Harold James on Weightless Globalization
Robert Zoellick on the Last Fifty Years
Fred Bergsten Behind the Scenes With John Connolly

50TH ANNIVERSARY: THE DOLLAR-GOLD DELINKING

THE INTERNATIONAL ECONOMY

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The Secret Meeting *in* 1971 *that* Changed *the* World

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THE INTERNATIONAL ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY

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The Magazine of International Economic Policy

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THREE DAYS AT CAMP DAVID: THE FIFTIETH ANNIVERSARY

GLOBAL MARKETS TODAY

DEPARTMENTS

FROM THE

FOUNDER

Statecraft in Search of a Vision

In early 1987, nine months before the stock market crashed, we began to explore the idea of this magazine. The thought was to produce a journal that would serve as a bulletin board for proposed changes to the international economic statecraft.

We were newcomers to the global economic policy world that was still heavily anchored by a tight and closed relationship between the U.S. Federal Reserve System and the Bank of England.

Yet the global financial markets were changing. The floating exchange rate system, in place since the early 1970s, was under attack. A soaring dollar against the yen in response to the economic conditions of the mid-1980s (including the collapse of inflation) was threatening to bring about an international trade war. The status quo in currency affairs was unsustainable. Meanwhile, the Bank of England had become less important in a new world where Germany and Japan had emerged as economic powerhouses.

We nevertheless remained unsure about the reception a new publication would receive in this exclusive, rarified world. So we flew to Frankfurt to seek the advice of one of the major figures in European policymaking, Bundesbank President Karl Otto Pöhl. Seeking out Pöhl's advice made sense. He had come to central banking from the field of journalism.

As we entered his office, to our surprise the head of Europe's most powerful central bank began with one question: "Would the magazine be run from Washington, London, or New York?" He was pleased when we told him Washington, D.C. He responded: "The global financial system is too heavily influenced by the London crowd. Your publication can be helpful by bringing in new voices."

As the meeting was about to end, Pöhl said that the evolving process of defining and refining a global financial "statecraft" was so important that he, as sitting president of the Bundesbank, would agree to chair our publication's editorial advisory board, assuming we were interested. We were interested.

We launched The International Economy precisely because we believed the global economic statecraft needed to evolve with the changing times.

Of course, those years represented a golden era in policy coordination and cooperation. With the Cold War raging, the free world's policy leaders were bound together not only by economics but by a common set of

values that still lingered forty years after the end of World War II.

So we launched *The International Economy* precisely because we believed the global economic statecraft needed to evolve with the changing times. Indeed, less than a decade after our publication's launch, the Soviet Union dissolved and large parts of the world, led by China and India, joined the capitalist community. The statecraft could not keep up with such rapid change.

Today the statecraft is in tatters. In a world where a common set of values is a faint memory even among some members of the G-7, the Biden Administration has nevertheless rolled up its sleeves, hoping to rebuild a new and improved framework for international economic understanding and cooperation. We wish them luck. But the task will be difficult, which is why it is important to examine the past. Only by examining history do we fully appreciate the future's opportunities and pitfalls.

A Troubling Question

Jeffrey Garten's book *Three Days at Camp David* is an illuminating, fun read. Turn its pages and you are almost certain to ask yourself, "Where are today's versions of those gifted, heavyweight strategic thinkers and tactical wizards?" Who's the next Paul Volcker? George Shultz? Even Pete Peterson? Where are the astute policy playmakers willing to put country before party to set in motion a long-term global vision? Who's going to help us maneuver through this impossibly complex international economic maze?

—D. Smick

Former Federal Reserve Chairman **Paul Volcker**

Which brings us to this issue's celebration of the fiftieth anniversary of the August 15, 1971, delinking of the dollar from gold, an extraordinary exercise, for good and bad, in international economic statecraft. In his new book *Three Days at Camp David: How a Secret Meeting in 1971 Transformed the Global Economy,* Jeffrey Garten paints a fascinating portrait of this important moment in global economic history, when a rare collection of gifted policy strategists and tacticians came together at a weekend at Camp David, the presidential retreat. The goal: to try to set new parameters in a world that a quarter-century after the end of World War II had become less U.S.-centric. The individuals present represented a surprising cross-section of ideological viewpoints. With some exceptions, they seemed disinterested in partisan politics. They knew they were defining nothing less than America's future relationship with the world. Most were in their forties and, as Garten notes, almost all would go on to achieve great things.

In this issue of *TIE,* a collection of thinkers—some actually involved behind the scenes at the Camp David meeting, some who worked on the creation of the Plaza and Louvre Accords, and other experts—offer their thoughts on this fiftieth anniversary milestone in general and on Jeff Garten's new book in particular.

I believe most of these thinkers would agree that the world's tattered statecraft needs to be repaired. We also need to better understand what we don't know. The recent track record is not reassuring. Policymakers missed the call on the 2008 financial crisis. Before then, they failed to appreciate the paradoxical nature of globalization. Beginning in the mid-1990s, the world's excess savings as a result of huge current account imbalances had shifted heavily into developing world sovereign debt, particularly U.S. Treasury securities, helping drop interest rates to historic lows. Equity markets boomed, but wages failed to keep pace, contributing to a rising tide of inequality. The statecraft sadly failed to fully understand globalization, which left in its wake a fragile world of political chaos.

Now our leaders face a post-pandemic world of aging demographics, cyber warfare, cyber-based currencies, artificial intelligence, and cloud computing that are poised to redefine employment and dramatically widen the productivity gap between the world's have and have-not economies. The picture is not reassuring. Backed by impressive models, our economists seem incapable of even telling us something as fundamental as when robust asset prices are legitimate or when they represent dangerous bubbles.

Garten's book is an illuminating, fun read. Turn its pages and you are almost certain to ask yourself, "Where are today's versions of those gifted, heavyweight strategic thinkers and tactical wizards?" Who's the next Paul Volcker? George Shultz? Even Pete Peterson? Where are the astute policy playmakers willing to put country before party to set in motion a long-term global vision? Who's going to help us maneuver through this impossibly complex international economic maze?

—David M. Smick
Founder, editor, and publisher,
The International Economy

Camp David, August 13–15, 1971:
At a top-secret meeting, U.S. President Richard Nixon and an extraordinary group of his top advisers made decisions that would rock America's political alliances, set the U.S. dollar on a radically new course, and reshape the U.S. and global economies.

PHOTO: RICHARD NIXON FOUNDATION

The Weekend That

TIE *Founder and Editor David Smick interviews Jeffrey Garten, author of the new book* Three Days at Camp David: How a Secret Meeting in 1971 Transformed the Global Economy, *which argues that there are many parallels between August 1971 and August 2021. The currency move was only part of the story.*

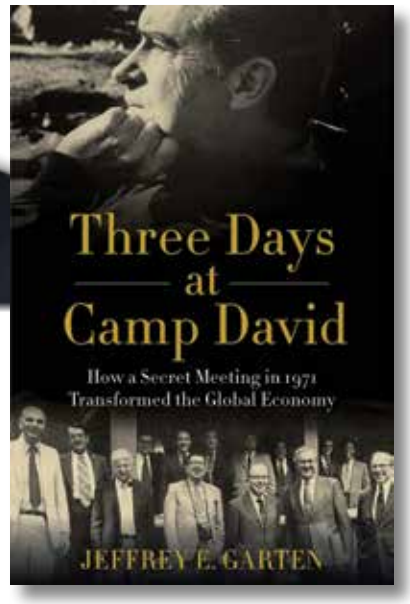
The fiftieth anniversary of the August 15, 1971, Camp David decision to delink the dollar from gold.

Smick: The book is a terrific, suspenseful read. It is part a sophisticated yet understandable explanation of what went on at a crucial moment in U.S. economic history. But it also reads like a Hollywood script. The characters come alive, from a Trump-like John Connally as Treasury secretary breaking all the china, to a serious, astute, quiet, and universally trusted hero figure—Paul Volcker, then-Treasury under secretary for international monetary affairs—tearing his hair out (what hair he had left) trying to keep the train from derailing. Financial scholars aren't supposed to be able to write this way. What got into you? How do you do it?

Garten: Thanks for the compliment! Maybe the starting point is that neither I nor anyone else would classify me as a financial scholar. Barry Eichengreen, Harold James, and a host of their peers have forgotten more about financial theory than I ever knew. I see myself as someone fortunate enough to have had a wealth of practical experience in the international financial and trading arena—in the Nixon, Ford, Carter, and Clinton Administrations; as an investment banker at Lehman in the 1980s and the Blackstone Group in the early 1990s with extensive involvement in everything from sovereign and corporate debt restructuring to running broader investment banking operations in Asia from a base in Tokyo; and as someone teaching Yale students about the global economy for many years.

In *Three Days at Camp David,* I deliberately set out *not* to write a theoretical book, or even a policy book, but to tell the story of an important historical event that anyone could understand. I

Jeffrey Garten



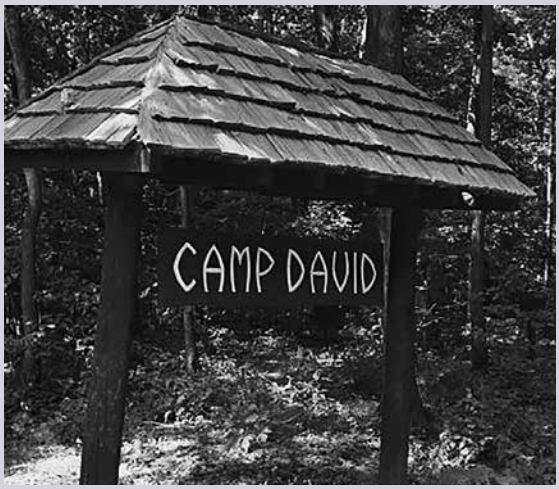
Changed *The* World

wanted to entertain as well as to inform, although I fell far short of what a better writer could have done, I'm sure. I thought the best way to try was to focus on the people and on the blow-by-blow account of the actual decision, and make it like a television program as best I could.

The story of why and how Nixon severed the link between the dollar and gold was just one part of a larger story. That story was the end of the era that began with the Marshall Plan and terminated with Vietnam.

You ask me how I did it. My first step was to interview everyone who was at Camp David who is still alive, as well as people who knew them. So I spoke at length to Paul Volcker, George Shultz, and a host of staff members who had accompanied them to Camp David, and who had done a lot of the preparatory work. Fred Bergsten, Robert Hormats, and John Petty were in and around the events I write about, and were also exceptionally helpful. I didn't rely on memories of fifty years ago for facts, but rather for atmosphere. I was influenced in my thinking by George Shultz, when he said that people tend to remember the good things they did, not the things they are not so proud of. The other thing I did was to study diaries and notes from speechwriter William Safire, White House Chief of Staff H.R. Haldeman, and Fed Chair Arthur Burns, all of whom were at Camp David, and I studied the Nixon tapes and read other authors' analyses of them, too.

Smick: You said that on August 15, 1971, President Richard Nixon didn't just announce a change in monetary policy. It was a change in how Americans saw the world. Please explain. You also quote Hugh Sidey of *Time* who wrote, "The men around Nixon [in August 1971] were to be the tacticians in a campaign already conceived in its broader outlines." Describe those broader outlines.



MOSHE WALKER, BPG

A Net Plus Outcome

Camp David created a world economy characterized by two powerful trends. On the one hand, the global market became more unstable, more prone to crises, and more characterized by hyper-complexity. On the other hand, it was a world in which globalization could proceed at warp speed, with trade, investment, and the spread of technology and ideas growing at a tremendous pace.

Both trends are with us today. They are the legacy of the decisions made at Camp David on August 13–15, 1971. On balance, I think Camp David was thus a net plus.

—J. Garten

Garten: Sidey had two concepts in mind, I believe. First, as I try to show in the book, the story of why and how Nixon severed the link between the dollar and gold was just one part of a larger story.

That story was the end of the era that began with the Marshall Plan and terminated with Vietnam. Nixon and then-National Security Adviser Henry Kissinger were trying to lessen the global burdens on the United States, and give Washington room to focus more of its energies and resources on the massive economic and social problems at home, still boiling over from the late 1960s. In 1969, the president announced the Nixon Doctrine, which essentially said that aside from defense treaties, the United States would not automatically come to the defense of its friends. It might supply money and weapons, but not American troops.

This doesn't sound very dramatic today, but it was a very big change of policy at the time. At Camp David during the August 13–15 weekend, Nixon essentially announced the economic component of the Nixon Doctrine. It said that maintaining the dollar-gold standard—the commitment of the United States to exchange $35 for each ounce of gold—had created too much of an economic burden for the United States. The yen and the West German mark would have to be revalued; the Japanese and Europeans would have to open their markets wider and deeper to U.S. products, matching the level of concessions that Washington had accorded them in the past two decades; and the allies would have to increase their defense spending.

There are many parallels between August 1971 and August 2021.

A second thing that Sidey had in mind was this: The United States was running out of gold. In 1955, it had about 160 percent more gold than dollars outstanding in governments and central banks. In 1971, the figure was just 25 percent. In effect, the emperor had no clothes and the United States had no choice but to abandon gold. Nixon, Connally, and Volcker knew that. The issue was getting the entire administration and Congress aboard, and the issue was also how to get the allies to cooperate and not precipitate a global financial crisis as a result of the changes in the global monetary system.

Smick: You suggest that the sword suddenly hanging over the head of the policy group was a decision by the British to ask for "cover" for $3 billion of its dollar reserves. Panic set in because no one on the American side knew what was meant by the word "cover." (Kind of like the mysterious and unexplainable "letters of transit" in the movie *Casablanca*?) A sense of urgency set in and, as you put it, the group felt it had no choice but to "dive off the diving board." Did the British ever get around to explaining what they meant by "cover"?

Garten: This is an entire story unto itself. It shows how nervous the administration was that several governments would try to exchange their currencies for gold at the same time and cause the equivalent of a run on the bank. It is also a story of how even talented and experienced public servants, pressed for time and confronting many issues at the same time, can fail to see the precise picture.

My sense is that Connally was so paranoid about a run on gold that he was all too happy at Camp David to use the

momentary confusion about what was meant by "cover." He was even eager to assume the most extreme definition of what the Brits might have had in mind so as to paint the most dire picture at the opening of the Camp David meeting, even if it wasn't accurate.

The question is, why didn't Volcker have a better understanding of the British demand? Did he really not know, or was he playing games, too? I think the issue of what "cover" meant was clarified during the next day or so, but by then it had already had a dramatic impact, and the decision to abandon gold had already been made.

Smick: I was struck by the differences—both in temperament and ideology—of the advisors that Nixon brought to the table. A shrewd operator, Nixon built a powerful consensus by fitting together the various pieces of the puzzle.

Two thoughts came to mind. First, why would someone so gifted at reading the minds and personalities of his various policy operatives not have seen the risks of Watergate? Second, I also thought of the silliness of Hollywood's treatment of Washington policymaking (think the television series *West Wing*) when compared to the nuanced picture you paint of the policymaking process, in this case on the global front. To what extent was Nixon's choice of the actors in his August 1971 drama, and knowing their likely interplay, the reason for its success?

I thought the best way to try was to focus on the people and on the blow-by-blow account of the actual decision, and make it like a television program.

Garten: I really have nothing original or smart to say about Watergate. But in terms of Nixon's economic advisers, I do have some thoughts. First, we should remember that Nixon—a former congressman, senator, and

Continued on page 64

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The team that closed the gold window (l–r): Federal Reserve Board Chairman **Arthur Burns,** *U.S. Secretary of the Treasury* **John Connally,** *President* **Richard Nixon,** *Office of Management and Budget Director* **George Shultz,** *and Council of Economic Advisers Chairman* **Paul McCracken.**

From Dick Nixon *to* Joe Biden

Fifty years of global economic triumph and disappointment.

By Robert B. Zoellick

Library bookshelves bend under the weight of tomes about Richard Nixon's foreign policy. Jeffrey Garten's splendid new book *Three Days at Camp David* narrates the rarely researched companion story of Nixon's major international economic initiative. In doing so, Garten encourages historians to consider the intriguing parallels between Nixon's security and economic transformations.

Nixon was a war president from day one. His fate was to direct a retreat, a most dangerous maneuver. This withdrawal was more than tactical; Nixon believed that his strategic challenge was to reorder the international politics of power because of the relative decline of U.S. economic might.

