Journal of Post Keynesian Economics

ISSN: 0160-3477 (Print) 1557-7821 (Online) Journal homepage: http://www.tandfonline.com/loi/mpke20

The meaning of an inflation crisis: steel, Enron, and macroeconomic policy

WESLEY W. WIDMAIER

To cite this article: WESLEY W. WIDMAIER (2005) The meaning of an inflation crisis: steel, Enron, and macroeconomic policy, Journal of Post Keynesian Economics, 27:4, 555-573

To link to this article: https://doi.org/10.1080/01603477.2005.11051461

WESLEY W. WIDMAIER

The meaning of an inflation crisis: steel, Enron, and macroeconomic policy

Abstract: *How do crises shape policy possibilities? While some scholars cast crises as material shocks, this paper offers a Post Keynesian or constructivist theory of crises as events that agents* interpret. *It contrasts opposing Galbraithian and classical interpretations of the 1962 steel crisis and the 2000–2001 California energy crisis. Whereas Galbraithian interpretations of the former stressed abuses of market power and legitimated wage–price guideposts, classical interpretations of the latter stressed regulatory excesses and delayed the imposition of price caps. This paper concludes that the absence of wage–price guidelines compelled the post-1970s use of austerity to limit inflation, explaining reduced U.S. growth.*

Key words: *constructivism, crisis, imperfect competition, inflation, market power.*

How do economic crises structure policy choices? To what degree do prevailing economic understandings and societal attitudes matter more than "material" pressures? What are the implications for economic growth? Some argue that crises matter most, as they disrupt the material bases of political coalitions, spur political realignments, and thus legitimate particular definitions of policy interests. However, such analyses are incomplete to the extent that agents under conditions of uncertainty cannot react to events until they have *interpreted* them (Keynes, 1936). Even materially similar events can be viewed in a range of fashions, legitimating varying policy responses. Consider, for example, the steel crisis of 1962 and the energy crisis of 2000–2001. Each spurred debate

Wesley W. Widmaier is an Assistant Professor of Political Science at St. Joseph's University in Philadelphia. For their insights, the author thanks Lisa A. Baglione, Jacqueline Best, Mark Blyth, Paul Davidson, David V. Edwards, James K. Galbraith, Thomas Kane, Francis Graham Lee, Benjamin Liebman, and Alexander Wendt. An early version of this paper was presented at the Haub School of Business Research Forum, St. Joseph's University. The usual disclaimers apply.

0160–3477 / 2005 $9.50 + 0.00.

over the implications of market power for inflationary trends. Yet, despite their underlying material similarities, they engendered quite different policy reactions. In the 1962 crisis, President John F. Kennedy marshaled presidential rhetorical and administrative resources to press the steel companies, threaten antitrust efforts, and force a rollback of the price increase. In the 2000–2001 energy crisis, policy-makers resisted calls for price controls and urged deregulation to induce greater supply. Only after power prices in California and the western United States had topped $1,000 per megawatt hour (MWh) at points over the December 2000–June 2001 period did the imposition of controls bring prices down to an average $59 per MWh by July and August 2001 (Fox, 2003, pp. 219–220; Sweeney, 2002, pp. 146–154). Indeed, even after this successful use of controls, the public and policy-makers alike continued to assign blame for the crisis to the policies of then-Governor Gray Davis—rather than power companies—and continued to favor deregulation.

To explain this variation, this paper provides what political scientists would term a *constructivist* analysis of economic crises (Blyth, 2002; Widmaier, 2003, 2004), one broadly in accord with the assumptions underlying Post Keynesian economics. Constructivist approaches emphasize the role of intersubjective understandings—similar to Keynes's (1936) notion of "conventions"—in shaping interpretations of crises and policy interests. The next section applies this framework by contrasting *Galbraithian* interpretations of inflation as driven by the abuse of market power with *classical* constructions of inflation as a function of macroeconomic pressures. In the Galbraithian view, market failures justify the use of exhortation, guidelines, or controls to stabilize price expectations.[1] From the classical perspective, government and policy missteps legitimate combinations of monetary restraint and deregulation to curtail demand and increase efficiency. The third section contrasts constructions of the Kennedy steel crisis and the California energy crisis. Whereas the Galbraithian emphasis on steel companies' abuse of market power legitimated the use of wage and price guideposts to stabilize expectations, classical stresses on regulatory excesses in California legitimated a later emphasis on monetary restraint and deregulation. The

[1] Exhortation, guidelines, and controls were used through the early post–World War II period to coordinate monetary expectations. Since the 1970s, exhortationary attempts to encourage restraint or voluntary guidelines have fallen into disuse, whereas controls have been used in a less "social," and instead more coercive, fashion.

paper concludes by suggesting that this Post Keynesian–constructivist analysis offers unique insights into the post-1970s decline in U.S. economic growth: from the 1940s into the 1970s, the use of guidelines enabled average annual U.S. growth rates of nearly 4 percent. In contrast, from 1980 to 2002, reliance on monetary policy to stem wage and price increases—in the absence of guidelines—resulted in reduced average growth rates of 2.9 percent.[2] From this vantage point, a post–Vietnam War breakdown in "social capital"—or the ability of agents to trust one another and employ resources effectively (Coleman, 1988; Putnam, 1996)—impeded the use of guidelines as alternatives to monetary austerity.[3] This demonstrates the merit of Post Keynesian insights—which emphasize the weight of uncertainty and the importance of conventions—in explaining not only policy choices but also macroeconomic outcomes.

