of harm . . . is your taking its [monetary policy's] effects to operate solely through the "credit" market. If this is right, then any other device for affecting "credit" will do as well, such as investment controls, and the like; and, indeed, will be better since they will enable you to affect what you want to directly, not indirectly.

Friedman's analysis was prophetic. If the behavior of prices does not depend on money, but instead depends on factors specific to particular markets, then direct controls are an effective way to constrain inflation.

9. CONCLUDING COMMENTS

Burns did not consider monetary policy to be the driving force behind inflation. He believed that inflation emanated primarily from an inflationary psychology produced by a lack of discipline in government fiscal policy and from private monopoly power, especially of labor unions. It followed that if government would intervene directly in private markets to restrain price increases, the Federal Reserve could pursue a stimulative monetary policy without exacerbating inflation. Almost from the beginning of his tenure as Fed Chairman, Burns lobbied for government intervention in private wage and price setting. When such measures were enacted into wage and price controls on August 15, 1971, he became willing to continue the expansionary monetary policy that had begun early in 1971.

The fundamental divide in monetary economics is whether the price level is a monetary or a nonmonetary phenomenon. If the price level is a monetary phenomenon, it varies to endow the nominal quantity of money with the real purchasing power desired by the public. The central bank is *the* cause of inflation.

If the price level is a nonmonetary or real phenomenon, its behavior possesses multiple, changing causes. Direct intervention by government in the price setting practices of the public can lower inflation. Such intervention permits a more expansionary monetary policy designed to lower unemployment and stimulate real growth.

Burns conducted monetary policy on the assumption that the price level is a nonmonetary phenomenon. The Congress and the administration, public opinion, and most of the economics profession supported that policy. The result was inflation. That inflation eventually led to the present consensus that the control of inflation is the paramount responsibility of the central bank.

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