The president aimed to regain advantage through agile world leadership. In foreign policy, Nixon aspired to redraw the map of power as a new multipolarity. In doing so, the president wanted to avoid a slide back to American isolationism. Nixon's plan for a new international economy seemed less deliberate. Nevertheless, Garten's tale shows that Nixon attempted to rebalance global economic responsibilities and avoid the protectionism of the past.

Nixon's new foreign policy sought better relations with Moscow in order to prevent nuclear war and restrain Soviet expansionism. His entente

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Robert B. Zoellick has served as President of the World Bank, U.S. Trade Representative, U.S. Deputy Secretary of State, and Counselor to the Secretary of the Treasury. He recently published America in the World: A History of U.S. Diplomacy and Foreign Policy *(Twelve, 2020).*

with China treated Beijing as an instrumentality, not as a partner, in a triangular relationship that would deter catastrophic war among big powers. Nixon signaled to allies that they would have to earn Washington's support;

Nixon believed that his strategic challenge was to reorder the international politics of power because of the relative decline of U.S. economic might.

Europe and Japan could no longer take America's market and dollar for granted. Nixon hoped these maneuvers would lead the American public to view him as a man of peace and prosperity.

Nixon's inaugural address called for a shift from years of confrontation to an era of negotiation. Scholars have recognized how Nixon translated that summons into foreign policy, but most have overlooked the implications for the president's international economic platform.

Nixon's strategies reflected his reading of history. The president believed that nations which lost the ability to pursue great ideas ceased to be great. Nixon's audacity would give history a nudge. The president also believed that democratic leaders needed bold moves to electrify the public and sustain support. Garten's account reveals these precepts of Nixon's thinking in economics, just as daring moves typified Nixon's security strategies.

In foreign policy, then-U.S. National Security Adviser Henry Kissinger's trademark preferences for maneuver, ambiguity, and nuance complemented Nixon's approach. Kissinger viewed himself as a strategic negotiator who continually pursued stability, not perfection, amidst perpetual change. The president had no such counterpart on his economic team. U.S. Treasury Secretary John Connally was a blunt disrupter and dealmaker. However, Office of Management and Budget Director George Shultz recognized the need for adaptive equilibria, which he believed could be achieved through freer markets.

Ironically, Nixon's and Kissinger's foreign policy strategy overlooked an American capacity that Shultz appreciated: The U.S. aptitude for innovation, especially through technology and in the private sector. Even as Nixon was trying to refashion world politics and economics to suit his expectations of America's decline, the United States landed a man on the moon (1969), began a transformation of the Bretton Woods monetary and exchange rate order (1971), opened a door to a new relationship with China (1971–1972), and began technological revolutions, especially in information.

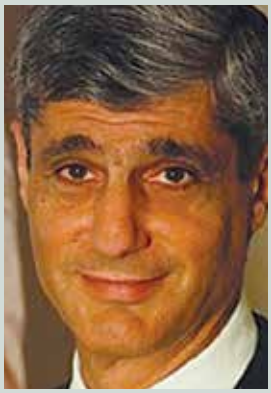
Ronald Reagan, whose view of America's potential differed markedly from Nixon's, would launch the next stage of transfiguration in global systems based on the American capacity for revival.

ADAPTING THE INTERNATIONAL ECONOMY

Garten's book also prompts readers to consider why—and how—U.S. leaders forced the adaptation of the international economic regime that Washington had created after World War II. Nixon's bold stroke in August 1971 was the first, but not the only, American venture over the past seventy-five years to reshape the rules, expectations, norms, and even the institutional architecture of the international economic order. As the leaders of the global market economy, U.S. officials have struggled continually to pursue the right mix of national—but also systemic—interests.

Garten's account reveals the interconnections among exchange rates, monetary and fiscal policies, capital

Nixon's and Kissinger's foreign policy strategy overlooked an American capacity that Shultz appreciated: The U.S. aptitude for innovation, especially through technology and in the private sector.



Robert Rubin,
U.S. Treasury Secretary, 1995–1999

Alan Greenspan,
U.S. Federal Reserve Chairman, 1987–2006

Lawrence Summers,
U.S. Treasury Secretary, 1999–2001

The Firefighters

The team of Robert Rubin, Alan Greenspan, and Larry Summers orchestrated case-by-case problem-solving—working within the existing international economic system—without redesigning the institutional order. But their firefighting led to adaptations, especially for the International Monetary Fund and World Bank. Economic historians might conclude that the methods of the 1990s more closely approximated those of Nixon in 1971 than those of Baker in the late 1980s; the Clinton team prioritized packages to deal with immediate problems over Baker's model of combining actions with systemic redesigns.

—R. Zoellick

flows, trade, and domestic plans and politics. These elements reappear in later cases—up to today.

The experience of 1971 offered lessons for astute successors. Shultz's preference for flexible exchange rates eventually became the new policy norm; the adaptability of markets enabled the international system to adjust to both shocks and longer-term shifts, although often with pains. The U.S. private sector demonstrated an impressive resilience, especially through technological innovation. Nixon's experience also shows that protectionism does not work, but is politically popular. His wage and price controls neither worked nor won political favor.

Nixon's mistakes, combined with energy price shocks, contributed to the stagflation of the 1970s. American industries and unions that ignored competition and the need to adapt confronted costly realities. The Carter Administration of the late 1970s struggled to find answers as problems multiplied.

The next major transformation of the international economic regime took place during Reagan's second term. During the early 1980s, the dollar soared in value as Reagan's economic boom and Federal Reserve Chairman Paul Volcker's monetary policies dramatically altered expectations about growth, interest rates, and inflation. The U.S. current account deficit surged, and trade protectionism raged.

In 1985, U.S. Treasury Secretary James Baker and his deputy, Richard Darman, steered toward a new international economic system. The Plaza and Louvre announcements in 1985 and 1987 adjusted exchange rates and then sought flexibility within ranges. But Baker and Darman viewed exchange rates as elements within a larger strategy. The finance ministers of the G-7 economies—in concert with central bankers—sought to coordinate policies for growth, low inflation, and open markets without economically and politically unsustainable imbalances. The Economic Summits were supposed to crown the process through conferences of leaders who had the political mandates to make fundamental economic decisions. The International Monetary Fund assumed a new role as honest auditor—and eventually, proponent—of whether the sum of national economic policies added up to growth and stability.

Baker, as chair of the President's Economic Policy Council, orchestrated a complementary U.S. trade policy. The shift from an overvalued dollar was supposed to ease the trade deficit and counter Congressional protectionism. The Reagan Administration added an offensive trade agenda—to fight protectionism by lowering international barriers to trade; it pushed for the launch of the GATT Uruguay Round in 1986. To win congressional support for new trade negotiating authority ("fast-track," later Trade Promotion Authority), the executive introduced a competitiveness plan that eventually took the form of the Omnibus Trade and Competitiveness Act of 1988. Congress gave the administration license to negotiate without adding many new barriers, but at the price of requiring a new rulebook of "process protectionism."

Even as the United States began building a G-7 system, one could see the first glimpses of the era that would succeed the G-7 world.

The Baker-Darman strategy faced issues similar to those on Nixon's agenda in 1971, but in a different economic context. By the 1980s, floating exchange rates and much larger capital flows dominated the picture. Like Nixon, the Reagan team acted boldly, pressing their international economic partners to adjust. Unlike Nixon, they negotiated a coordinated international effort before announcing their surprise. Baker and Darman supported their project with a new regime for consultations among finance ministers and central bankers, plus an added role for the International Monetary Fund. In addition, the U.S. strategists of the late 1980s offered a contribution from the start—especially to keep markets open and even to negotiate reductions in trade barriers.

The Reagan and George H.W. Bush Administrations also began to face another historic shift in the international economic system: the rising influence of developing economies. Even as the United States began building a G-7 system, one could see the first glimpses of the era that would succeed the G-7 world.

During the 1980s, the debt crises of developing economies prompted Washington to encourage the International Monetary Fund and World Bank to assume new roles—as crisis managers that negotiated debt restructurings backed by macroeconomic reforms, rolled over financings, and eventually encouraged structural reforms. By the end of the 1980s, the debt deals included partial forgiveness.

The Reagan and Bush Administrations translated their initiatives into striking results. The successful revitalization of the G-7 economies contributed to Soviet President Mikhail Gorbachev's recognition that the Soviet Union could not keep up, leading within a few years to the end of the Cold War in Europe and even the collapse of the USSR. The Bush Administration completed NAFTA, which the Clinton Administration guided through Congress. In its final months, the Bush team resolved the complex agricultural issues of the Uruguay Round, paving the way for Clinton to complete the accord that created the World Trade Organization.

After moving to the U.S. State Department in 1989, Baker helped invent the new Asia-Pacific Economic Cooperation group. He recognized that the rapid rise of East Asian economies, combined with a shift to a post-Cold War agenda, called for a new trans-Pacific economic arrangement that would keep the United States closely linked to the world's most dynamic region.

President Bush even extended his internationalism to the environment, negotiating the 1992 United Nations Framework Convention on Climate Change, the only climate treaty ever ratified by the Senate and the basis for all subsequent negotiations (including this year's Conference of the Parties in Glasgow). But the brief economic recession of 1991 led to Bush's defeat, and the second era of international economic transformation waned.

The Clinton Administration faced an international economy in transition to a new and vastly different epoch. The end of the Cold War opened the door to a

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James Baker,
U.S. Treasury Secretary, 1985–1988

Richard Darman,
Deputy U.S. Treasury Secretary, 1985–1987

The Policy Coordinators

In 1985, Treasury Secretary James Baker and his deputy, Richard Darman, viewed exchange rates as elements within a larger strategy. The finance ministers of the G-7 economies—in concert with central bankers—sought to coordinate policies for growth, low inflation, and open markets without economically and politically unsustainable imbalances.

—R. Zoellick

Bretton Woods 1971–2021

By David C. Mulford

The birth of the new age of modern markets.

Closing the U.S. gold window and scrapping fixed exchange rates happened in August 1971. It was bound to happen eventually—and it did, later than it should have. The writing was on the wall at least three years before the event.

Wage and price controls were also introduced at the same emergency monetary meeting at Camp David and this was a significant mistake by President Nixon and the Federal Reserve. These actions did not contain inflation as hoped nor did they help generate growth.

To understand why closing the gold window and scrapping Bretton Wood's fixed exchange rate regime were not mistakes, and wage and price controls were a mistake, one has only to look at the history of the times before and after each of these policy events.

Abandoning the Bretton Woods fixed exchange rate system and terminating the U.S. dollar's link to gold proved to be an historic regime change that influenced world economic developments and the evolution of global markets for the rest of the century. Essentially, over these years the world moved from a system of pervasive capital controls to the free movement of capital which today is taken for granted in world markets. Wage and price controls, on the other hand, was simply a damaging policy mistake that was overcome by new policies in a few years.

David C. Mulford is currently a Distinguished Visiting Fellow at Stanford University's Hoover Institution. He previously served as Vice Chairman International at Credit Suisse, as U.S. Ambassador to India, and as both Under Secretary and Assistant Secretary for International Affairs of the U.S. Treasury. Ambassador Mulford also served in Saudi Arabia from 1974–1983 as senior advisor at the Saudi Arabian Monetary Agency.

By the mid-1960s, the United States was suffering from a sharply rising balance-of-payments problem. This was due to the economic recovery of Europe and Japan after the destruction of World War II, and accelerated by the costly U.S. military buildup in Vietnam and President Johnson's simultaneous commitment of resources to his Great Society programs. U.S. companies were also investing heavily overseas in these years and American tourists were flooding to Europe to spend their new savings.

The fixed exchange rate system as advertised was not for real. Instead, it was a fixed system which from time to time, without warning, was adjusted by individual players deciding suddenly under duress to devalue their currencies, such as the United Kingdom devaluing sterling by 14 percent in November 1967. These mini-crises themselves defined the reality of the fixed exchange rate system, making the Bretton Woods system appear more like a large-scale stop-and-start exercise, with no predictive order or consensus.

What was significant at the time was the combination of these forces. The outflow of U.S. dollars taken as a whole was creating and fueling the popularly known Euro bond and Euro currency markets in London from 1963 onwards. Although relatively small at the time, these were by and large unregulated, cross-border markets that provided an important source of financing to companies and governments. They were supra-national in nature, spread across and over national, still-closed, and regulated European markets, which continued to follow the regulatory habits of the post-war period. U.S. policy actions helped fuel this growing market initially, first by imposing the U.S. interest equalization tax in 1963, effectively closing the U.S. market to foreign borrowers for the next ten years. A policy response that closed off the U.S. capital market to foreign borrowers was entirely consistent at the time with a global capital controls mentality.

On top of this prohibition, the United States also imposed a restriction on its own companies seeking to invest overseas. This was known as the Office of Foreign Direct Investment program, which forced U.S. companies expanding overseas to raise financial resources outside the United States. These two actions had the effect of further stimulating and expanding the Euro markets, introducing dozens of major U.S. corporations for the first time to a new offshore financial market.

A New First—The Saudi Loan

In early 1981, there was a new first for G-5 cooperation which resulted from Saudi Arabia's willingness to make the largest private placement loan ever to the International Monetary Fund. The loan of $10 billion (SDR 12 billion) enabled the funding of the IMF's new Enlarged Access Supplemental Financing Facility, which was complementary to its Supplemental Financing Facility for developing countries. The new loan would also serve as the key building block for other countries to come together to provide yet additional funds to the IMF's total resource base for addressing the critical balance-of-payments challenges of developing world.

By early March, SAMA had completed the negotiations with the IMF on the terms and conditions of the new loan, which was set to close on May 1 at the time of the spring ministerial meetings of the IMF and the World Bank in Washington, D.C. I had been in charge as SAMA's senior adviser of the loan negotiations with the IMF and was surprised to be called by the governor of SAMA to be given new directions regarding the completion of the loan, which were not a part of the already-completed documentation. This was that I was to go to Washington to meet privately with President Reagan's new Secretary of Treasury, Donald Regan, to place before him two additional conditions that would not be part of the loan documentation, but would have to be agreed for the loan to close on May 1.

The first condition was that Saudi Arabia's quota position in the IMF would have to be lifted from position number thirteen to position number six. The second condition was that Saudi Arabia would have to be given its own permanent seat on the IMF's formal Executive Board of Directors, making Saudi Arabia the unofficial leader of the developing world. Both conditions represented unprecedented changes in the IMF.

My instructions were to go to Washington to present these conditions to Secretary Regan, and to remain in Washington for additional personal meetings with the secretary until agreement was accomplished. It was explained that I was being asked to carry out this delicate and complex mission because it was known that I had a longstanding personal/professional relationship with Secretary Regan.

I returned to Saudi Arabia two weeks later when Secretary Regan had concluded his discussions with the IMF leadership and the G-5. On March 28, the *Washington Post* reported the IMF's version of the new agreement between the IMF and Saudi Arabia.

—D. Mulford

It was the perfect storm for expanding the Euro dollar and the Euro bond markets to break free from controls and become engines for promoting free capital flows. I was there in London at the time as a young investment banker enjoying the creative surge of new financing.

By dithering for years over closing the gold window in the United States and abandoning fixed exchange rates, the United States had actually helped expand and deepen the fledgling, unregulated Euro markets, and taken the first step to expanding international cross-border capital markets. By the time the United States acted to close the gold window in 1971–1972, it and other leading countries in the financial system found that they had already inadvertently laid the foundation for the modern, sophisticated, truly global financial markets of today.

This revolutionary transition took a little time to mature—only twelve months, to be exact. All of a sudden, in December 1973, the OPEC states led by Saudi Arabia suddenly introduced a nearly four-fold increase in the price of oil. What followed may be described as the largest, most abrupt transfer of liquid financial assets ever experienced in the modern world. In the short space of a few months, the world of developed industrial nations was cast into recession and inflation. Gasoline prices skyrocketed. Lines at filling stations became hours long, foreign exchange markets were highly volatile, interest rates and inflation both rose sharply. The flow of liquidity to OPEC states and the Euro markets became a flood.