Theoretical framework: the social construction of monetary crises

The approach employed in this paper—combining insights from Post Keynesian and constructivist perspectives—is premised on assumptions that intersubjective understandings (1) give meaning to incentives and constitute state and social interests, and (2) are sustained or transformed through ongoing interaction. This counters materialist views of crises as exogenous shocks or as combining "a major downturn in the investment/business cycle, a major change in the geographical distribution of production, and a significant growth of new products and new productive processes" (Gourevitch, 1986, p. 20). Such events ostensibly reshape domestic coalitions in ways that spur shifts in policy choices. In contrast, from this more "socialized" perspective, intersubjective understandings must first give meaning to events *as* crises. Policy-makers cannot, after all, react to "exogenous shocks" until they have endogenously interpreted them. When agents participate in debates over the meaning of such events, they engage in the *construction of crises,* sustaining and sometimes transforming understandings and interests (McCloskey, 1990, pp. 24–27). These struggles manifest themselves in public and elite policy

[2] Calculations from Federal Reserve Bank of St. Louis (research.stlouisfed.org/fred/data/gdp/gdpca); CEA, 2003.

[3] The importance of social capital has, of course, long been recognized by Post Keynesians. For example, a desire to combine social capital and market incentives played a key role in motivating the Wallich–Weintraub tax-based incomes policy proposals of the 1970s.

debates, academic discourses, and presidential and administration (e.g., Council of Economic Advisers [CEA]) pronouncements. They involve the use of rhetorical and narrative practices to cast events as signifying particular kinds of problems, requiring the provision of governance for specific purposes, and at times legitimating a new intersubjective framework in the reversal of the precrisis state.[4]

In applying this approach to postwar U.S. debates over inflation, this paper distinguishes *Galbraithian* from *classical* understandings. These, respectively, stress the more *oligopolistic* or *perfectly competitive* nature of markets, and the importance of *market failures* or *state failures* in explaining instability. Whereas Galbraithian perspectives highlight the role of market failures and monopolistic or oligopolistic firms' use of market power to drive up prices, more classical approaches stress the destabilizing effects of policies that suppress market incentives. Of course, debates over such perspectives can never be decisively settled, as regulations can always be justified with reference to prior market errors, and ostensible market errors can be attributed to regulatory distortions. More fundamentally, the apparent "accuracy" of either Galbraithian or classical assumptions often depends on the prevailing beliefs of state and societal agents, as the wider acceptance of either view can imbue it with the force of a "self-fulfilling prophecy."[5] This paper, therefore, offers not a theory of how economic agents "objectively" interact but, rather, one that emphasizes the ways in which economic understandings can have self-fulfilling effects on interests and policy possibilities.

Galbraithian assumptions: imperfect competition and market failures

Over the past several decades, among the most influential analyses of oligopolistic practices and the merit of price controls have been pro-

[4] Neither of the crises under study here could be viewed as "transformative," as each ultimately sustained the prevailing conventional wisdom of its time. Examples of such transformative crises, which reshape prevailing understandings and interests, include the 1929 stock market crash and "stagflations" of the 1970s.

[5] The notion that economic discourses affect public attitudes has gained increased notice in recent years, most prominently in Robert Frank's research regarding the reflexive effects of classical theory in "teaching" agents to be more selfish. In this light, while classically oriented observers may argue that wage and price guidelines "do not work," the strength of such claims may depend on their accord with the prevailing social context, which can imbue them with the status of a self-fulfilling prophecy. On "self-fulfilling prophecies," see Wendt (1999, p. 186); on classical economics and its reflexive effects on behavior, see Frank et al. (1993).

vided by the economist John Kenneth Galbraith.[6] In *The Affluent Society,* Galbraith distinguishes competitive sectors, in which "prices and costs are impersonally determined by the market for all" from oligopolistic ones, in which firms enjoy market power over prices (Galbraith, 1958, p. 186). This distinction matters because "firms in competitive markets . . . cannot pass higher interest costs ahead to the consumer," yet "firms in the oligopolistic sector are likely . . . to pass higher [wage and interest] charges along to the consumer" (ibid., pp. 185–186). In oligopolistic sectors, there will therefore exist a greater tendency to inflation. For this reason, price controls can have a beneficial effect if they force monopolistic or oligopolistic firms to increase output to the point where prices fall to more "competitive" levels. Galbraith so argues that the government should counter private price fixing by defining wage and price standards to highlight public interests in private decisions. As he famously put it, "it is relatively easy to fix prices that are already fixed" (Galbraith, 1952, p. 17).

This analysis has added implications for monetary policy and economic growth. Galbraith also distinguishes "rising prices associated with specific *bottlenecks*" from "rising prices associated with an approach to full employment," arguing that where oligopolistic collusion creates bottlenecks, monetary restraint might undermine growth well in advance of any effects on inflation (Galbraith, 1941, p. 82). Monetary restraint would "check inflation by checking the whole expansion process" (ibid., p. 83). In order to prevent preemptive recourse to monetary restraint, Galbraith argues that exhortation, guidelines, or controls could stabilize price expectations in a manner that avoids the need for austerity. Such administrative measures can then neutralize the ostensible Phillips curve trade-off between increased rates of inflation and unemployment, as it "would not be necessary to enforce any substantial amount of idle capacity and unemployment" to prevent inflation (Galbraith, 1958, p. 194). In sum, from the Galbraithian vantage point, the inability of monetary restraint to contain wage–price spirals necessitates the use of exhortation, guidelines, and controls.