This I also know because once the flows had gained momentum, I was in Jeddah instead of in New York or London, serving for the next nine years as senior advisor of a small team of investment bankers hired by the Saudi Arabian Monetary Agency in late 1974. We were the very challenged few, three from White, Weld & Co. in New York and three from Baring Brothers in London who were hired to advise SAMA on managing and deploying these massive flows of liquidity.

Abandoning the Bretton Woods fixed exchange rate system and terminating the U.S. dollar's link to gold proved to be an historic regime change that influenced the evolution of global markets.

The fixed exchange rate system as advertised was not for real. Instead, it was a fixed system which from time to time, without warning, was adjusted by individual players deciding suddenly under duress to devalue their currencies.

Open markets prospered, regulated and closed markets did not. At SAMA, new funds in excess of $100 million arrived every day to be invested consistently and responsibly into what was rapidly becoming a global market. This transformation was nothing like that of 1971–1972, except that at first it took place mainly in U.S. dollars, into open markets like the United States, not into the still heavily regulated markets which remained restricted for the time being.

Currency volatility became a regular feature of markets and "imbalances" in global trade and payments began to dominate policy dialogues between the major nations. So too did concerns about "stagflation" and rising interest rates.

During the tenure of U.S. Treasury Secretary George Shultz (1972–1974), he gathered together an informal group of the world's five leading-country finance ministers (the United States, the United Kingdom, Germany, France, and Japan) in the library of the White House to discuss key macroeconomic and monetary policy issues and challenges in the world's newly transformed global economy and financial system. The "Library Group" later became the G-5, the most important international policy group for the balance of the twentieth century.

Meanwhile, global markets continued to globalize. SAMA and other OPEC funds recycled vast amounts of dollars through the global banking system, which due to excess liquidity in the banks from lower economic activity in the industrial nations, resulted in significant new direct bank loan flows to developing nations in central and south America. This laid the basis for the Latin American debt crisis of the 1980s.

SAMA avoided lending directly to developing countries, and had become the largest holder of government fixed-income securities in the United States and all other developed country bond markets. SAMA also opened another multibillion-dollar private placement business directly with a large group of industrial country governments, international financial institutions, and high-quality multinational corporations.

As SAMA was the central bank of issue in Saudi Arabia, it also established access to major government markets in all significant currency markets. This was central to the opening and deregulation of markets in countries whose priority was accessing new sources of finance for restoring their recession-hit countries. This also offered SAMA the critically important opportunity to diversify away from its almost exclusive dependence initially on a weakening U.S. dollar. This was followed by creating large managed equity portfolios in all the major currency markets, another important diversification of risk and possibly higher returns.

Currency volatility and misalignment were to become increasing challenges in global markets. So also were President Jimmy Carter's economic policies which led to higher inflation and rising interest rates. SAMA now had an investment portfolio of some $200 billion and new monthly revenues exceeding $3 billion.

One outcome of SAMA's currency diversification policy, which avoided the limitations of operating in narrow currency markets, was to broaden the mix of currencies used to denominate at issue SAMA's now-large flow of private loans to national governments and the International Monetary Fund. This achieved instant large-scale currency diversification. It also saved the costs of moving large dollar amounts through sometimes narrow or volatile foreign exchange markets, and freed up SAMA's daily demand for non-dollar currencies to settle foreign currency bank deposit transactions and purchases of non-dollar bonds and securities.

Gradually markets "globalized." By the early 1980s, the main markets around the world were fully open, far bigger in size, more diverse, and cross-border investment was easier.

With the strengthening dollar, the challenge of potentially destabilizing global imbalances returned with a vengeance, along with growing political support in Congress for enacting protectionist trade legislation. Rising tensions with Germany and Japan added further heat to protectionist forces.

Not surprisingly, initiatives for more formal economic dialogue and even closer economic policy coordination among the G-5 countries became a new international policy focus of ministers and officials across the global economy, who judged that open trade and financial markets were vital to maintaining world growth and stability. By now, I was serving as undersecretary of the U.S. Treasury for international affairs for nine years in the Reagan and George H.W. Bush Administrations.

Once Fed Chairman Paul Volcker restored disciplined U.S. monetary policy and began bringing dollar interest rates down, and President Ronald Reagan restored strong U.S. growth, the global evolution of financial markets continued. The strengthening dollar picked up momentum and the G-5 became more prominent as a forum for discussing and negotiating tensions related to the strengthening dollar, global trade and payment imbalances, and the then-rising threat of protectionism.

Over the next twenty years, G-5 (later G-7) cooperation deepened, growth in the world economy improved, and millions escaped poverty. The G-20 also emerged as a force in global affairs. The Plaza Accord of 1985 broke new ground in economic policy cooperation, as did later international coordination on the Baker and Brady plans for resolving the Latin America debt crisis. The U.S.-Japan yen/dollar negotiations (1984–1988) completed the cycle of opening national markets around the world, and the collapse of the Soviet Union in 1991 was handled without a crisis in global financial markets thanks to G-5 shared efforts. Next came the movement to create the euro in the 1990s and the rise of the emerging market economies. Clearly, we had experienced a thirty-year "historic economic and financial regime change" for the world, which has taken us from a Bretton Woods world of regulation-dominated financial markets to a world of open global markets and free capital movement. ◆

By the time the United States acted to close the gold window in 1971–1972, it and other leading countries in the financial system found that they had already inadvertently laid the foundation for the modern, sophisticated, truly global financial markets of today.

Nixon, the Dollar, *and the* Emerging New Money Revolution

By Harold James

The emergence of weightless globalization.

Richard Nixon in 1971 embraced a mendacious narrative of economic nationalism that has haunted, and damaged, the United States ever since: it shaped a new approach to money, without dethroning the U.S. dollar. Today, protectionist currency politics are also rampant; but rapid technological developments in money and payments technology are generating a radically transformative rethinking of money.

Nixon's announcement on August 15, 1971, was, as he intended, game-changing—but not at all in the way that Nixon imagined or promised. He started his televised address with the observation that: "Prosperity without war requires action on three fronts: We must create more and better jobs; we must stop the rise in the cost of living; we must protect the dollar from the attacks of international money speculators."

The American president did indeed, eventually, end the long war in Vietnam, perhaps the prime driver of the increasing American malaise. But instead of creating more jobs, the end of the par value system (Bretton Woods) produced a decade in which unemployment soared and manufacturing jobs were lost; inflation increased dramatically rather than falling; and international capital markets (also known as international money speculators) had a bonanza. Far from being repelled as a result of government action, they took over the American economy.

Harold James is Professor of History and International Affairs, Princeton University, and author of Making a Modern Central Bank *(Cambridge University Press, 2020).*

Rapid technological developments in money and payments technology are generating a radically transformative rethinking of money.

It wasn't just a bad prophecy or prediction. Nixon's speech was full of a dishonesty that was starkly apparent at the time. The president assured: "Let me lay to rest the bugaboo of what is called devaluation. If you want to buy a foreign car or take a trip abroad, market conditions may cause your dollar to buy slightly less. But if you are among the overwhelming majority of Americans who buy American-made products in America, your dollar will be worth just as much tomorrow as it is today. The effect of this action, in other words, will be to stabilize the dollar."

Nixon was uncannily echoing another persistently mendacious political leader, Britain's Harold Wilson, who had told the British public after the 1967 devaluation of sterling that: "From now on, the pound abroad is worth 14 percent or so less in terms of other currencies. That doesn't mean, of course, that the Pound here in Britain, in your pocket or purse or in your bank, has been devalued." That pronouncement too had been subjected to immediate ridicule, as the effect of devaluation on import prices was even more apparent in Britain, as a smaller and more open economy.

There were also parallels in the repercussions of the 1967 and the 1971 currency moves. The devaluation of the world's second reserve currency, the British pound, set the stage for increasing nervousness about the future of the dollar as the world's central reserve currency.

The Nixon speech was a rejection of any multilateral solution of the exchange rate issue—the International Monetary Fund had been preparing recommendations on a new structure of exchange rates, but it was ignored. It also set about the demonization of capital markets: "Now who gains from these crises? Not the workingman; not the investor; not the real producers of wealth. The gainers are the international money speculators. Because they thrive on crises, they help to create them."

As the crisis of Bretton Woods was building up, the Canadian economist Robert Mundell prepared a remarkable essay, with three big—and for the late 1960s completely surprising—predictions. They turned out to be spot on. The dollar would remain the world's leading currency for the foreseeable future; Europe would get a single currency; and the Soviet Union would disintegrate.

Mundell's trinity proved a much more successful act of prophecy than Nixon's hope for job creation, no inflation, and curtailing international speculation. The prophecies were interconnected. It was the new dynamism of the capital markets and of American banking (operating increasingly offshore) that ensured the continuing preeminence of the dollar. Worries about the international position of the dollar, especially when the currency was weakening, in the late 1970s, the late 1980s, and the early 1990s, provided a decisive push to Europe to institutionalize closer currency cooperation. The need of the Soviet Union to access international capital markets in the late 1990s accelerated the process of dissolution.

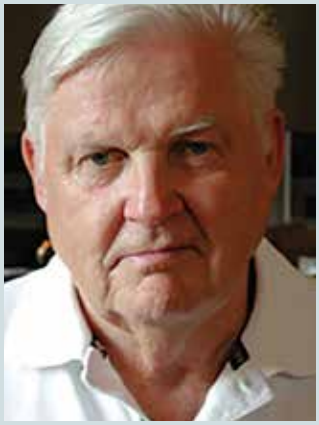
The immediate effect of Nixon's price controls was to encourage more consumption and more imports. Eventually there were shortages, especially of heating oil in the winter of 1972–1973. The chronology of descent into scarcity matters because a great deal of the mythology of the 1970s arose from the claim the rest of the world—in

History Lesson

After the bitterly divisive election of 2020, with the very tight Senate race and the prospect of a possible blowback in 2022 (a repeat of Obama's 2012 "shellacking"), the Biden Administration is making a calculation analogous to the Nixon calculation in the lead-up to the 1972 election. Fiscal and monetary stimulus can be pushed simultaneously on a scale unprecedented in peacetime because of the unique position of the dollar, the only currency to have a true monetary sovereignty.

—H. James

U.S. Treasury Secretary
Janet Yellen



The Remarkable Mundell Essay

As the crisis of Bretton Woods was building up, the Canadian economist Robert Mundell prepared a remarkable essay, with three big—and for the late 1960s completely surprising—predictions. They turned out to be spot on. The dollar would remain the world's leading currency for the foreseeable future; Europe would get a single currency; and the Soviet Union would disintegrate.

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—H. James

Nobel Laureate **Robert Mundell,** *1932–2021*

particular the oil producers, but also other commodity suppliers—had abused their position. Americans continued in Nixon's vein: blaming foreigners for a domestically produced disorder, driven by a combination of loose fiscal policy and politically motivated monetary policy. In reality, of course, the rest of the world was responding to developments driven by the United States—and by the many other western countries that had embarked on the same course of self-confident expansion.

There might have been a new stable multilateral system of exchange after the December 1971 Smithsonian meeting, but Nixon was unwilling to take his feet off either the monetary or the fiscal pedals, as he was fixated by the 1972 election and the need to maintain an economy running hot in order not to risk election defeat. Instead, a non-system, to use the neat phrase of the late economist John Williamson, emerged.

However, the center of the non-system, the dollar, is gradually eroding. We have come a long way from the unipolar moment of the 1990s. Doubts about the dollar were raised by another unpopular and ill-judged war, the 2003 invasion of Iraq; by another financial crisis in 2007–2008; and by the increasing weaponization of the dollar as an instrument of geopolitical coercion. Juan Zarate, one of the architects of the specific plan to use financial sanctions in the 2000s, correctly noted that it was a highly successful instrument against North Korea, but that it would be less effective and possibly counter-productive when applied to more internationally connected economies such as Iran or Russia.

After the bitterly divisive election of 2020, with the very tight Senate race and the prospect of a possible blowback in 2022 (a repeat of Obama's 2012 "shellacking"), the administration is making a calculation analogous to the Nixon calculation in the lead-up to the 1972 election. Fiscal and monetary stimulus can be pushed simultaneously on a scale unprecedented in peacetime because of the unique position of the dollar, the only currency to have a true monetary sovereignty.

The centrality of the United States to everyone else's discussions of global governance may look to some optimists in Washington as if it must inevitably persist, and that the worst that could happen from a resurgence of inflation would be an episode of dollar depreciation followed by rebalancing, similar to that of the Carter presidency in the late 1970s. After all, the United States provides two common goods that everyone still, for the moment, needs—the English language as a common medium of expression, and the American dollar as a common medium of exchange. Will those advantages endure even after the relative decline of America's share in the world economy,

International capital markets (also known as international money speculators) had a bonanza. Far from being repelled as a result of government action, they took over the American economy.

It was the new dynamism of the capital markets and of American banking (operating increasingly offshore) that ensured the continuing preeminence of the dollar.

the rise of big new economic powers, the fragility of the international order, and the increased push (even with new administration) to disengage from the world?

Both language and dollar are now under threat. The past years have seen enormous advances in automatic translation.

And what about money as a translator of wants and needs? There are already warnings: the 2020 liquidity strains in the Treasury market, the weak foreign demand for Treasury securities. The long preeminence of the dollar is under challenge, but not primarily from other currencies—though both the euro and the renminbi may well be bolstering their attractions as claimants to the throne of the dollar. The national era in money is drawing to a close at the same time as a technological revolution gives radically new methods of addressing the problem of a cross-border monetary language.

One consequence of the new possibilities is the unbundling of the apparently solid historical link between money and monetary stability and government fiscal management. Experiments to tackle the economic fallout from Covid-19 through large central bank stimulus programs, promised for long time periods, risk a new vulnerability and raise inflationary dangers. It is likely that the world will demand a new monetary revolution; and at the same time, the means for that revolution is supplied by the way loose monetary policy pushes flows into alternative asset classes.

As money is unbundled into different functions, with new platforms of exchange, where is innovation most likely to occur? One prediction would be that the innovation would occur where states are weak and not trusted, and consequently state promises are not seen as highly credible.

In rich and well-developed industrial societies there is another logic. Where the promise of social cohesion means less, being able to separate peacefully into different groups may become a way of avoiding clashes and conflict. Currencies will establish communities, bound together by exchanges of information.

We will unbundle different aspects of our lives. Thus, Starbucks cards might be used as an international currency for luxury food products, or Apple music or Spotify plans/memberships for buying or selling sounds. It is also possible to imagine that the new digital ecosystems may be rebundled in new ways: excessive consumption of coffee or of sugars, for example, might be linked to alerts to medical service providers. And the willingness to use smart currencies might be linked to reduced health and life insurance premia (while correspondingly, an unwillingness would be penalized through higher prices).

New money may be ending the long period of dollar hegemony. Covid has accelerated that development, as in many other areas of life. It is making for more digital globalization, and less actual globalization, less movement of people and of goods. There is more information flowing—this is the ultimate weightless economy or weightless globalization.

The dollar's centrality was prompted by the global demand for a deep and liquid safe asset; and that centrality will only disappear when alternative safe assets emerge, backed in some cases by non-state providers. In the past, alternative safe assets dominated—when precious metals were the basis for currency issue. Even in the late twentieth century, nostalgic commentators looked back to that era. The alternative is to think of currency as having a real collateral—in this particular case, information generated by the participants in a wide variety of overlapping communities.

The Nixon speech set about the demonization of capital markets.

The action of 1971 marked the final end of a commodity (gold-based) monetary order, and the beginning of a new world of fiat currencies, which the world's governments and central banks only learnt to manage effectively in the 1990s. We are moving to a new monetary order, with a sort of commodity base: information. The learning process of how to manage that new system may be faster than the tumultuous experiments of the late twentieth century, but it won't be easy. ◆

1971 and the Undermining *of* Fed Independence

By Roger Lowenstein

Today the U.S. central bank's sense of a shared mission with the administration has been internalized.

Postwar, there were two revolutions in American central banking.

The second occurred in 1971. On a Sunday night in August when most Americans were returning from beaches and preparing to watch *Bonanza,* President Richard Nixon stunned the country by delinking the American dollar from gold.

Nixon closed the gold window because America had issued too much paper for its available bullion. Once the window was shut, America discovered what inflation really looked like. Over the next decade, the dollar lost more than half of its purchasing power.

Bonanza is not coming back, but it is fashionable to think that another Nixon shock, that is, monetary upheaval, is a-comin'. Maybe, but people looking for an historical mirror should be familiar with the first revolution, twenty years earlier.

This one did not occur on national television. Its architects were little-known monetary officials. But it gave us the independent monetary authority that many think of as essential. The story is worth telling in some detail, because it demonstrates the danger of political capture of the central bank.

The Federal Reserve was essentially a tool of the Treasury through World War II and its aftermath. It not only committed to a short-term rate of 0.375 percent, but set an upper limit of 2.5 percent on bonds. This accommodative policy enabled the government to finance the war and the recovery, but in the late 1940s it led to severe inflation.

Journalist Roger Lowenstein is the author of America's Bank: The Epic Struggle to Create the Federal Reserve *(Penguin Press, 2015).*

By 1950, the Fed was chafing to reassert control. President Harry Truman and his Treasury Secretary, John Snyder, wanted none of it. Both Truman and Snyder, an Arkansas businessman, were populists with little regard for the theory of an independent central bank. When the Korean War erupted, the dispute turned into the monetary equivalent of a shooting war.

Allan Sproul, president of the New York Fed, insisted that the Fed reassert control of monetary policy. With FOMC support, he raised short-term rates.

By September, newspapers were reporting a rift, and Fed officials were pushing for a further rate increase. This would clearly threaten the long-term rate.

With the war (and Treasury's borrowing needs) intensifying, Truman was adamant that the Fed publicly guarantee the 2.5 percent bond ceiling—which meant monetizing bonds at the pegged rate. The president tartly observed to Thomas McCabe, the Fed chairman, that raising rates was "exactly what Mr. Stalin wants."

In January 1951, even as inflation accelerated, Secretary Snyder assured the public that Chairman McCabe had agreed to maintain the bond rate. The trouble with this soothing communiqué was that it was false. Marriner Eccles, a Fed governor, retaliated by testifying, in public, that requiring the Fed to purchase at the pegged rate would turn the entire banking system into "an engine of inflation."

A furious Truman summoned the FOMC to the White House. With the military situation deteriorating, Truman told the bankers the present emergency "is the greatest this country has ever faced."

Since Nixon, strong-arming has gone out of a favor. (Donald Trump was an exception.) The greater threat to independence is from "soft suasion," or the use of a crisis to sustain a sense of a shared mission between the Fed and the administration.

Federal Reserve Chair **Jay Powell** *participates in the virtual Federal Open Market Committee press conference on June 16, 2021.*

From Greenspan to Powell

Fed Chairman Alan Greenspan initiated the interagency fusion by avidly hobnobbing with cabinet members and presidents. His successor Ben Bernanke worked closely with the Treasury, but that was during a genuine crisis—the mortgage collapse. Since then, the Fed has not reestablished its prior distance. Suasion is barely necessary—the sense of shared mission has been internalized. Co-option might have been expected during the pandemic, but it has morphed into a follow-on mission to support a Biden New Deal.

—R. Lowenstein

The following day, the president announced that the FOMC had "pledged … to maintain the stability of Government securities." Eccles bluntly informed the press that the Fed had done no so such thing.

Snyder's minions in Congress turned up the heat. Wyoming's Senator Joseph O'Mahoney (D) charged that the Fed, by spurring disunity, was doing the Soviets' work of wrecking the capitalist world. The FOMC defiantly replied by quoting economist John Maynard Keynes: "The best way to destroy the Capitalist System was to debauch the currency."

By now, the Treasury realized that the public war was damaging its credibility. In March, the two agencies

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Oil *and* August 15th

By Philip K. Verleger, Jr.

An unintended consequence of the three days at Camp David: the complete reconstruction of the global petroleum system.

Jeffrey Garten's new book, *Three Days at Camp David: How a Secret Meeting in 1971 Transformed the Global Economy,* focuses on international finance. However, his insights about what was discussed and decided by President Richard Nixon and his advisers at that meeting also provide a clear explanation of what happened with oil in 1971, developments that eight years later would cause the 1979 Tokyo economic summit to limit its discussion almost entirely to that subject.

The key events for oil in the United States that followed President Nixon's August 15, 1971, speech to the nation were the ninety-day wage and price freeze and, as explained by Garten, Nixon's efforts to win the cooperation of the Democrats in Congress.

The 1971 wage and price freeze (phase I) was followed by three additional phases. In June 1973, Nixon instituted a second freeze, this one for sixty days. Then came a two-tiered system of price controls. The terms "old oil," oil from wells producing before 1973, and "new oil," oil from wells that had just begun to produce, entered the lexicon.

Old oil prices were frozen at about $3 per barrel and would remain near that level until 1981 even as world prices rose to more than $30. The architects of the price control program included an incentive to boost production, allowing any incremental output from old oil wells above 1973 levels to receive a higher price. Those writing the regulations, though, failed to recognize the laws of physics and geology, which cause output to decline over time. Thus, the perceived economic incentive was absent.

Garten's comment regarding President Nixon's desire to bring the Democrats with him in the program offers a hidden insight into the longer

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Aggressive moves by the United States would likely have restrained the rise in world prices.

consequence of the crude oil and other petroleum regulations: the Democrats were waiting for an opportunity to get oil. The Democrat-majority Congress elected in 1974 was determined to punish the oil industry for decades of perceived harm. Following the October 1973 oil price increase noted by Garten, the Democrats passed legislation to extend limits on oil price increases, constrained the ability of refiners and other processors to raise margins, and prevented firms from changing historical contractual relationships. The legislative actions were justified as being necessary to dampen price rises to consumers and prevent large firms, principally the multinational oil companies, from using their market power to destroy smaller competitors.

No doubt some actions would have been taken after the 1973 price surges. However, their impact would likely have been far less draconian if price controls had not been in place.

The impact of the regulatory program on the U.S. petroleum sector was notable. While world oil prices increased from $2.24 per barrel in 1971 to $36.83 in 1980, a rise of 31 percent per year, the price for old oil rose only to $6.24 from $5 in 1974. It is not a surprise to note that U.S. production declined from 9.2 million barrels per day to 6.8 million barrel per day between 1971 and 1980.

The limits on retail prices also discouraged conservation. Consumers paid $0.33 per gallon for gasoline in 1971 and $0.85 in 1978. Prices jumped to $1.30 per gallon in 1981 with decontrol. U.S. consumption rose from 15.2 million barrels per day to 18.8 million barrels per day in 1978 before declining to 17 million barrels per day in 1981.

The decline in consumption of 1.8 million barrels per day from 1978 to 1981 was caused in part by the sharp price increase and in part by the severe recession. I would attribute probably half the decline to the higher prices.

Consumption would have been lower in 1980 had prices not been controlled. U.S. oil production would have been higher, possibly as much as one million barrels per day. The combined impact of reduced use and increased production would have lowered the volume of U.S. imports. Net imports of petroleum rose from 3.7 million barrels per day to 6.3 million barrels per day between 1971 and 2000.

The cost of these imports rose from approximately $3 billion in 1971 to $93 billion in 1980. Absent price controls, the cost would have increased to $60 billion in 1980 if global oil prices had been unaffected by U.S. actions. Aggressive moves by the United States would likely have restrained the rise in world prices. I estimate that the U.S. merchandise trade deficit in petroleum would have been less than $50 billion in 1980 had the controls program not been implemented.

There is an irony here. Garten reports that the goal behind the U.S. actions on August 15, 1971, was a reduction in the U.S. merchandise trade balance of $13 billion. The price controls on oil, though, had the long-term effect of boosting the merchandise balance by between $30 billion and $50 billion.

U.S. energy policies and particularly the subsidization of oil imports were the primary topics of the June 1979 G-7 economic summit held in Tokyo. President Carter was reportedly angered by French President Valéry Giscard d'Estaing, who, when asked about U.S. effort to conserve energy, replied, "They haven't started."

The French were especially miffed at a U.S. Department of Energy program that offered subsidies for distillate fuel oil imports weeks before the meeting. Global supplies were tight, and the Department of Energy's $5-per-barrel bounty

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French Barb

President Carter was reportedly angered by French President Valéry Giscard d'Estaing, who, when asked about U.S. effort to conserve energy, replied, "They haven't started."

—P. Verleger

KEYSTONE PRESS / ALAMY STOCK PHOTO

U.S. President **Jimmy Carter** *and French President* **Valéry Giscard d'Estaing,** *1978.*

The Reincarnation of *John Connally*

Could Trump's crude, bullying global shocks play the same role as the Connally/Nixon shocks did in 1971?

By C. Fred Bergsten

On August 18, 1971, three days after President Richard Nixon announced the cessation of dollar convertibility into gold for foreign monetary authorities and an across-the-board import surcharge, rocking the world economy and essentially ending the original Bretton Woods system of fixed exchange rates, I and three other economists from outside government—the late Richard Cooper, Harry Johnson, and Henry Wallich—were invited to the U.S. Treasury Department to meet with Secretary John Connally and his top lieutenants including Under Secretary for Monetary Affairs Paul Volcker. Connally, who was Nixon's chief adviser on these issues and the major proponent of the new U.S. strategy, began the session by indicating "You know what we have done. Please advise us on what we should do next." It was clear that he did not know what to do next, so we outsiders were immediately extremely worried.

The discussion, led throughout solely by Connally, lasted for six hours. Cooper and I urged the officials to use the new environment to promote lasting reform in the international monetary and trading systems, which needed major improvements. But it became increasingly clear that Connally had no interest in systemic reform. At about 4 p.m., the Secretary indicated that it was time to close and that he wanted to share his own philosophy with us before departing: "The foreigners are out to screw us. It is our job to screw them first. Thank you for your help."

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I immediately reported this encounter to National Security Adviser Henry Kissinger, whose deputy for foreign economic policy I had been until six months earlier. I warned him that he was dealing with a powerful xenophobe at Treasury, who would severely jeopardize his entire foreign policy. Kissinger was then planning to broker *détente* with the Soviet Union and the historic opening to China. Both of those initiatives required full support from America's traditional allies, who were outraged by the Nixon shocks and refused to even meet with Nixon until the economic crisis was resolved. Kissinger eventually orchestrated that resolution.

The Nixon shocks, and these underlying attitudes in at least some key quarters of his administration, were a watershed in the evolution of U.S. foreign economic policy. They severely disrupted the global financial system and indeed the entire world economy for a couple of years. Both of the key policy steps, though they could arguably be justified in legal terms, violated fundamental norms of the extant international economic order: convertibility between the dollar and gold, which provided the foundation for fixed exchange rates among the major currencies, and the openness of trading markets (especially the U.S. market) to foreign imports.

The Nixon shocks put the world on notice that the United States would defend its own interests even if that meant trampling on the interests of others. They were an eerie precursor of President Donald Trump's "America First" policy and rhetoric almost fifty years later. The immediate and widespread reaction around the world was that the United States had gone rogue and had abdicated its global economic leadership—much as Trump did almost fifty years later. I helped mount the attack on Nixon and Connally, including with immediate Congregational testimony and a lead article in *Foreign Affairs.*

The "Nixon shocks" were clearly undertaken with domestic U.S. politics (especially the upcoming 1972 elections and growing protectionism), as well as international pressures on the dollar, very much in mind. They had little intention of providing positive systemic leadership. Their ultimate results, however, turned out to be highly constructive. Long after Nixon and Connally had lost interest in the issue and handed it off to others, the United States and its allies acquiesced to the pressure from markets to abandon fixed exchange rates altogether and to adopt a wholly new regime of flexible rates. This tectonic shift provided what remains the most fundamental reform of the international monetary system in the postwar period.

The global monetary system, while by no means perfect, has functioned far more successfully ever since. The currency crises among industrialized countries that were so common in the 1960s and early 1970s became a thing of the past (until the Europeans restored fixed exchange rates among themselves by creating the euro and thus fostered currency crises for some individual eurozone countries in the early twenty-first century). The Tokyo Round in the GATT, which originated from the trade component of the August 1971 program, restored the forward momentum of liberalization and significantly extended the disciplines of the global trading system to key non-tariff barriers, incorporating new rules to govern subsidies and government procurement.

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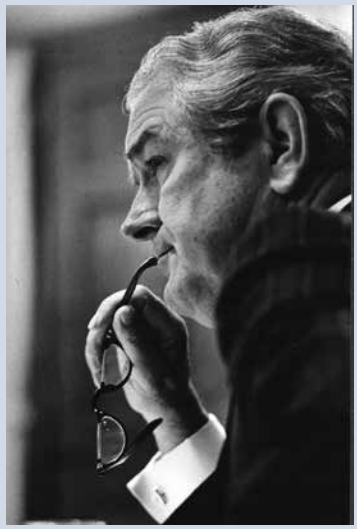
The Nixon shocks were a watershed in the evolution of U.S. foreign economic policy.

"Screw the Foreigners"

I and three other economists were invited to the U.S. Treasury Department to meet with Secretary John Connally and his top lieutenants including Under Secretary for Monetary Affairs Paul Volcker. The discussion, led throughout solely by Connally, lasted for six hours. But it became increasingly clear that Connally had no interest in systemic reform. He wanted to share his own philosophy with us before departing: "The foreigners are out to screw us. It is our job to screw them first. Thank you for your help."

—C. F. Bergsten



NATIONAL ARCHIVES AND RECORDS SERVICE.

U.S. Treasury Secretary **John Connally,** *August 15, 1971.*

A *Highly Symbolic* Act

By Otmar Issing

Though symbolic, the 1971 changes were a major catalyst for development of the European Monetary Union and the euro.

To characterize U.S. President Richard Nixon's declaration of August 1971 as a highly symbolic act has two dimensions. "Highly" indicates that the declaration sent a message that had a great influence on international policies around the world. "Symbolic" signals that the effect came not from the substance of the announcement but from a mere change in perception.

Why only symbolic? The declaration of 1971 is widely seen as the end of the gold exchange standard (or gold-dollar system). This characterization of the international monetary system, which ended in 1971, goes back to the International Monetary Fund Statute ratified in 1945. Article IV, 1(a) specified: "The par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944." This established a relation between the dollar and gold at a value of $35 per ounce. What followed in the 1960s were endeavors to preserve the official gold price via arrangements within the "gold pool." But was a gold exchange standard really established in 1945?

The gold standard of the nineteenth century collapsed with the outbreak of World War I. On a global level, the return to gold brought an important modification to the previous system in the form of the gold-exchange standard. Under this regime, countries or in most cases their central banks were allowed to hold their reserves in gold and/or foreign currencies that were pegged to gold. The crucial element of this regime is that it finally allowed money to be converted

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into gold at a fixed price. This was guaranteed by a fixed exchange rate and a fixed parity between the reserve currency and gold.

Was such a regime established in 1945? Definitely not. No legal obligation to redeem the U.S. dollar at a fixed price was introduced either domestically or internationally. For many years, the United States converted official dollar balances into gold at the price of US$35 on the request of foreign monetary authorities. This was a practice, not a legal obligation. It was obvious that, as foreign dollar reserves rose, this practice would (and must) come to an end. This finally became the official position of the United States in 1971. One major reason it did not happen much earlier was that Germany did not follow French President Charles de Gaulle's attack on the dollar by presenting its much higher dollar reserves to be converted into gold.

The position of the U.S. dollar as the leading currency in the post-World War II international monetary system was based not on its relation to gold but on the whole ensemble of factors necessary for a dominating role. First of all, the dollar was the only major currency in the world with full convertibility. When the post-war period of "dollar shortage" gradually shifted towards a situation of "dollar glut" due to the increasing balance of U.S. payment deficits, it became obvious that the principal element for a currency tied to gold was missing—the "golden brake on money creation."

The system of fixed but adjustable exchange rates founded in 1945 collapsed largely (though not only) because U.S. domestic policy neglected the country's responsibility for the global monetary system. The move toward flexible exchange rates was already under way in 1969, when Germany introduced a "floating exchange rate"—at that time intending to provide a limited phase of flexibility (*de facto* four weeks) to find out the appropriate level at which to fix the exchange rate again.

CONSEQUENCES FOR EUROPE

In Europe, the Nixon announcement was understood as a signal that the U.S.-dollar-centered post-World War II international monetary system of fixed but adjustable exchange rates had irrecoverably collapsed. Parity changes and flexibility in exchange rates had an immediate effect on the common agricultural policy of the European Economic Community, which was based on fixed administered prices. In general, the idea gained ground to isolate "Europe" from turbulence in foreign exchange markets.