Ironically, whereas classical economists have tended to downplay Galbraithian insights in recent years, industrial agents remain highly

[6] E.H. Chamberlin's *Theory of Monopolistic Competition* (1933) and Joan Robinson's *The Economics of Imperfect Competition* (1933) anticipated Galbraith's arguments, though did not as fully develop implications for macroeconomic policy autonomy.

attuned to their relevance. For example, in a manner at odds with wider claims regarding Enron's role in increasing market efficiencies, one-time Enron CEO Jeffrey Skilling actually based his own view of the economy on a Galbraithian model. In an address at the University of Virginia, Skilling cast Enron as an "asset-light" company that sought to trade around bottlenecks. He held out as a model the example of Standard Oil under John D. Rockefeller, noting that Rockefeller had emphasized the importance of marketing, distribution, and the accumulation of control over smaller firms, rather than the acquisition of oil production assets themselves. Skilling argued that "[Standard] focused strictly on logistics and marketing . . . [b]ecause that was the only place that there was a bottleneck in the system, and by owning the network they would maintain the bottlenecks" (Fox, 2003, p. 99). Despite their differences over the need to promote more public or private interests, Galbraith and Skilling share the same view of markets as more imperfectly than perfectly competitive, with the existence of bottlenecks having a critical importance. Yet, among academic economists, the trend has been to treat markets as more perfectly competitive, an assumption with significantly different implications for policy.

Classical assumptions: perfect competition and government failures

In contrast to Galbraithian views, classical assumptions hold that market agents are efficient or employ "all available information" in determining asset prices, limiting possibilities for market errors, and raising questions regarding government efficiency (Lucas and Sargent, 1978; Muth, 1961). Responding to the Galbraithian advocacy of price controls, classical economists—most prominently, Milton Friedman—warn that price ceilings discourage production by removing the incentive for firms to fully satisfy demand. Controls suppress the price mechanism and create situations in which the demand for goods exceeds supply. Further, although controls might temporarily repress inflationary tendencies, they may contribute to higher prices in the long run. Inverting Galbraith's arguments regarding monetary policy, classical economists argue that apparent ease of controls risks tempting monetary policymakers into recklessly increasing the money supply. This possibility was perhaps best demonstrated in the early 1970s, when price controls imposed by the Nixon administration were accompanied by a period of monetary expansion at the Federal Reserve under its then-chairman, Arthur Burns (Woolley, 1984).

Developing these policy implications, Friedman argues that oligopolistic pricing will not lead to generalized inflation "unless the cost–push" dynamic in isolated industries "produces a monetary expansion" by the central bank (1968, p. 21). Such a concern for monetary policy excesses is reflected in Friedman's famous dictum that inflation is "always and everywhere a monetary phenomenon, resulting from and accompanied by a rise in the quantity of money relative to output" (1966, p. 18). Put differently, inflation occurs when "too much money chases too few goods," leaving the proper role for monetary authorities, as William McChesney Martin, Federal Reserve chairman from 1951 to 1970, famously put it, to "lean against the winds" of inflation by tightening up on monetary policy (Greider, 1987, p. 328). Friedman therefore argues that "the only effective way to stop inflation is to restrain the rate of growth of the quantity of money" (1966, p. 18).

Classical economists finally hold that market efficiency in the use of information justifies the treatment of economies *as if they were* perfectly competitive. Even in apparently oligopolistic industries, the existence of substitutes and threat of entry by competitors ensures that markets will clear at competitive prices. For example, Friedman argues that even if a steel cartel raised prices, any increase "would reduce the amount of steel that people want to buy," as purchasers "would shift to substitute products." With respect to wages, steel producers "would hire fewer workers" who would, in turn, "seek employment elsewhere, tending to drive down wages and prices in other industries" (Friedman, 1968, p. 21). More recently, Nobel laureate Robert Merton suggested that financial and technological innovations might even make once-oligopolistic industries more perfectly competitive. For example, by "entering into contracts that call for the delivery of crude oil by the firm on one date in return for receiving a mix of refined petroleum products at a later date," a firm with no refining capabilities "could complete the vertical integration of the firm by using contractual agreements instead of physical acquisition of a refinery," effectively creating "a synthetic refinery." Firms would not have to invest in refining capabilities themselves, eliminating a key barrier to entry. Merton even cited Enron as a firm whose practices may "lead to a revisiting of the industrial-organization model for these industries" (Merton, 1998, pp. 342–343). In sum, classical views deny any need for guidelines or controls, justifying instead deregulation and austerity as means to price stabilization. The following sections demonstrate the effects of these assumptions on policy, employing an interpretive methodology to examine two materially similar events, and thus highlight the importance of intersubjective variation in shaping policy choices.[7]

The construction of crises: interpretation and policy possibilities

The 1962 steel crisis: market failure and the common interest

The social backdrop to the 1962 steel crisis, marked by a post-depression and post–World War II identification with a broader common interest, facilitated the use of wage and price guidelines to spotlight "public" interests in "private" decisions. Yet, within the Kennedy administration, neoclassically oriented Keynesians, such as Kennedy adviser Paul Samuelson and CEA chairman Walter Heller, viewed guidelines in an ambivalent fashion, believing that they were best used only in the short run. In administration debates, these Neoclassical Keynesians favored using the Phillips curve framework, which posited a trade-off between inflation and unemployment, to guide the discretionary use of fiscal policy (Samuelson and Solow, 1960). However, once the administration decided to seek tax cuts as a fiscal stimulus, Galbraithian and Neoclassical economists came together in support of wage and price "guideposts." This was because—to the extent that a tax cut was feared to have potential inflationary consequences—guideposts could provide an added impetus to price stability. Introducing the guideposts in its 1962 *Economic Report of the President,* the administration cast them as "aids to public understanding," addressing not "the relation of employers and employees to each other, but rather . . . their joint relation to the rest of the country" (CEA, 1962, p. 185). Guideposts so pertained to the macro—or public—interest, rather than the micro—or individual—interest of firms or unions.

In its approach to inflation, the Kennedy administration (as had its predecessors) viewed the steel industry as having a particular import. Heller, in one memo to the president, pointed out "steel bulks so large in the manufacturing sector of the economy that it can upset the price applecart all by itself" (Matusow, 1984, p. 39). Reinforcing this view,

[7] In examining the effects of intersubjective constructions, I employ a symbolic interactionist methodology, alternating between what Herbert Blumer termed a more formal "inspection" of abstract models with an "exploration" of events as agents react to them (Blumer, 1969, pp. 40–47). This contrasts with approaches that assume the intersubjective context (or stock of social capital) can be reduced to some set of material relations (Costa and Kahn, 2003; Hero, 2003).

the Council referenced in the *Report* a presidential letter sent to the heads of the 12 largest steel companies. This noted that steel was "a bellwether as well as a major element in industrial costs" and that a "rise in steel prices would force price increases in many industries and invite price increases in others." Yet this letter also suggested that price restraint would be rewarded by public and (implicitly) administration pressure for wage restraint on the part of unions:

> If the industry now were to forego a price increase, it would enter collective bargaining negotiations next spring with a record of three and a half years of price stability. It would clearly then be the turn of the labor representatives to limit wage demands to a level consistent with continued price stability. The moral position of the steel industry next spring—and its claim to the support of public opinion—will be strengthened by the exercise of price restraint now. (CEA, 1962, pp. 182–183)

In the fall of 1961, United Steelworkers and the steel industry accordingly reached—with the help of Labor Secretary Arthur Goldberg—a moderate wage settlement, one that the administration expected the industry would reciprocate by limiting price increases. Instead, on April 10, 1962, the U.S. Steel Board of Directors announced a $6 per ton, or 3.5 percent, price increase. The next day, the Kennedy administration responded on a number of fronts, deploying antitrust threats, diverting contracts, considering legislation, and appealing to smaller companies (Barber, 1975, pp. 171–176). At a White House press conference, Kennedy accused the industry of flouting the public interest:

> The simultaneous and identical actions of United States Steel and other leading steel corporations, increasing steel prices by some six dollars a ton, constitute a wholly unjustifiable and irresponsible defiance of *the public interest.* In this serious hour in our nation's history, when we are confronted with grave crises . . . at a time when restraint and sacrifice are being asked of every citizen, the American people will find it hard, as I do, to accept a situation in which a tiny handful of steel executives whose pursuit of *private power and profit* exceeds their sense of *public responsibility* can show such utter contempt for the interests of 185 million Americans. (Sorensen, 1965, pp. 450–451, emphases added)

Kennedy stressed the primacy of this collective interest in restraint over private interests in maximizing wages or profits, arguing that the price increase "would seriously handicap our efforts to prevent an inflationary spiral . . . make it more difficult for American goods to compete in foreign markets . . . and thus more difficult to improve our balance of payments position, and stem the flow of gold." He even referred back to his inaugural appeal, noting "[s]ome time ago I asked each American what he would do for his country and I asked the steel companies. In the last twenty-four hours, we had their answer." Finally, Kennedy stressed the Galbraithian market failure rationale for restraint, noting that "the suddenness by which every company in the last few hours . . . came in with . . . almost identical price increases . . . isn't really the way we expect the *competitive* private enterprise system to always work" (ibid., p. 451, emphasis added). Public condemnation and hostile press coverage, coupled with pressures on the smaller steel firms to rescind price increases, eventually proved successful in enforcing the rollback.[8]

In facilitating Kennedy's successful use of exhortation on behalf of the wage and price guideposts, intersubjective conventions played a key role. First, the success of the Kennedy guideposts—and similar efforts by other postwar administrations—accorded with the post-depression/World War II climate of trust, or, put differently, the enhanced awareness of common interests in private restraint. Indeed, wage and price guideposts could not have been maintained solely through coercion, but rather, required a broader legitimacy. The CEA chairman under Lyndon Johnson, Gardner Ackley, acknowledged the existence of disagreements, but also stressed that corporate leaders recognized the public interest in price decisions. Ackley recalled, "never once has any [businessman] said to me, 'It is none of your business.' Rather, without exception, the answer has been, 'I accept the outlines of your program. I recognize my responsibility'" (Ackley, 1966, pp. 73–74). Second, this public setting shaped debate among economists. During this period, the academic discipline was less divided over the basic merit of controls than the appropriate duration of their use. Whereas Galbraith was forced to defend the long-run utility of the guideposts against Neoclassical challenges, even Neoclassical critics accepted that the guideposts had short-term utility. Finally, the use of price controls benefited from the use of presidential leadership and rhetoric to nurture this sense of the common interest. From Roosevelt through Carter, presidential attempts to sustain a public interest in private sacrifice played a crucial role in sustaining guidelines.

However, over a prolonged period, in the context of the Vietnam War, Watergate, and the Nixon administration's later inconsistent use of wage and price controls, support for guidelines and controls would erode com-

[8] See Perry (1967) for the most developed argument regarding the success of the Kennedy guideposts in holding wages and prices to a level below what might otherwise have been the case.

pletely by the 1980s.[9] By the early 1990s, price controls were associated—even during the administration of Bill Clinton, a Democrat—not with the Kennedy administration but, rather, with that of Nixon.[10] The magnitude of this transformation can be most clearly demonstrated in an overview of the 2000–2001 California energy crisis.