The effect came not from the substance of the announcement but from a mere change in perception.

The position of the U.S. dollar as the leading currency in the post-World War II international monetary system was based not on its relation to gold but on the whole ensemble of factors necessary for a dominating role.

With the deutsche mark linked to the dollar, the Bundesbank had to buy increasing U.S. dollar amounts to defend the fixed parity. The consequence was an import of inflation triggered by the enforced rise in base money. Under the threat of massive capital inflows, the Bundesbank put high pressure on the government to abandon the fixed parity against the dollar. The German government was very reluctant, as such a unilateral move would be seen in France, with its enduring preference for fixed exchange rates, as an unfriendly act. Ultimately, however, it granted the urgent request of the Bundesbank. In March 1973, Germany adopted a flexible exchange rate for an unlimited future period, thereby escaping from the "uneasy triangle."

With this decision, the Bundesbank was able, for the first time in the period of free capital movements, to conduct a monetary policy geared towards maintaining (domestic) price stability, its main legal objective.

Under the umbrella of a flexible exchange rate to the outside world, a varying number of EEC members decided to limit exchange rate volatility between their currencies. A period of many years was marked by a sequence of arrangements, starting with the "snake," that led to the establishment of the European Monetary System in 1979.

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The Nixon Shock *and the* Trading System

By Douglas Irwin

The difference between the Nixon and Trump experiences.

The famous August 1971 weekend at Camp David that Jeffrey Garten brings to life is best remembered for the closing of the gold window, effectively marking the end of the Bretton Woods system, and the imposition of wage and price controls.

An often overlooked but key part of the Nixon Shock was the decision to impose a 10 percent surcharge on all foreign goods imported into the United States. The purpose of the surcharge was not to protect domestic firms from foreign competition, a traditional objective of import duties. Rather, the goal was to move the exchange rate—an attempt to force other countries, mainly Japan, to revalue their currencies against the dollar.

Although the surcharge was temporary (it was removed in December 1971), the incident illustrates the recurring connection between exchange rates and trade policy that we see play out to this day.

The backstory to U.S. President Richard Nixon's decision to impose an import surcharge was the slide in the U.S. trade balance from surplus to deficit. American policymakers feared that the United States was losing its "competitiveness" *vis-à-vis* other countries, particularly Japan and Germany. Those countries had been clients whom the United States sought to rebuild after World War II, but had now become competitors in the production of manufactured goods.

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Although the trade deficit was miniscule, its appearance was considered an alarming development at the time. The dollar had become overvalued due to the increase in domestic prices and the slower productivity growth in the United States relative to its trade partners. The impact on the trade balance could not be relieved by a devaluation because the dollar was the world's reserve currency. As the anchor of the international monetary system, other countries could revalue or devalue their currencies against the dollar, but the United States could not devalue the dollar against other currencies. And other countries were reluctant to revalue their currencies against the dollar because they did not want to jeopardize the competitive position of their export industries.

U.S. Treasury Secretary John Connally—who memorably stated that "the foreigners are out to screw us; our job is to screw them first"—proposed the surcharge and was the driving force behind its adoption. President Nixon liked the idea—"the import duty delights me"—because it was a way of striking back against other countries and extracting concessions from them. The president thought that "the border tax is not too damned aggressive, just aggressive enough."

The announcement of the surcharge unleashed massive selling of the dollar on foreign exchange markets. Japan's central bank intervened massively to prevent the yen from appreciating but soon gave up. The 10 percent surcharge "worked" and other countries revalued their currencies in the Smithsonian Agreement of December 1971. You remember it—that's the one that President Nixon hailed as "the most significant monetary agreement in the history of the world."

An often overlooked but key part of the Nixon Shock was the decision to impose a 10 percent surcharge on all foreign goods imported into the United States.

As the dollar fell, protectionist pressures receded. The U.S. trade balance shifted back to surplus, temporarily. But, for better or worse, the world economy entered a new era. Floating exchange rates became the standard, a shift that had enormous implications for international capital mobility. In support of fixed exchange rates, countries maintained capital controls under the Bretton Woods system. With the shift to flexible exchange rates, such controls were no longer necessary, and they were relaxed. The rise of international capital mobility led to much larger trade imbalances across countries, starting in the 1980s.

The relationship between exchange rates and trade policy soon reappeared. The appreciation of the U.S. dollar in the early 1980s led to a growing current account deficit and rising protectionist pressures in the United States as exports sagged and imports soared, forcing domestic firms into tougher competition from other countries. The Reagan Administration did not impose a general import surcharge, although Congress and the Congressional Budget Office explored the idea. Instead, a variety of *ad hoc* industry-specific protectionist measures were adopted. Antidumping and countervailing duties were imposed in response to industry complaints, and the administration negotiated export restraints to protect the automobile, steel, and textiles and apparel industries. Like in 1971, many of these measures were aimed at Japan.

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Global Blowback

When President Nixon acted, other countries retreated—and never seriously considered retaliating against the United States. When President Trump acted, the retaliatory blowback against U.S. exports was immediate.

—D. Irwin

OFFICIAL WHITE HOUSE PHOTO BY SHEALAH CRAIGHEAD

President **Donald Trump** *joins G7 leaders during a working session on global economy, foreign policy, and security affairs in August 2019 in Biarritz, France.*

The greenback may be felled not by a pair of giants, but by a swarm of midgets.

Gold, The Dollar, *and* What Comes Next

By Barry Eichengreen

President Richard M. Nixon's decision to close the gold window on August 15, 1971, almost exactly fifty years ago, marked the end of an era—the era when the United States was able to determine, all but unilaterally, the shape of the international monetary order. That decision launched Europe down the road that led to the Snake, the European Monetary System, and the euro. It led Japan to abandon the currency peg of 360 yen to the dollar put in place more than twenty years before at the behest of U.S. occupation authorities.

The one thing the demise of Bretton Woods didn't change, to the surprise of many, was the international role of the dollar. The dollar remained—and remains—the dominant international and reserve currency. More countries peg their exchange rates to the dollar than to any other currency. The dollar is the vehicle for the majority of international interbank transactions. It is the most traded currency on foreign exchange markets.

Why is not hard to see. The United States was then, when Nixon closed the gold window, and remains today the single largest economy in the world. The market in U.S. Treasury securities, by some measures, is the single largest and most liquid financial market.

The fact that the dollar's dominance survived not only the collapse of Bretton Woods but also the Great Inflation, the Global Financial Crisis

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(for which the United States was heavily responsible), and the Trump Administration (with its efforts to weaponize the greenback) points us to yet another supportive factor, namely, the absence of alternatives. Even if the bread is stale, the hungry man will eat it if it's the only bread he's got.

The question is whether this is about to change. The Trump Administration's threat to deny access to dollar credit to European entities doing business with Iran prompted the European Union to renew its efforts to enhance the international role of the euro. However, there's little evidence of progress. The practical obstacle to euro internationalization is the absence of an adequate stock of AAA-rated government securities for central banks to hold as reserves. The outstanding stock of AAA-rated euro area government bonds is just one-third the corresponding supply of U.S. Treasury securities. Moreover, nearly half the euro area total is held by the European System of Central Banks and other multilateral financial institutions. Much of the rest is held by Europe's own banks to meet their capital requirements.

This leaves little for central bank reserve managers in other parts of the world. And if central banks outside Europe don't have adequate euros to provide to the markets at times of stringency, they will be reluctant to allow their banks and firms to become indebted in euros or otherwise do cross-border business in the currency. The €750 billion of debt issued by the European Union to finance its Recovery Plan for Europe may be a first step in eliminating this shortfall. But there is a palpable reluctance to follow up on that precedent. Don't hold your breath, in other words.

Many will see the Chinese renminbi as a more serious potential competitor to the dollar. Compared to Europe, China is more successfully expanding the platform for its currency, by growing its economy and continuing to increase its international transactions. As a strategic rival of the United States, it has a stronger incentive to reduce its dependence on the dollar. The Chinese government is actively promoting use of the renminbi in transactions with other countries. And the People's Bank of China is poised to become the first major central bank to digitize its currency.

Many people see a Chinese CBDC as a game-changer. Digital renminbi that reside on an app on the cellphones of end-users will be easier to use in transactions with China and other countries than a plain-vanilla renminbi deposit in a bank account in Hong Kong. And lower transactions costs make for wider use.

But the People's Bank of China may limit how many renminbi can be held in a digital wallet as a way of preventing capital flight and to avoid disintermediating the Chinese banking system. If so, China's CBDC may be suitable for buying a cup of coffee, but not for shipping a container of iPhones across the ocean. And even if there are no limits on digital renminbi balances, there may be privacy and security concerns. Will the Chinese authorities be privy to who is using their CBDC, and for what? Other countries can point to strong rule of law and political checks and balances as allaying such security and privacy concerns. The Chinese authorities may deny that they have the ability to track transactions, but will we know for sure?

In all, it's hard to see a Chinese CBDC as upending the international monetary order. Rather, where new technology may change the game is by enhancing the role of what have been viewed, up to now, as second-tier international currencies. Central bank reserve managers are focused on the dollar and, prospectively, on the euro and the renminbi because, as the currencies of large economies with large financial markets, these units can be widely used subject to limited transactions costs. However, by digitizing their currencies, the central banks of smaller economies can bring down the cost of using their currencies as well. Adding the currency of a small, specialized economy may be unattractive to central bank reserve managers, even if it can be used in market operations, owing to that currency's volatility. But a diversified portfolio of such currencies may display just the stability that reserve managers and other investors desire.

In the end, the dollar may be felled not by a pair of giants but by a swarm of midgets. ◆

The one thing the demise of Bretton Woods didn't change, to the surprise of many, was the international role of the dollar. The dollar remained—and remains—the dominant international and reserve currency.

The Late 1990s Fatal Hubris

How the Camp David decisions produced policies that failed to recognize capitalism's intertemporal nature.

By Bernard Connolly

The Covid-19 epidemic has been a human tragedy. The Keynesian recession and financial collapse in the world which loomed in March 2020 was averted by unusually prompt and effective fiscal and monetary action.

But the pandemic is now provoking economic, political, and social tragedy by instituting the reign of big government and Davos Man—by importing, in effect, a Chinese model of state/crony capitalism into the West. Yet the problem goes deeper than the pandemic. As economists and financial markets agonize about the threat of a return to destructively inflationary conditions in the world, and the United States in particular, the question arises of whether the fatal hubris of the late 1990s, from which so many problems have flowed, was preordained by the Camp David decisions of 1971.

Economist Rudi Dornbusch once wrote that the problem with the world monetary order is not that there are too many currencies but that there are too many countries. The monetary order is less important than the democratic order, which requires national sovereignty. But Rudi put his finger on what was the true great fault in the classical gold standard.

In the rapidly changing global dynamics of the final third of the nineteenth century and the beginning of the twentieth century, very high rates of return on capital in what a hundred years later would be called "emerging markets"—very importantly initially including the United States and subsequently including Tsarist Russia—put upward pressure on world real interest rates (relative to a baseline). This created severe economic difficulties, with attendant social and political strains, in the more mature economies,

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notably Britain, France, and Belgium, and subsequently imperial Germany. As real interest rates rose in those mature economies, mainly via falling prices, there were pressures there to boost rates of return to match those in emerging markets. The results—cartelization; protectionism; an intensified and competitive search for colonization opportunities; increased conflict between capital and labor; union militancy and the rise of socialist parties—certainly contributed to the slide towards the First World War (and of course in the United States the robber barons had already gained sway by the 1890s).

Given the classical gold standard, the only way to avoid economic strains and divisions leading to conflict would have been the dystopian nightmare of world government (one in fact now being imposed by totalitarian wokeism). One can see the colonies-grab by the United States, Germany, and Japan late in that period, joining the earlier British and European imperial powers, as a prelude to a battle about who was going to impose that nightmare.

In a sense, the monetary order established in the free world after the Second World War was an attempt to establish a free world monetary authority while avoiding a formal imperium. The Bretton Woods monetary order was, like the security order embodied in NATO, a hegemonic one, but with significant responsibilities placed on the hegemon, the United States. (In Bretton Woods, the commitment was to convert, on demand, other countries' dollar reserves into gold; in NATO, the commitment was to provide most of the forces and treasure.) The satellites had the right to adjust their exchange rate against the dollar in circumstances of "fundamental disequilibrium" (a phrase that should have, but generally did not, prompt a recognition that the exchange rate is an intertemporal variable as well as an international one).

In the early years of postwar reconstruction in Europe and Japan and of "dollar shortage" (supposedly, at least), the economic and financial dominance of the United States was so great that those Bretton Woods responsibilities were not over-burdensome. But reconstruction involved high rates of return. As the reconstructing economies grew rapidly, the United States began to experience some of the problems that Britain had suffered in the previous century. U.S. real rates of return began to get out of kilter with free world-average rates of return and free world-average *ex ante* real interest rates. In addition, the Kennedy/Johnson Vietnam war and the Johnsonian "Great Society" turned what had perhaps been a dollar shortage into what was undoubtedly a dollar glut.

Yet the United States was the only country that could not devalue, and countries such as West Germany stubbornly refused to revalue against the dollar. The travails of the London Gold Pool in the late 1960s were a harbinger of what was to come (and a reminder, in France's mischievousness, of similar Gallic mischievousness at the beginning of the 1930s in the interwar gold-exchange standard). Camp David was the ineluctable outcome.

The demise of the postwar remnants of the gold standard mitigated the international aspect of anchoring a dynamic global economy, and thus did something to reduce international tensions. But its ultimate successor—inflation targeting in its various forms, plain vanilla or exotic—replicated the fatal intertemporal fault of the gold standard within countries. Inflation targeting cannot cope with a dynamic economy in which creative destruction ("destructive creation" would be a more insightful term) has, as it should, free rein. Economist Oliver Blanchard made the point, perhaps without foreseeing all its implications, in his well-known 2000 paper: Say's Law does not hold unless intertemporal prices—the interest rate—are right.

The process of destructive creation in a dynamic capitalist economy—such as that of the 1990s "New Economy"—should do what it says on the tin: the emergence of firms and projects with high rates of return should put less-dynamic firms out of business. That is a manageable and indeed desirable process within a country, whereas the gold standard equivalent was neither manageable nor desirable among countries. But it can happen only if the real rate of interest in a country goes up when a leap in productivity (essentially, via a burst of investment in products and processes) is in prospect.

Instead, inflation forecast targeting, explicit or implicit, meant, most crucially in the United States, that central banks were very reluctant to allow real interest rates to

Continued on page 77

The Inadequacy of Inflation Targeting

The demise of the postwar remnants of the gold standard mitigated the international aspect of anchoring a dynamic global economy, and thus did something to reduce international tensions. But its ultimate successor—inflation targeting in its various forms, plain vanilla or exotic—replicated the fatal intertemporal fault of the gold standard within countries. Inflation targeting cannot cope with a dynamic economy in which creative destruction ("destructive creation" would be a more insightful term) has, as it should, free rein.

—B. Connolly

View from the Beltway

The Case for Humility

By Owen Ullmann

The experts grapple with understanding inflation.

When he ran the Federal Reserve during his legendary career, Alan Greenspan used to joke that he found economic models to be of great use to him as he contemplated the Fed's interest rate policies. Not, mind you, to predict where the economy was headed, but to look backwards and explain how it got where it is. The problem with models, he would chuckle, is that they are good predictors until some unanticipated trend comes along to make the models outdated in forecasting the future—and something unexpected always comes along.

Greenspan's contempt for models seems particularly appropriate today as some of the brightest economists on the planet engage in a high-stakes debate about the future trajectory of inflation in the United States.

The hand-wringing inflation-phobic camp is led by such luminaries as former U.S. Treasury Secretary Larry Summers and, to a lesser extent, former International Monetary Fund chief economist Olivier Blanchard. They have warned that the United States is headed toward an inflation explosion unseen in half a century because the Biden Administration is pouring trillions of dollars of fuel on top of an already blazing economy, as Jerome "Jay" Powell's Fed is helping to spread the fire around the world with ultra-low interest rates and an unabated bond-buying spree.

Alan Greenspan: The problem with models is that they are good predictors until some unanticipated trend comes along to make the models outdated in forecasting the future—and something unexpected always comes along.