The California energy crisis: deregulation and the irrelevance of controls

In the 2000–2001 California energy crisis, controls would be used only as a "last resort," and, even after their apparent success, their merit would remain obscured by the broader classical context of the day. In the initial stages of the crisis, attempts to contain rising energy prices involved—given prevailing classical views—monetary restraint. For, as the global economic crises of 1997–98 receded, the Federal Reserve began raising interest rates, from 4.75 percent to 5 percent in June 1999, peaking at 6.5 percent in May 2000. Admittedly, inflation had begun to climb, from 1.6 percent in 1998 to 3.4 percent by 2000. However, inflation also remained at bay in more perfectly competitive sectors of the economy: for commodities, inflation ran at 2.7 percent in 1999 and 2000; for food, inflation ran at 1.8 percent in 1999 and 3.3 percent in 2000; for services, inflation ran at 2.6 percent in 1999 and 3.9 percent in 2000. In contrast, prices increased much more dramatically in more oligopolistic sectors, such as energy, by 13.4 percent in 1999 and by 14.2 percent in 2000. Even in its minutes of June 29, the Federal Reserve stated that much of the increase in other consumer prices was "associated in part with a jump in energy prices. . . . Producer prices of finished goods also were affected by the volatility of energy prices in April and May" (Federal Reserve Board, 1999; CEA, 2003, p. 350).

[9] The breakdown of support for wage and price controls is a topic that exceeds the scope of this paper. For useful discussions of these interlocking trends, see De Marchi (1975) and Matusow (1998).

[10] The Clinton administration's New Keynesian economists often upheld classical orthodoxy regarding prices. According to Bob Woodward, at an early Clinton health-care meeting, "[Deputy Office of Management and Budget Director] Alice Rivlin stepped forward and ripped the notion [of price controls] hard. Nixon had tried price controls and they had failed. . . . Her remark started an avalanche. [CEA chair] Laura Tyson wondered how price controls might be put in place. . . . [CEA member] Alan Blinder said that one of the first messages from the new Democratic Administration should not be to put one seventh of the American economy under the command and control of the federal government" (Woodward, 1993, p. 122).

These pressures partly reflected the global recovery, but they also reflected structural complications in California, where a two-tiered "wholesale" and "retail" energy market had become plagued by bottlenecks. These played a key role in driving rising energy prices: established in 1996, a wholesale California Power Exchange (Cal PX) conducted auctions a day in advance of actual energy sales, while a retail California Independent System Operator (Cal ISO) managed transmission lines, or the "grid," and held auctions to set final rates. Initially, the deregulation appeared a success, as wholesale power was even free for a brief period in April 1998 (Thurm et al., 2002). Yet, by the summer of 2000, wholesale prices escalated dramatically, leading to the rationing of power across the state in a series of rolling blackouts. By June 2000, prices reached levels "that exceeded by three or four times those seen at comparable demand conditions in prior years," leading the Federal Energy Regulatory Commission (FERC) to conclude that this "began what has been termed the California Energy Crisis," one that would be interpreted in varying fashions (FERC, 2002a, p. 19).

However, as Galbraith noted, monetary policy cannot be applied selectively to such oligopolistic sectors, but rather, affects the entire economy. By January 2001, concerns for the overall rate of growth led the Federal Reserve to abandon its restrictive monetary stance. This left two broad alternatives in the quest to stabilize energy prices, either to promote deregulation as a means to greater competition or to apply price controls. In early 2001, the administration of George W. Bush supported a more classical stress on deregulation, holding that price caps would discourage conservation and deter new investment. President Bush argued that price controls do "not increase supply, nor reduce demand" (Dunne, 2001, p. 7) and Vice President Dick Cheney affirmed that the administration remained opposed to "any type of price-control legislation" (VandeHei and Smith, 2001, p. A22). Cheney oversaw the drafting of the May 2001 *National Energy Policy* report, which cast the California crisis as a result of excessive regulation. The report argued that "despite an economic boom, a rapidly growing population, and a corresponding increase in energy needs, California did not add a single new major electric power plant during the 1990s." Stressing need for greater supply, the report ignored the issue of price caps, asserting "there are no short-term solutions to long-term neglect" (National Energy Policy Development Group, 2001, pp. viii, 1.4). In advising the Cheney task force, former Enron CEO Ken Lay argued that "the Administration should reject any attempt to re-regulate wholesale power markets by adopting price caps. . . . Price caps, even if imposed on a temporary basis, will be detrimental to power markets and will discourage private investment by significantly raising political risk" (Fox, 2003, pp. 218–219). More informally, Lay argued that "an imperfect market is better than a perfect regulator" (ibid., p. 200).

In contrast to these classical arguments, more Galbraithian perspectives stressed the inflationary effects of the electric companies' decisions to cut output, as they had idled between one-third and one-quarter of generating capacity in late 2000 and early 2001, driving prices upward. Indeed, the *Wall Street Journal* reported that "[b]y mid-November [2000], nearly one-fourth of [California's] generating capacity sat idle for planned maintenance or emergency repairs" (Thurm et al., 2002). The most public advocate of these Galbraithian views, *New York Times* columnist Paul Krugman, conceded the merit of classical criticisms that the Californian deregulation had been incomplete and that more capacity was needed, but, nevertheless, held that the main factor in explaining rising prices was the firms' abuse of market power. Krugman recognized that "homes and businesses had no financial incentive to conserve electricity," but continued to argue that "to reduce demand enough to eliminate today's shortages, retail electricity prices would have to rise enormously" (Krugman, 2001a, p. 4.13). Still-more formal arguments were offered by ten prominent academic economists, including Cornell University Professor Fred Kahn (who had overseen the deregulation of the airline industry) in a letter that California governor Davis later personally handed to President Bush. While the economists stressed that they were "mindful of the potential dangers of applying a simple price cap," they argued that "California's electricity markets *are not characterized by effective competition,*" leaving the FERC's definition of "cost-of-service prices" as "an obvious remedy" (Bohn et al., 2001, p. 2).

Yet it was less the power of such arguments than a confluence of institutional and partisan forces that engendered eventual resort to controls. These included the late April 2001 shift in power in the Senate from Republican to Democratic control, following the party-switch by Senator Jim Jeffords (VT), which gave control of such committees as Government Affairs and Energy to Senate Democrats. Splits further began to develop within the Republican Party, not simply along moderate/conservative ideological lines, but along regional ones. Protests from California Republicans, and, as price increases spread, Republicans from other western states, attracted the administration's attention, given the implications for control of the House. Indeed, according to the *New York Times,* one White House adviser cast the use of price caps as explicitly political, arguing, "Don't think about this purely in terms of megawatts.

We need to produce more electricity, but we also need to produce some more seats in the House" (Sanger, 2001, p. A14).

In this setting, the FERC would ultimately impose controls on June 18, 2001. This imposition of price caps was followed by a rapid collapse of energy prices. However, even this success failed to prompt a wider reconsideration of classical understandings. To be sure, from a Galbraithian vantage, Krugman stressed the contribution of price caps in inducing electric companies to increase output and produce *as if* they faced more perfect competition. He observed that in spring 2001, "around 15,000 megawatts, a third of the state's capacity, was mysteriously unavailable" but that by June 2001, offline capacity was "less than 4,000 megawatts" (Krugman, 2001b, p. A23). The extent of the industry collusion would be even more extensively documented in later FERC investigations. On May 6, 2002, the FERC released two Enron memoranda from December 2000, documenting practices by which Enron sought to create bottlenecks in the electricity market, and then to profit by appearing to rebalance the system, or, as the memos put it, to "get paid for moving energy to relieve congestion without actually moving any energy or relieving any congestion" (FERC, 2002b).

Nevertheless, classical economists continued to succeed in insisting on the irrelevance and danger of controls. In one study cited by Arnold Schwarzenegger in the final weeks of his campaign for governor of California (Dowd, 2003, p. A27), Hoover Institution economist James L. Sweeney argued:

> It is difficult to access definitively the impacts of the FERC April 26 and June 19 Orders. Just before they came into effect, wholesale prices fell to below the maximum prices allowed under these mitigation rules and soon fell to well below the maximum prices. Although it is conceivable that FERC price control rules caused a sharp decline in prices, price controls typically do not cause prices to fall well below the controlled levels. (2002, p. 216)

In other words, because prices had fallen *even more steeply* than controls had mandated, price controls were cast as irrelevant. Sweeney thus concluded, "it is unlikely that either the bid caps or the nonemergency price caps can account for the observed reduction in prices" (ibid., p. 216). While Galbraithians might argue that the price caps, in forcing more supply onto the market, simulated the kind of perfect competition in which the firms lost *all* control of prices, this classical analysis treated the *greater* decline in prices as evidence of the irrelevance of controls.

In impeding the use of price caps and obscuring their effectiveness, intersubjective constraints again played—as they had in the early 1960s—

a key role. First, in contrast to the early post–World War II period of societal cohesion, the lingering legacy of the Vietnam War and Watergate engendered an erosion of trust in government. Compared to the depression and World War II—two crises that might be bluntly seen as "solved" by the state—Vietnam and Watergate were more often seen as "caused" by the state. Discussions of the "Vietnam War inflation" often explicitly linked the wartime mendacity of the Johnson administration to similar fiscal policy errors.[11] The importance of such attitudes became even clearer in the 2003 California gubernatorial recall election, in which Governor Davis was ousted in large part due to the energy crisis and associated budget shortfalls. Even the generally pro-Davis *Los Angeles Times* recognized prior to the recall election that the governor's approach to the crisis had been somehow lacking, "fixing in many people's minds the sense of weak leadership." Even though "inquiries revealed that Enron and others bore much of the blame for creating false shortages" a *Times* poll showed that "likely voters who want Davis recalled offered energy as the No. 2 reason" in an August 2003 poll (Nicholas and Rabin, 2003, p. A1). Second, to the extent that academic economists do not exist in a political vacuum, the scope for Galbraithian arguments had been considerably curtailed, with no prominent economist arguing for permanent controls. At most, the "New Keynesians" of the 1990s—as heirs to Samuelson and Solow—offered qualified support for temporary controls, combined with combinations of monetary restraint and deregulation. They dissented from classical arguments regarding the efficiency of markets in the short term, but still held that markets would "get it right" over the long term. Support for controls to offset permanent concentrations of market power was thus made inconceivable (Bohn et al., 2001; Krugman, 2001b, 4:13).