By 2022, according to this view, an inflationary spiral will be well underway, forcing interest rates to jump, the dollar to drop, and the stock and bond markets to swoon. Early evidence they cite as of mid-June included red-hot economic growth in the second quarter and soaring price increases for homes, used cars, food products, and commodities, from lumber to oil—all contributing to

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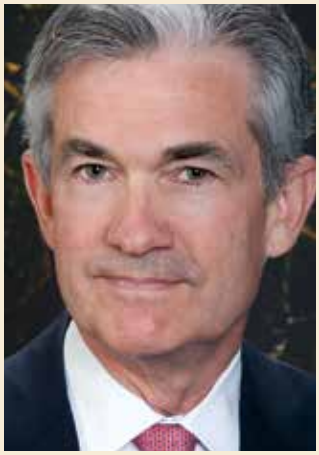


On the One Hand…

"We really don't have a template or any experience of a situation like this. We have to be humble about our ability to understand the data."

Jerome Powell, *Chair, Federal Reserve Board of Governors*

the highest increases in the consumer price index in more than a decade.

On the other side is a not-to-worry coalition led by Powell and U.S. Treasury Secretary Janet Yellen. They contend that inflation likely will rise in 2021 to as much as 3 or 3.5 percent, but then drop back into the 2 percent range in subsequent years. They base their projections on the belief that the Covid-19 pandemic which shut down the U.S. economy for several months in 2020 created price spikes because of temporary supply shortages, but supply and demand will return to balance once the economy returns to normal supply-and-demand patterns as the pandemic wanes.

In 1971, when summoned to Camp David, Fed Chair Arthur Burns appeared to succumb to White House pressure to lower interest rates to help President Nixon's re-election, only to unleash runaway inflation a few years later with the help of twin oil shocks.

Yes, they acknowledge, there is huge pent-up demand and $2 trillion in consumer savings itching to go on a buying spree, but that is offset by a labor force that remains weak compared to its pre-pandemic state. The labor participation rate as of mid-2021 was still below its level at the start of 2020, and there were still six million more people out of work than before the pandemic struck.

At its June 16 meeting, the Federal Open Market Committee raised its forecast for growth and inflation in 2021 and said its zero interest rate policy would likely end in late 2023. That was sooner than early forecasts that saw the first rate hikes coming in 2024. Even so, Powell stuck to his belief that the economy still needed to heal, that inflation would abate in 2022, and that the Fed had no timetable for curbing its bond purchases. In a sign of how skittish investors are about the Fed's changing forecast, the Dow Jones Industrial Average sank more than five hundred points two days later, when St. Louis Reserve Bank President James Bullard said he expects the Fed to start raising rates as soon as the end of 2022. But by the following Monday, the Dow had soared more than five hundred points.

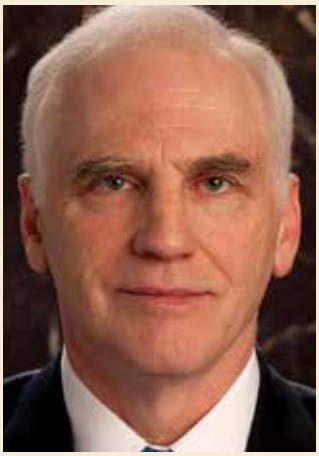
So who is right? As the old adage goes: Time will tell, but not the economic models. That's because, as Greenspan would quickly point out, too many unanticipated factors are clouding the crystal balls. That view is being embraced by a growing number of economists, but not Summers, so far.

The former Treasury secretary argues that you don't need to look to the future, just open your eyes to what is happening now. "We've already seen inflation statistics far greater than anything anybody expected," he said in mid-May. "Everybody was aware

Impossible to Deny That Inflation Looks More Plausible

"Everybody was aware that there were a lot of transitory factors. Everybody was aware that there were short-term bottlenecks. Nobody predicted anything like recent CPI or average hourly earnings figures. So, I think you've got to say that whatever one thought three months ago, the inflation view has got to look considerably more plausible today that it did then."

Former Treasury Secretary
Larry Summers



Theory Shortage

"I don't believe that there is a working theory of inflation that is relevant to 2021 that allows for more or less confident decisions by the Fed in real time."

Daniel Tarullo, *former member, Federal Reserve Board of Governors*

that there were a lot of transitory factors. Everybody was aware that there were short-term bottlenecks. Nobody predicted anything like recent CPI or average hourly earnings figures. So, I think you've got to say that whatever one thought three months ago, the inflation view has got to look considerably more plausible today that it did then."

In contrast to true believer Summers, Blanchard, who expressed his worries about inflation in February, was more circumspect just a month later. In his February article for the Peterson Institute for International Economics, where he is a senior fellow, Blanchard wrote: "The issue is whether the current relation between inflation and unemployment would hold, and there are good reasons to worry. The history of the Phillips curve is one of shifts, largely due to the adjustment of expectations of inflation to actual inflation. True, expectations have been extremely sticky for a long time, apparently not reacting to movements in actual inflation. But, with such overheating, expectations might well de-anchor."

Then, in a March 24 article on the great inflation debate in the *New York Times,* he is quoted as saying, "I shall plead Knightian uncertainty. I have no clue as to what happens to inflation and rates, because it is in a part of the space we have not been in for a very long time. Uncertainty about multipliers, uncertainty about the Phillips curve, uncertainty about the dovishness of the Fed, uncertainty about how much of the $1.9 trillion [Biden relief] package will turn out to be permanent, uncertainty about the size and the financing of the [proposed] infrastructure plan. All I know is that any of these pieces could go wrong."

In doubting the accuracy of inflation forecasts, Blanchard is in good company. A former top policymaker at the Fed, who has studied inflationary trends for decades, admitted great uncertainty about the outlook. "We haven't had this kind of experience before and the main reason, frankly, that nobody can be really perfectly sure is that we don't understand the inflation process that well," said the former official, who asked to remain anonymous in order to speak candidly.

"In particular, the conventional view, which I personally believe with a large standard error, is that inflation expectations are really critical but we don't understand inflation expectations very well," he continued. "So, it is possible that the combination of higher gasoline prices and car prices and food prices and all this stuff, which in some sense should fundamentally be temporary, will somehow break into the public consciousness in a way that invokes more of an inflationary psychology.

"And if that happens, then it gets a little tougher because the thing that really made the 1970s so bad was the conviction by the public that the Fed was not going to do anything about inflation and there would be no stability. I don't think that's going to happen. I think the Fed has enough credibility. I think we'll see that the Fed might be a little tighter than the markets think. The people who predicted inflation when the Fed launched QE [quantitative easing] in 2009 were kooks. This is different. An inflationary spiral is not impossible. It's not crazy, but the odds are quite against it going to 3 percent for very long."

Former Fed Governor Daniel Tarullo said he finds the inflation outlook hazy because "I don't believe that there is a working theory of inflation that is relevant to 2021 that allows for more or less confident decisions by the Fed in real time." Tarullo, who served on the Fed Board from 2009 to 2017 and now teaches at Harvard Law School, said output gap analysis is hampered by uncertain estimates of what the gap is, and the Phillips curve is no longer a reliable predictor. "The Fed, as with most central banks, is now highly reliant on expectations theory," he explained. "Intuitively, I think expectations play a role, but talk about something that is under-theorized. How do expectations get established and how do they change? That is the really important point. If we believe inflation expectations provide this incredible anchor, what's the mechanism by which they do it? There's never really been a great account of it."

As a risk manager, Tarullo would have scaled back Biden's relief

package, say, to $1.3 trillion, just to be on the safe side. "If you know you're vulnerable, you want to be careful because you don't want to create a circumstance in which some secondary exogenous event somehow changes the minds of central bankers, foreign exchange guys, asset managers around the world," he said. "Psychology can shift overnight. Underlying conditions may not change from day one to day two, but the world may look at those same conditions very differently on day two."

Jeffrey Frankel, a member of President Bill Clinton's Council of Economic Advisers who now teaches at Harvard's Kennedy School, noted that inflation predictions have been flawed going back a decade, when inflation first remained higher than expected given the level of unemployment, and then remained stubbornly lower than predicted even as unemployment kept falling. "The entire history can be explained by the Phillips curve being flat, that variations in output and employment just don't have as big of an effect on inflation as they used to," he concluded.

Likewise, former Fed Governor Jeremy Stein, who now chairs Harvard's economics department, said he and his colleagues "need to be super humble because nobody knows a thing about how to forecast inflation. And even if they did, now is a particularly unusual time given all the fiscal stimulus and the rebound of the economy. If you put a gun to my head and said, 'Give me your forecast for inflation three years forward,' I would have moved it up a little bit, 20 or 30 basis points, to 2.3 or 2.5 percent, nothing that if you woke up from a long sleep and found it, you would be terribly concerned by."

A current Fed governor who would not talk on the record also admitted to real uncertainty about the inflation outlook. "I think the jury is still out," the official said. "Remember, we do have both an unprecedented crisis and an unprecedented fiscal response. So, I think it's a real open question about how the economy is going to proceed in the near term. I think it's a real debate, and it's a fair debate to be having certainly. I personally am very attentive to the risks on both sides."

Some former Fed governors are in the Summers camp, convinced that inflation is already accelerating and can't be easily reversed. Hoover Institution Visiting Fellow Kevin Warsh, who was on the Fed board during the 2007–2009 housing crash and subsequent recession, has told colleagues that he considers Powell to have embarked on a "radical" policy of allowing inflation to build up without taking into account the long lag time for interest rate moves to take effect.

Larry Lindsey, who served on the board in the 1990s and then became director of the National Economic Council for President George W. Bush, agrees with Summers that it's impossible to ignore the accumulating evidence of inflation building when you look at all the data coming in and listen to anecdotal reports from company executives. "It's happening, and it's a problem," he said. "The issue of whether inflation is

Forecast Wasteland

Former Fed Governor **Jeremy Stein,** who now chairs Harvard's economics department, said he and his colleagues "need to be super humble because nobody knows a thing about how to forecast inflation."

Not Worried at All

"I'm not worried about a return to the 1970s. We designed our new monetary policy framework for the very different world we live in now."

Randal Quarles, *vice chair for supervision, Federal Reserve Board of Governors*

It's All About Validation

"It's happening, and it's a problem. The issue of whether inflation is sustainable has to do with whether or not it's validated now."

Larry Lindsey, *former director, National Economic Council, and former member, Federal Reserve Board of Governors*

sustainable has to do with whether or not it's validated now. Secretary Yellen and Chairman Powell are saying we may get some inflation but it's going to be short-lived. Yet they're doing everything in their power to validate that inflation. And once it gets into inflation expectations, then the cat is out of the bag."

The current Fed leadership remains unconvinced. Fed Vice Chair Randy Quarles said in a speech to the Brookings Institution on May 26 that he expects inflation to run close to 2 percent at some point during 2022, despite his concerns that the size of Biden's relief package and a recent unexpected acceleration of wage growth "could make above-target inflation more persistent than we currently expect."

A former top policymaker at the Fed, who has studied inflationary trends for decades, admitted great uncertainty about the outlook. "We haven't had this kind of experience before and the main reason, frankly, that nobody can be really perfectly sure is that we don't understand the inflation process that well," said the former official, who asked to remain anonymous to speak candidly.

"I don't want to overstate my concern; I'm not worried about a return to the 1970s," Quarles continued. "We designed our new monetary policy framework for the very different world we live in now, which involves an equilibrium for the economy with slow workforce growth, lower potential growth, lower underlying inflation, and therefore lower interest rates. One of those differences is that the kinds of wage-price spirals that characterized inflation dynamics in the 1970s have not been present for a long time. … The best analysis we currently have is that the rise in inflation to well above our target will be temporary. But those of us on the FOMC are economists and lawyers, not prophets, seers, and revelators. We could be wrong, and what happens then?"

His answer: If inflation overshoots or undershoots the central bank's long-term 2 percent goal, "the Fed has the tools to address inflation that runs too high, while it's more difficult to raise inflation that falls below target. If we're wrong, we know how to bring inflation down," namely phase out the $120 billion monthly bond purchases and start raising interest rates sooner than planned. "Ultimately what drives inflation is people's expectations about what they're going to need in the way of wages, which then feeds into prices, which then feeds into wages," Quarles said, "and if that cycle starts, that's really what drives the kind of inflation spiral that gets difficult for the Fed to control. And I think those are imperfectly measured."

Fed Chair Powell put the quandary about the course of inflation more succinctly following the June 16 FOMC meeting: "We really don't have a template or any experience of a situation like this. We have to be humble about our ability to understand the data."

The Fed certainly should be humble considering its dubious track record over the decades. In the 1930s, it tightened lending during the depth of the Great Depression, which made the downturn even worse. In 1971, when summoned to Camp David, Chair Arthur Burns appeared to succumb to White House pressure to lower interest rates to help President Nixon's re-election, only to unleash runaway inflation a few years later with the help of twin oil shocks. In the early 1980s, Chair Paul Volcker had to reverse policy sharply and virtually overnight, when it became clear the Fed had tightened too much and was putting the economy in grave danger. More recently, Powell himself has been criticized for one too many rate hikes in December 2018, which forced the Fed to start cutting rates in 2019.

Humility is in order, indeed. Perhaps, as Greenspan wisecracked, Powell and Co. will construct a new inflation model—to explain in later years what they did right or wrong in 2021. ◆

What About the Risk Of a Bursting Asset Bubble?

The global economic policy world is in the midst of a debate over the risk of inflation, including the definition of the word "transitory." But what about the risk of the bursting of an asset bubble?

What is surprising is the minimal amount of discussion about whether today's so-called "era of free money" has created dangerous asset bubbles. History shows that the bursting of asset bubbles can bring nasty macroeconomic consequences.

Note that in the United States alone, new corporate debt since the pandemic has skyrocketed. Mediocre companies have been able to buy back their stock. Wouldn't these firms be the first to collapse in a financial panic? Then again, does the fact that the Wall Street banks are so well capitalized minimize the negative effect to the broader U.S. economy from a panic-driven market correction? In such a correction, what would be the safe haven? U.S. Treasury bonds? Gold? Cryptocurrency? Commodities in general? If the latter, wouldn't there also be unpleasant macroeconomic consequences?

On a scale of one to ten, more than twenty noted observers rate the risks.

An 8. The Achilles heel has been over-reliance on the "financial asset channel" as the main transmission mechanism for macroeconomic policy to the real economy.

MOHAMED A. EL-ERIAN
President, Queens' College, Cambridge University; Chief Economic Adviser, Allianz; and author, **The Only Game in Town: Central Banks, Instability, and Avoiding the Next Collapse** ***(Random House, 2016)***

Score: eight. Pockets of excessive and, in some cases, irresponsible risk-taking have been fueled by years of ample and predictable liquidity injections by the Federal Reserve and European Central Bank, the world's most systemically important central banks.

The context has been that of admirable dedication by central bankers to delivering their economic objectives, but one that has not been accompanied until recently by sufficient policy effectiveness on the part of other economic policymakers.

The Achilles heel has been the resulting and protracted over-reliance on the "financial asset channel" as the main transmission mechanism for macroeconomic policy to the real economy.

The unintended consequences and collateral damage have included a major disconnect between fundamentals and market valuations (Main Street versus Wall Street), deepening asset price distortions, over-borrowing, and widening resource misallocations.

This has all been turbocharged by behavioral factors including an overriding investor confidence in central banks always being the markets' best friend—or what's more commonly referred to as the "central bank put." This has encouraged too many investors to embrace the liquidity paradigm irrespective of the underlying fundamentals, and traders have piled on, surfing the enormous liquidity wave and over-extending the risk-taking both in scale and scope.

El-Erian, *cont.* The risk is not limited to the future credibility of central bank policies and the possibility of unsettling financial volatility. There is also the threat of widespread economic spillbacks and spillovers: to economic recoveries in the United States and Europe that need to be durable, strong, inclusive, and sustainable; and to developing countries whose financial resilience has been eroded and policy flexibility is more limited.

The solution lies in a timely rebalancing of the monetary/fiscal/structural policy mix, together with a major step up in macroprudential regulation, especially that pertaining to the non-bank financial sector.

A 3. I assign a relatively low probability to a meaningful tightening of monetary policy.

THOMAS MAYER
Founding Director, Flossbach von Storch Research Institute, and former Chief Economist, Deutsche Bank Group

My answer to this question is: three.

In his classic book on bubbles (*Famous First Bubbles: The Fundamentals of Early Manias,* MIT Press, 2000), Peter Garber wrote: "…'bubble' characterizations should be a last resort because they are non-explanations of events, merely a name that we attach to a financial phenomenon that we have not invested sufficiently in understanding."

So what is the phenomenon in financial markets that many call a "bubble" today? My understanding is that it is the result of a monetary policy, prevalent in almost all industrial countries, that has driven interest rates to historical lows, and in the course of the Covid-19 pandemic induced the creation of a monetary overhang of a size previously only seen in times of war. Low interest rates raise asset valuations while excess cash balances induce portfolio reallocations towards other financial and real assets.

This phenomenon will only disappear when central banks put their policy in reverse gear. But since they have become prisoners of fiscal policymakers and financial markets, I assign a relatively low probability to a meaningful tightening of monetary policy.

A 9. Asset prices are high by historical standards.

JEFFREY A. FRANKEL
Harpel Professor of Capital Formation and Growth, Harvard University's Kennedy School

My response: nine out of ten.

Financial markets are indeed experiencing bubbles, spurred in part by easy money. Eventually the bubbles will end. A bursting could have severe adverse consequences for the real economy, as in 1929 or 2008; but that outcome is not guaranteed.

Asset prices are high by historical standards. For example, Shiller's ratio of U.S. stock prices to cyclically adjusted earnings is above 37 as of June 2021. It has been above 30 only twice before: 1929 and 2000.

A high price-to-earnings ratio need not imply that prices have overshot the present discounted value of future earnings, particularly during a time of innovation. But investors are innovating egregious bubble behavior.

Consider four recent examples:

- Cryptocurrencies. Bitcoin's price surged six-fold from October 2020 to April 2021.
- The GameStop bubble. The video-game retailer's stock price increased eighteen-fold in January 2021.
- The entire phenomenon of NFTs (non-fungible tokens).
- The boom in SPACs (special purpose acquisition companies). Their very definition calls to mind a notorious 1720 company prospectus in London's South Seas bubble: "an undertaking of great advantage; but nobody to know what it is."

A 7. I'm watching U.S. housing markets.

ADAM S. POSEN
President, Peterson Institute for International Economics

Concern about a bubble should be driven by both how likely is a bubble underway, and how likely is it that a bubble in that particular asset class or sector will have destructive effects (through distortion or collapse). Scale of the overvaluation, of the sector or assets involved, or of average people's exposure can contribute to the impact of a bubble, but these are not sufficient statistics for predicting harm, and sometimes are quite misleading. Equity price bubbles, for example, rarely have persistent macroeconomic effects.

What matters most is the connectedness of the bubblelicious asset class and the leverage of the investors in it. As a result, the simple rule of thumb for when public policy should be concerned about a bubble is when it either involves residential real estate across a large part of the economy or the systemically important banking institutions. Large-scale housing price bubbles are almost sufficient to predict serious harms, as are over-leveraged banking systems. Absent either, it is rare that bubbles do much harm.

So, I currently am at a seven out of ten in concern on the lookout to raise my alarm because of recent developments in U.S. housing markets. At the start of 2020, prior to the pandemic, I would have given it a 4, since the bubbles at the time—and most of the ones since—have been in assets which don't matter. The resilience of the core U.S. banking system to the pandemic shock of spring 2020 and to the Archegos collapse this year vindicates the capital requirements and stress tests of today, and therefore reassures me. But widespread housing price bubbles do almost always mean trouble.

A 2. Asset prices remain volatile and difficult to predict.

JOSEPH E. GAGNON
Senior Fellow, Peterson Institute for International Economics

My concern about asset bubbles is two on a scale from one to ten.

A bubble exists when the price of an asset greatly exceeds its fundamental value. That is not the case at present for any of the main asset classes: bonds, equity, and real estate. All of these assets are expensive by historical standards, as one would expect when interest rates are near zero. Future rents, profits, and coupon payments are discounted at a low rate. Nevertheless, asset prices remain volatile and difficult to predict.

Aging work forces, declining population growth, and weak productivity growth have pushed equilibrium real interest rates to record low levels. We may be near the trough and rates may gradually rise from here, but the process will continue to be slow and we are not likely to return to the high real rates of the 1980s. Population growth, at least, will remain low.

When combined with ultra-low inflation, low equilibrium real rates keep economies at or near the zero lower bound on interest rates, with persistent excess unemployment. Fiscal policy can help push economies away from the lower bound, but the best response is to moderately raise central bank inflation targets to 3 or 4 percent.

A 6 or 7. The situation is worrisome.

ROBERT SHAPIRO
Chairman, Sonecon, and former U.S. Under Secretary of Commerce for Economic Affairs

Yes, the possibility of asset bubbles bursting is worrisome—on a scale of one to ten, I'm a six or seven. The presence of bubbles is clear. Over the past twelve months, the S&P 500 has risen more than 38 percent, and no one can credibly claim that those enormous gains reflect increases in underlying economic value. Rather, they appear to be mainly a credit phenomenon. Since March 2, 2020, just before the pandemic struck here, the U.S. Federal Reserve increased its balance sheet by $3.7 trillion or a remarkable 87.5 percent. This helps explain much of the recent large price increases for not only stocks and corporate paper, but also housing, art, and cryptocurrencies.

So bubbles are real. Moreover, the Fed will soon begin to taper its purchases, which may produce significant market corrections. Whether those steps or other developments lead to the bubbles bursting or simply deflating gradually may depend on how leveraged and vulnerable large financial institutions are today to significant price declines.

How worried am I? Just a 3.

LAURENCE M. BALL
Professor of Economics, Johns Hopkins University, and Research Associate, National Bureau of Economic Research

A 9. I am very concerned.

EWALD NOWOTNY
Former Governor, Oesterreichische Nationalbank

Potential for asset bubbles bursting: nine (very concerned).

I am not concerned about consumer price inflation, where I expect medium-term normalization. But I am very concerned about the potential for asset bubbles bursting with regard to a wide field of asset classes.

The most important field is real estate, the asset class most deeply integrated with the rest of the economy. In addition, with the general debt overhang after the Covid-19 pandemic, we see a tendency toward excessive risk-taking in a great number of markets and the growing importance of poorly regulated non-bank financial intermediaries, ranging from huge exchange-traded fund providers to influential family offices. Leveraged loan financing is feeding a fast-growing high-yield market with many aspects of excessive leverage and liquidity mismatches.

The wild ride of crypto "currencies" and insane valuations of some stocks may also be seen as an indicator of excessive risk-taking and the influx of new and inexperienced groups of investors.

In general, one of the problems may be that the generation that experienced the shocks of 2008 is leaving the markets and a new generation of younger and inexperienced risk-loving investors is getting more important. This seems to be especially relevant for capital market-based financing in the United States, compared to the bank-based financing system of continental Europe.

A 4. The pandemic macroeconomic responses have been successful.

JACOB FUNK KIRKEGAARD
Senior Fellow, Peterson Institute for International Economics and German Marshall Fund of the United States

I'm a four, so I guess slightly less worried about asset bubbles than normally.

The speed and scope of fiscal and monetary policy stimulus in response to Covid-19 saw U.S. income inequality temporarily decline, most Europeans' pandemic wages largely paid by the government, central bank balance sheets expand, and asset prices boom, despite a dramatic decline in economic output. Successful stimulus has seen the global economy avoid a collapse in demand and caused trade to quickly rebound, while the pandemic has accelerated the productivity-increasing shift toward a more digitized and flexible economy. Temporary inflationary pressures are inevitable, as stimulus and pandemic household savings are spent in reopening economies, but will in the face of high levels of unused economic capacity and continued demographic aging prove temporary.

The pandemic's political need for governments to act decisively looks to have ushered in a new era of more activist government with lastingly higher public investment levels, as public health and climate change must be confronted. Pandemic macroeconomic responses have boosted asset prices, but done so through successfully salvaging and reinvesting in the global economy, rather than merely feeding asset price bubbles.

A 7. There are risk factors that might lead to potentially disruptive asset bubbles.

THOMAS MIROW
Chairman, German National Foundation, and former President, European Bank for Reconstruction and Development

On a scale of one to ten, I currently see the risks of imminent asset bubbles at seven.

Why? Signs of a global recovery in economic activity over the second half of 2021 are strengthening. Quick progress on vaccines—in the industrial world—gives cause for optimism. Not very surprisingly and because of a multitude of reasons, the faster-than-expected return to a post-crisis growth phase is accompanied by supply bottlenecks and growing cost pressure, resulting in, at least, a "transitory" rise of inflation. All in all, however, the prospects for a sustained recovery, led by the United States and China, but also supported by Europe, seem quite solid.

This being said, there are risk factors that might lead to potentially disruptive asset bubbles. At the forefront: the corporate sector. The pandemic's economic legacy, in combination with digitalization and a pressing need to tackle climate change, will require new business models in many industries that fiscal and monetary stimulus should encourage and must not delay. But what we see in some areas, particularly in the United States, is corporate leverage—quite elevated already before the crisis—speedily increasing further. Highly indebted firms, however, will not only constrain investments and lower productivity. They may also become a serious source of contagion in financial markets once the monetary and fiscal stance becomes less accommodative.

A 3. Policymakers as well as regulators are watching the risks closely.

HOLGER SCHMIEDING
Chief Economist, Berenberg

Risk rating: three. Despite a great bull run in equities and some signs of excess in niche markets, the risk that a big asset bubble may burst and cause serious economic trouble remains low.

Yes, some companies have used rock-bottom rates to build up too much leverage, cryptocurrencies are on a wild ride, and tech stocks are pricing in a lot of good news to come. Occasional corrections may be inevitable. But most companies are well-capitalized, household balance sheets are strong, and overall equity indices do not look overvalued relative to the prospects for solid gains in earnings underpinned by rapid economic growth at financing costs that look set to remain modest in real terms.

In addition, financial institutions are mostly well capitalized and policymakers as well as regulators are watching the risks closely. They are all still quite aware of the mistakes they made upon the collapse of Lehman in 2008 and in the euro crisis of 2008–2009. In case of some financial turbulence, they would likely use their by now well-honed instruments to prevent serious contagion to the economy at large. Never say never, but for the next few years, the outlook remains encouraging.

A 7. Equities, corporate bonds, and Treasuries are in bubble territory.

MARC SUMERLIN
Managing Partner, Evenflow Macro, and former Deputy Assistant to the President for Economic Policy and Deputy Director of the National Economic Council

The current bubble risk level is seven out of ten. There are two distinct investment worlds. In one, the central bank is like a wind at your back, enhancing nominal investment returns with low rates and asset purchases. In the other, the central bank is like a wind in your face, raising rates and slowing the pace of asset purchases. In 2022 and 2023, the wind will be in the face of investors and asset prices will find a new equilibrium.

Equities, corporate bonds, and Treasuries are in bubble territory. Wealth is seven times greater than income, a higher ratio than the 2007 peak. But house prices are reasonable given the dearth of supply, and bank balance sheets are strong. A popping bubble would be closer to a 2000-like event than a 2008-like event.

Once started, the Fed will raise rates until financial conditions seize up, as happened in 2018. Under the Fed's new strategy, sustained 3 percent inflation would call for a 4 percent Fed funds rate, a level that would clearly break markets first. In other words, if inflation sticks then asset markets are in trouble.

An 8. Those central banks that are continuing with quantitative easing are rapidly becoming part of the post-pandemic problem.

RICHARD C. KOO
Chief Economist, Nomura Research Institute, and author, **The Other Half of Macroeconomics and the Fate of Globalization** ***(2018)***

The danger level is at eight. There seems to be an alarming complacency among Fed officials and others that sky-high asset prices are okay as long as banks are well-capitalized.

But when a bubble bursts, the economy suffers from financial crisis, which is a lender-side problem, and from balance sheet recession, which is a borrower-side problem. Having well-capitalized banks will lessen the damage from the former, but the damage from the latter could still be enormous.

The post-2008 economies suffered only two years of the former, but nearly ten years of the latter because a large part of the private sector was forced to minimize debt in order to remove debt overhang caused by the bursting of the debt-financed bubble.

As a result, the private sectors of both the United States and Europe have become huge net savers (meaning financial surpluses) despite zero or even negative interest rates, requiring public sectors to borrow and spend the excess savings in the private sectors to keep the economies going. With asset prices where they are now, those central banks that are continuing with quantitative easing are rapidly becoming part of the post-pandemic problem instead of being part of the solution.

A 7. Commercial real estate, corporate debt, and stock markets will be choppy and overly sensitive as the Fed tapers and normalizes policy.

GREGORY D. HESS
President and CEO, IES Abroad, former staff member, Federal Reserve, and Member, Shadow Open Market Committee

I put my concerns about the possibility of financial disruption at a seven. Here's why. Since the financial crisis in 2008, the Federal Reserve has taken aggressive and sustained policy actions to directly support financial activity and economic activity. They have used both orthodox tools (lowering the funds rate) and unorthodox ones (quantitative easing, which has lowered longer-term interest rates) to provide exceptional liquidity to financial markets for more than a decade.

The Fed's actions have helped to provide momentum to spending, but the corresponding distortions induced on the yield curve will have consequences—there's no free lunch! First, by lowering the return on safe(r) assets, such as Treasury bonds, the Fed has intentionally induced risk-taking in longer-term assets such as stock prices. Second, corporate borrowing across all credit classes has dramatically risen, since borrowing is cheap. Clearly, risk is being holistically underpriced. As a result, I expect that commercial real estate, corporate debt, and stock markets will be choppy and overly sensitive as the Fed tapers and normalizes policy. That major money-center banks are well capitalized will keep us from a ten.

Broad diversification, to include alternatives and real assets, may be the safest harbor for this global unwind.

An 8. Monetary policy has driven investment behavior and asset prices to unsustainable levels.

RICHARD JERRAM
Chief Economist, Top Down Macro

In terms of worrying about a bubble, put me down as an eight. I don't see much doubt that emergency (okay, reckless) monetary policy has driven investment behavior and asset prices to unsustainable levels. What restrains me from a double-digit score is that it's not clear how much damage will be caused when the bubble bursts.

When looking at valuations, just pick a number. PE, Shiller's CAPE, Tobin's Q, junk yield spreads, housing affordability—all tell roughly the same message. But bubbles aren't just about valuations. They are also characterized by speculative frenzies and exploitative behavior. SPACs, meme stocks, cryptocurrencies, and NFTs (bubbles generate their own acronyms) echo the craziness seen so many times before. Much of the exploitation and corruption tends to be revealed only once a bubble has burst, but this time some of it is hiding in plain sight.

Is it dangerous? Policymakers and regulators are usually fighting the last war, so it is difficult to judge the risks until the bubble bursts. If it's mainly a story of speculators' equity being wiped out, then systemic damage should be fairly limited. And that shouldn't be too socially disruptive either, just a case of the rich giving back some of their gains. It could be that equity destruction causes a mild recession, similar to the one that followed the dot.com era, and then the threat comes from the lack of viable policy responses.

Where to hide? My best guess is that rising inflation squeezes monetary policy, which in turn hits asset prices. In that case, we will struggle to find refuge. Commodities are the obvious focus, but I suspect plenty will shelter in short-term government debt, prepared to accept mildly negative real interest rates in exchange for confidence about return of capital.

A 5. Cleaning up after the next mess will be more uncertain and more difficult than in past recessions.

ROBERT E. LITAN
Non-resident Senior Fellow, Brookings Institution

Bubble risk: five.

Prices of just about everything, but especially assets—financial and real—have been going up fast. Whether the price advances are bubbles—rising because of expectations or the fear of missing out (FOMO)—or reflecting fundamental supply and demand forces and low interest rates, our collective level of concern depends on the product of the answers to two questions.

First, will the spring's expected jump in product prices be sustained, triggering Fed tightening, popping any asset price bubble? Count me as skeptical this will happen, but still worried.

Second, if asset prices suddenly fall, how much macro damage will ensue? Since the asset price runups are largely not debt-driven, as was true with housing in the 2000s, and bank capital cushions are much thicker, the damage should resemble the relatively mild post-dot.com recession more than the 2008–2009 financial crisis.