Finally, in contrast to the 1962 Kennedy crisis, the absence of high-profile presidential leadership undermined the scope of any public debate and possibilities for drawing broader lessons. President Bush accorded the California price caps little public note, and administration figures denied that there even *were* price caps. Ari Fleischer, the

[11] For example, *Washington Post* economics correspondent Hobart Rowen began his discussion of the inflation of the 1970s by declaring that Johnson "made two decisions that would have a profound effect not only upon his presidency, but also upon the future of the American economy. In February [1965], he started the systematic bombing of North Vietnam. Then, in July, he made the commitment—kept secret from the nation—to bring troop strength in Vietnam up to 500,000." Basic intuitions about policy failure in Vietnam harmonized with intuitions regarding economic policy (Rowen, 1994, p. 3).

president's spress secretary, even declared the day after the caps were imposed that "*[t]his is not a price control.* . . . This is a market-based mitigation plan that now will extend to 11 Western states" (Sanger, 2001, p. A14, emphasis added). In this way, the administration's ability to use the FERC as a means of imposing controls enabled it to benefit from the perception of addressing the crisis while avoiding direct ownership of the policy response. Similarly, in the Bush administration's 2003 *Economic Report of the President,* the Council of Economic Advisers conceded that some market manipulation had occurred, as generators "found that . . . withholding electricity supply led to higher prices." However, the CEA ultimately faulted the regulators who "had not planned for this extreme situation," and the *Report* simply made no mention of the July 2001 price caps (CEA, 2003, pp. 166–167). In such constructions, controls were simply removed from the narrative, precluding meaningful debate.[12]

Conclusions: implications for theory and policy

This analysis has important theoretical and policy implications, highlighting the intersubjective influences on state and societal interests, interpretations of crises, and possibilities for economic growth. It suggests that what Keynes (1936) termed economic "conventions" can take on "lives of their own," shaping state interests and policy possibilities: in the early 1960s Galbraithian setting, concerns regarding the possible manipulation of market power legitimated the use of exhortation, guidelines, and controls. However, by the 1990s—against the backdrop of the Vietnam War, Watergate, and a broader decline of trust—such views had yielded to more classical alternatives. The California energy crisis was, therefore, seen as not caused by market error but, rather, by government excesses. This legitimated calls for deregulation as a means to

[12] Contrast the press's acquiescence to the classical construction with the skeptical response in the fall of 2000 to Vice President Al Gore's announcement of the Clinton administration's decision to release petroleum from the strategic reserve. Gore's action was much less explicable in classical terms, given the comparatively slight quantities involved, but it made sense from a more Galbraithian vantage, where it might carry political weight and serve as a notice to companies engaged in the abuse of market power. This is not to argue that the press was intentionally biased against Gore and for Bush, but merely to point out that they—and the wider public—lacked the ability to make sense of the Gore action, and more intuitively appreciated the Bush aversion to controls.

induce the increased provision of electricity and thus lower prices. Even though the imposition of price controls in California was closely followed by price reductions, classical discourses remained strong enough to obscure these contributions and limit debate (Sweeney, 2002).

This analysis further demonstrates the need for a more political analysis of the economy, based not on the brute data analysis of macroeconomic aggregates but, rather, a more explicit analysis of economic conventions and prevailing institutional arrangements. Such an analysis could offer new insights into economic controversies over the intensity of trade-offs between inflation and unemployment. Indeed, it suggests that one fundamental economic debate—over the shape of the Phillips curve—may need to incorporate a greater focus on the social and institutional context. In contrast to the Samuelson and Solow (1960) treatment of the Phillips curve as negatively sloped, and the Friedman (1968) treatment of the curve as vertical over the long run, this analysis suggests that the Phillips curve can "flatten out" at some horizontal guideline, as social restraint limits the effects of full employment on wage or price trends. From this vantage, the erosion of social capital since the 1970s helps to explain the above-mentioned postwar slowdown in U.S. economic growth. In the absence of exhortation, guidelines, or controls, the Federal Reserve has been forced to bear the entire burden of monetary stabilization, achievable only by undermining output and employment. Intersubjective understandings and conventions—rather than material forces—therefore, seem to provide the main influences on both policy choice and prospects for economic growth.

REFERENCES

Ackley, G. "The Contribution of the Guidelines." In G.P. Shultz and R.Z. Aliber (eds.), *Guidelines, Informal Controls, and the Market Place.* Chicago: University of Chicago Press, 1966, pp. 67–78.

Barber, W.J. "The Kennedy Years: Purposeful Pedagogy." In C.D. Goodwin (ed.), *Exhortation and Controls: The Search for a Wage-Price Policy 1945–1971.* Washington, DC: Brookings Institution Press, 1975, pp. 135–193.

Blumer, H. *Symbolic Interactionism: Perspective and Method.* Berkeley: University of California Press, 1969.

Blyth, M. *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century.* Cambridge: Cambridge University Press, 2002.

Bohn, R.; Borenstein, S.; Bushnell, J.; Cramton, P.; Kahn, A.; Joskow, P.; Klevorick, A.; Porter, R.; Shapiro, C.; and Wolak, F. "Letter to the Honorable George W. Bush, et al." May 25, 2001 (available at ftp://zia.stanford.edu/pub/papers/economists.let.pdf).

CEA (Council of Economic Advisers). *The Economic Report of the President.* Washington, DC: U.S. Government Printing Office, annual editions.

Chamberlin, E.H. *Theory of Monopolistic Competition.* Cambridge: Harvard University Press, 1933.

Coleman, J.S. “Social Capital in the Creation of Human Capital.” *American Journal of Sociology,* 1988, *94* (supplement), 95–120.

Costa, D.L., and M.E. Kahn. “Civic Engagement and Community Heterogeneity: An Economist’s Perspective.” *Perspectives on Politics,* 2003, *1* (1), 103–112.

De Marchi, N. “The First Nixon Administration: Prelude to Controls.” In C.D. Goodwin (ed.), *Exhortation and Controls: The Search for a Wage-Price Policy 1945–1971.* Washington, DC: Brookings Institution Press, 1975, pp. 295–353.

Dowd, M. “Gams to Gladiators.” *New York Times* (September 25, 2003), A27.

Dunne, N. “U.S. Regulators to Vote on Curbing Energy Prices.” *Financial Times,* June 2001, *19,* 7.

Federal Reserve Board. “Minutes of the Federal Open Market Committee.” June 29, 1999 (available at www.federalreserve.gov/fomc/minutes/19990629.htm).

FERC (Federal Energy Regulatory Commission). “Initial Report on Company-Specific Separate Proceedings and Generic Reevaluations; Published Natural Gas Price Data; and Enron Trading Strategies Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices in PA02–2.” August 13, 2002a (available at ferris.ferc.gov/idmws/common/opennat.asp?fileID=9548231).

———. “Memo: Traders’ Strategies in the California Wholesale Power Markets/ISO Sanctions.” Internal Memorandum Posted to FERC Web site, 2002b (available at www.ferc.gov/industries/electric/indus-act/wem/pa02–2/12–08–00.pdf).

Fox, L. *Enron: The Rise and Fall.* Hoboken, NJ: John Wiley and Sons, 2003.

Frank, R.; Gilovich, T.; and Regan, D.T. “Does Studying Economics Inhibit Cooperation?” *Journal of Economic Perspectives,* 1993, *7* (2), 159–171.

Friedman, M. “What Price Guideposts?” In G.P. Shultz and R.Z. Aliber (eds.), *Guidelines, Informal Controls, and the Market Place.* Chicago: University of Chicago Press, 1966, pp. 17–40.

———. “The Role of Monetary Policy.” *American Economic Review,* 1968, *58* (1), 1–17.

Galbraith, J.K. “The Selection and Timing of Inflation Controls.” *Review of Economic Statistics,* 1941, *23* (2), 82–85.

———. *A Theory of Price Control.* Cambridge: Harvard University Press, 1952.

———. *The Affluent Society.* Boston: Houghton-Mifflin, 1958.

Gourevitch, P. *Politics in Hard Times: Comparative Responses to International Economic Crises.* Ithaca: Cornell University Press, 1986.

Greider, W. *Secrets of the Temple.* New York: Simon and Schuster, 1987.

Hero, R.E. “Social Capital and Racial Inequality in America.” *Perspectives on Politics,* 2003, *1* (1), 113–122.

Keynes, J.M. *The General Theory of Employment, Interest and Money.* London: Macmillan, 1936.

Krugman, P. “Turning California On.” *New York Times* (June 27, 2001a), A23.

———. “The Unreal Thing.” *New York Times* (February 18, 2001b), 4.13.

Lucas, R.E., and Sargent, T. “After Keynesian Macroeconomics.” In *After the Phillips Curve: Persistence of High Inflation and High Unemployment.* Boston: Federal Reserve Bank of Boston, 1978, pp. 49–72.

Matusow, A.J. *The Unraveling of America: A History of Liberalism in the 1960s.* New York: Harper and Row, 1984.

———. *Nixon’s Economy.* Lawrence: University Press of Kansas, 1998.

McCloskey, D. *If You’re So Smart: The Narrative of Economic Expertise.* Chicago: University of Chicago Press, 1990.

Merton, R.C. "Applications of Option-Pricing Theory: Twenty-Five Years Later." *American Economic Review,* 1998, *88* (3), 323–349.

Muth, J. "Rational Expectations and the Theory of Price Movements." *Econometrica,* 1961, *29* (6), 315–360.

National Energy Policy Development Group. *National Energy Policy.* Washington, DC: U.S. Government Printing Office, 2001.

Nicholas, P., and Rabin, J.L. "The State: Target of Anger: Recall Backers Are Critical of Gov. Davis, Fund-Raising, Attack Ads and Response to the Budget and Power Crises." *Los Angeles Times* (August 31, 2003), A1.

Perry, G.L. "Wages and the Guideposts." *American Economic Review,* 1967, *57* (4), 897–904.

Putnam, R.D. "The Prosperous Community: Social Capital and Public Life." *American Prospect,* 1996, *4* (13), 35–42.

Robinson, J. *The Economics of Imperfect Competition.* London: Macmillan, 1933.

Rowen, H. *Self-Inflicted Wounds.* New York: Times Books, 1994.

Samuelson, P., and Solow, R. "Analytical Aspects of Anti-Inflationary Policy." *American Economic Review,* 1960, *50* (2), 177–194.

Sanger, D. "The Lesson of When to Give Aid to Free Markets." *New York Times* (June 19, 2001), A14.

Sorensen, T.C. *Kennedy.* New York: Harper and Row, 1965.

Sweeney, J. *The California Energy Crisis.* Stanford, CA: Hoover Institution Press, 2002.

Thurm, S.; Gavin, R.; and Benson, M. "Juice Squeeze: As California Starved for Energy, U.S. Businesses Had a Feast." *Wall Street Journal* (September 16, 2002), A1.

VandeHei, J., and Smith, R. "White House Looks Isolated in Its Opposition to Energy Price Caps." *Wall Street Journal* (June 14, 2001), A22.

Wendt, A. *Social Theory of International Politics.* Cambridge: Cambridge University Press, 1999.

Widmaier, W.W. "Constructing Monetary Crises: New Keynesian Understandings and Monetary Cooperation in the 1990s." *Review of International Studies,* 2003, *29* (1), 433–453.

———. "The Social Construction of the 'Impossible Trinity': The Intersubjective Bases of Monetary Cooperation." *International Studies Quarterly,* 2004, *48* (2), 433–453.

Woodward, B. *The Agenda.* New York: Simon and Schuster, 1993.

Woolley, J.T. *Monetary Politics: The Federal Reserve and the Politics of Monetary Policy.* Cambridge: Cambridge University Press, 1984.