One big caveat: With government debt-to-GDP ratios already so high and the limits of easy money more evident, cleaning up after the next mess will be more uncertain and more difficult than in past recessions.

A 3. The question is not whether there will be bubbles, but how damaging they will be.

J. W. MASON
Assistant Professor of Economics, John Jay College-CUNY, and Fellow, Roosevelt Institute

Any time you have an asset held primarily for capital gains, a story that allows people to extrapolate from recent price increases to future ones, and a reasonably elastic credit system, you have the ingredients for a bubble. The question is not whether there will be bubbles, but how damaging they will be, and what steps we should take if we think one is developing in a particular asset market.

Corporate debt is an unlikely asset for a bubble. Unlike with equity, real estate, or currency, there are clear limits to potential capital gains. High levels of stock buybacks are problematic for a number of reasons, but they don't particularly suggest a bubble. When a greater share of corporate value added is paid out to shareholders rather than retained and invested or paid to workers, that may be bad news for the economy in the long run. But it is good news for owners of corporate stock, and there's nothing strange about it being priced accordingly.

Cryptocurrencies are a better candidate for a bubble. It's safe to say they are mostly held in expectation of capital gains, since they pay no income and, despite the promises of their boosters, have limited utility for transactions. It wouldn't be surprising if their value fell to a small fraction of what it is today.

But that brings us to the question of how damaging a bursting bubble will be. The housing bubble was exceptionally damaging because housing is the main asset owned by most middle-class families, housing purchases are mostly debt-financed, and mortgages are a major asset for the financial system. It's hard to see how a collapse of bitcoin or its peers would have wider consequences for the economy.

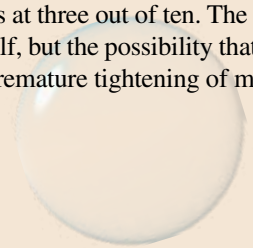
The other question is what to do about a bubble if we have reason to believe one is forming. One common answer is to raise interest rates. The problem is that, historically, there's no sign that low rates are more favorable to bubbles than high ones. The 1980s savings and loan crisis took place in an environment of—indeed was driven by—historically high interest rates. Similarly, Sweden's great real estate bubble of the late 1980s took place when rates were high, not low. And why not? While productive investment may be discouraged by high rates, expected capital gains at the height of a bubble are too high for them to have much effect. This was most famously illustrated in the late 1920s, when the Fed's efforts to rein in stock prices by raising rates did a great deal to destabilize European banks by reversing U.S. capital outflows, but had little or no effect on Wall Street.

A better policy in the face of a developing bubble is to directly limit the use of credit to buy the appreciating asset. Tighter limits on mortgage lending would have done far more than higher rates to control the housing bubble of the 2000s.

In other cases, the best policy is to do nothing. As economists going back to John Maynard Keynes have observed, a chronic problem for our economy is an insufficient level of investment in long-lived capital goods and new technology. To the extent that inflated asset values encourage more risky investment—as in the late 1990s—they may be even be socially useful.

By all means, let's take steps to insulate the core functions of the financial system from speculation in asset markets. But holding macroeconomic policy hostage to fears of asset bubbles is likely to do more harm than good.

Weighing the chance of a major bubble along with its likely consequences, I'd put my concern over asset bubbles at three out of ten. The biggest danger is not a bubble itself, but the possibility that a fear of bubbles will prompt a premature tightening of monetary policy.



World financial markets face two remarkable contrasts.

JIM O'NEILL
Former Commercial Secretary to the Treasury, United Kingdom, and former Chairman, Asset Management, Goldman Sachs International

It is quite clear as 2021 progresses that the world financial markets face two remarkable contrasts.

The first is a dramatically powerful short-term economic recovery from the Covid-19 pandemic, which for many countries could quite easily result in positive real GDP numbers unheard of by most of us in our lifetimes. Typically, from my own historical experience, the rate of momentum of economic growth is often especially powerful in determining asset market performance, whatever their levels of valuation. In this regard, how economies continue to perform relative to changing expectations will be key. An additional element, which has been a major discussion point for weeks now through the spring, is inflation and inflation expectations. In my view, it is too early to tell whether the year-on-year increases in many measures of inflation are merely transitory or more permanent. My own default, analytically, is the University of Michigan five-year inflation expectations survey. It has proved time and time again to be much more stable and not so sensitive to short-term influences compared to so many other measures of inflation expectations. This is presumably why a number of senior U.S. Federal Reserve policymakers going back through time have often given it a lot of weight.

This takes me to the core of the second issue, which of course is the remarkable generosity of monetary and fiscal policy, and at some point, especially if very strong growth persists and even more so if inflation expectations rise further, these will change. Markets then are likely to become quite vulnerable, and those that have vastly exceeded any notion of fair value will probably fall more than others. This said, as some famous money managers found out with Japan in 1987, the reversals might appear in other places first.

The "solutions" have become the "problem."

WILLIAM R. WHITE
Former Economic Adviser, Bank for International Settlements

"Bubble" fails to capture the challenge. Long before the pandemic, growing imbalances in the global private sector were being driven by excessive credit growth. These excesses arose from the interaction of accommodative monetary policy (encouraging demand for credit) and a responsive financial system empowered by new technology (creating supply). Monetary policy failed to recognize that massive monetary easing is not warranted when disinflationary forces arise from positive, global supply shocks. Regulatory policies, focused on constraining banks, failed to recognize the capacity of non-bank sources of credit to compensate. Worse, extending safety nets to these new credit sources has increased moral hazard. The "solutions" have become the "problem."

One result has been a continued increase in global debt ratios, currently at the highest levels ever and still rising rapidly. Another is elevated prices for financial assets and property, currently at record levels and again still rising. A third effect has been increased financial instability as shrinking profit margins have encouraged reckless behavior and resource misallocations. Since these unsustainable trends must stop, another serious downturn seems inevitable. Temporarily rising inflation and interest rates could provide the trigger.

The pandemic has worsened this long-standing threat of debt-deflation. "More of the same" policy responses would make it worse still. However, a new focus on debt restructuring would make the downturn more manageable. Better an unpalatable outcome than a disastrous one.

The chances are low. The market's ascent over the past two decades hasn't been impulsive, in contrast to many speculative episodes.

JAMES E. GLASSMAN
Head Economist, JPMorgan Chase & Co., Commercial Bank

The stock market and the economic possibilities it reflects may be the most important economic story of our time.

The value of the U.S. stock market broke into unprecedented territory almost a decade ago when it surpassed the size of the U.S. economy. It has climbed steadily further since then, doubling the size of the economy (in the best of times it was reasonable to assume that the value of the stock market might match the size of the economy, applying a price-to-earnings multiple of sixteen times earnings to the twentieth century's after-tax GDP profits share of 6 percent). Notably, the market's ascent over the past two decades hasn't been impulsive, in contrast to many speculative episodes.

This has the appearances of a bubble. But valuation metrics are unhelpful, because investors are guided by future possibilities, not the present. Equity prices may be lofty, but profound changes are reshaping the global economy and creating new opportunities.

It's notable that the market's ascent has emerged out of a turbulent time. Europe's important unification experiment survived an existential crisis in 2012. Russia's annexation of Crimea in 2014 revived Cold War memories. The U.S. economy's growth potential slowed to half the pace of that of the twentieth century. America's retirees (who draw on a lifetime of savings) swelled to 30 percent of the population from 20 percent in the span of decade. An unprecedented U.S. housing speculation episode derailed many economies. And now the global pandemic.

A Rip Van Winkle thought experiment sheds some light on the nature of the structural forces that are behind the stock market's rise. If Van Winkle fell asleep three decades ago, as the Berlin Wall was tumbling, and awoke today, he would be stunned.

First, he would have guessed that defense burdens would plunge after the fall of the Berlin Wall and collapse of the Soviet system. They did, to one-third what they were in the decades following the end of World War II. Massive resources were unleashed for other purposes.

Next, he'd be impressed that Europe's important unification experiment had survived a skeptical cognoscenti despite so much global turmoil.

Third, Rip would understand why the Fed was turning more reactive when he realized that inflation had become far less cyclical—the Phillips curve flatter—in the new millennium. He'd understand that a lower sustainable level of unemployment and shrinking inflation risk premia would support higher profits and price-to-earnings multiples.

Fourth, he'd be baffled by the advances in technological innovation. But he would know that innovation is disruptive and brings mixed blessings—Schumpeter's "creative destruction" idea. He would understand why tech innovation had driven the after-tax profits share of GDP up from 6 percent to 10 percent, why that might be sustainable, and why it was socially disruptive (widening the income distribution). Counter to consensus opinions, he might not be surprised that the profits share was not reverting to historical norms, if he realized that the transformation underway was more structural than cyclical. He'd know that if after-tax profit margins were rising from the 6 percent historical norm to 10 percent, the value of the stock market might be "worth" one and one-half times the size of the economy, in contrast to the historical "parity" relationship.

Fifth, he would not be surprised that the 2017–2018 tax reform, which effectively eliminated a decades-long gap between the U.S. corporate tax rate and that of others, would lift the stock market about 10 percent.

And last, it wouldn't take him long to realize that it's a small world after all, that while he was asleep, China's economy had come out of nowhere to match the size of that of the United States, that American companies were benefiting from new economic opportunities beyond U.S. borders, and that there is much more to come, with the living standard in the underdeveloped economies rising at the fastest pace in the history of the planet but still far below that enjoyed by the developed economies.

Given all that, Rip Van Winkle wouldn't be so sure he was looking at a stock market bubble.

At some point, the time of reckoning will come.

That is, unless we see a surprising boost in productivity.

LORENZO CODOGNO

Visiting Professor in Practice, London School of Economics and Political Science, and Founder and Chief Economist, Lorenzo Codogno Macro Advisors Ltd.

Let's face it. Stock market valuations were already overstretched before the pandemic. We may argue about the specific metric, be it forward-looking P/E ratios or else. However, market ratios were well above historical averages, even considering that the net present value of future cash flows was boosted by historically low discount factors and abundant global liquidity. Moreover, with little pay-out or dividends expected over the next few years, growth stocks got an even more significant boost. Arguably, this was the case for the U.S. stock market, and far less so for the European one, which is less exposed to tech stocks.

With the pandemic crisis requiring an unprecedented fiscal policy response, central banks had no choice but to do much of the same. Policy action pushed central banks even further into uncharted territory, such as additional liquidity, additional financial asset buying, even lower and flatter yield curves. It was a deliberate strategy. Supporting asset valuations was an inevitable and desirable side effect of the more important goal of preventing a meltdown in the economy. The policy response set the stage for a genuinely additional lease on life for the stock market, especially in the United States. The situation appears even more extreme in corporate bonds. The ongoing search for yield has pushed corporate bond yields, and in general risk premiums, to multi-year lows, and are thus susceptible to a major correction. Moreover, non-bank financial institutions have continued to increase duration, liquidity, and credit risk, making positions even more sensitive to a yield shock.

The possible bursting of the financial bubble may bring even more dangerous and nasty macroeconomic consequences. The good news is that the financial system is much better capitalized and prepared for a shock than at any other time in the past. However, we cannot say that there are no imbalances or unusual situations in specific financial market segments. Some institutions or sectors may have already been debilitated, coming from yet another shock. Their fragilities and weak fundamentals may have already been exposed. The impact on U.S. markets and spillovers into the rest of the world from a potential U.S. monetary policy tightening shock could be substantial.

The current spike in inflation may well be a sideshow or a transitory situation related to supply bottlenecks, temporary disruptions in production and trade, or adjustments in the production pipeline. Even signs of localized spikes in wage pressure may well be a transitory phenomenon. Over time, it will likely be addressed by supply catching up with policy-supported booming demand. Projecting well-behaved inflation back to central bank targets and continuing fiscal support through medium-term investment plans would still leave potential problems. Engineering a Goldilocks scenario, where the economy is fine-tuned towards a not-too-hot and not-too-cool position, may prove tricky. Fiscal and monetary support may well be extended for longer, further inflating the bubble. But at some point, the time of reckoning will come. Thus it would be better to start signalling sooner rather than later, test the water, and prepare market participants for a turning point. This move must be balanced with the need to preserve accommodating conditions for a prolonged time and avoid withdrawing policy support too early. Not an easy task at all.

The only way out for such a cornering of available policy options would be a surprising boost in productivity triggered by the structural changes accelerated by the pandemic crisis. Not impossible, but it would probably be too much of a dream book, at least judging from what we tentatively know so far. ◆

Is the Dollar In *Trouble?*

If the dollar continues to deteriorate, and as east Asian countries peg their currencies to the Chinese currency to maintain exchange rate stability, the greenback could lose its key currency status by the end of the 2020s, just as it did in Europe in the 1970s.

By Gunther Schnabl

In the wake of the coronavirus crisis, U.S. President Joe Biden aims to accelerate the economic recovery with another fiscal stimulus package. Given the package's large dimensions and the expectation that the U.S. Federal Reserve will continue to purchase large amounts of government bonds, "Bidenomics" are reminiscent of Japan's "Abenomics," which have been pursued since 2013. A main difference between the United States and Japan is, however, the international role of the currencies: whereas the dollar remains the leading international currency (including East Asia), the yen has in the past failed to take over this role in the region.

Now China may make an attempt to challenge the international role of the dollar in East Asia. The time may have come, as the large purchases of U.S. government bonds have inflated the balance sheet of the Federal Reserve, thereby eroding the trust in the dollar. At the same time, the Chinese economy is up and running again. Neither Chinese government debt nor the balance sheet of the People's Bank of China has grown to the same extent as in the United States. The Chinese government has signaled with the Regional Comprehensive Economic Partnership its economic leadership in East Asia.

History provides a blueprint of how de-dollarization in East Asia in favor of the Chinese renminbi could work. Beginning with the Bretton Woods system in 1944, the dollar became the foundation of the postwar monetary and economic order. The central banks at the periphery of the Bretton Woods system had to stabilize their exchange rates against the dollar as the anchor currency. This also brought the dollar into position

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For China, dependence on the dollar has long been a thorn in its side.

as the international reserve currency. When the United States financed the Vietnam War with the help of the Fed, the dollar came under depreciation pressure and the peripheral central banks had to buy large amounts of dollars to keep their exchange rates stable.

As the periphery countries *de facto* co-financed U.S. government spending, then-French Finance Minister Valéry Giscard d'Estaing complained about this "exorbitant privilege." Stanford University Professor Ronald McKinnon later dubbed this phenomenon a "quasi unlimited line of credit" within an "unloved dollar standard." In the early 1970s, the resulting fast accumulation of dollar reserves in the balance sheets of the central banks at the periphery of the Bretton Woods system came along with strong monetary expansions. The German central bank, which was strongly committed to low inflation, became concerned about imported inflation and—finally—delinked the German mark from the dollar. The mark strongly appreciated, other countries followed, and the Bretton Woods system collapsed. Europe became decoupled from the dollar, with the stable German mark becoming the regional anchor and reserve currency.

In contrast, the Asian countries (except Japan) kept stabilizing their exchange rates against the U.S. currency. When China opened up to international transactions by adopting IMF Article IV in 1994, it introduced a tight dollar peg. An informal dollar standard in East Asia emerged, with many countries commonly stabilizing their exchange rates—more or less tightly—against the dollar. The resulting high degree of exchange rate stability within the region intensified the division of labor and trade in the region, thereby promoting growth and welfare. China plays a pivotal economic role in East Asia, because unlike Japan it has been growing strongly since the 1990s.

This has favored the emergence of an East Asian production network: Southeast Asian companies often supply subcomponents to Chinese companies which export to the United States, the European Union, and other industrialized countries. China and the renminbi's close dollar peg stabilized the region during the 1997–1998 Asian crisis and the 2008–2010 global financial crisis, when neighboring countries' currencies sharply depreciated. And during the current coronavirus crisis, China and the renminbi are standing like a rock in the surf. Nevertheless, the renminbi has not yet become the regional anchor and reserve currency, as China's capital market remains strictly regulated and internationally sealed off by capital controls.

For China, dependence on the dollar has long been a thorn in its side. Between 2000 and 2014, China was forced to co-finance the U.S. rescue packages for Wall Street by following the expansionary monetary policy of the Fed in response to the bursting of the dot.com bubble and the outbreak of the subprime crisis. Chinese leaders have repeatedly expressed discontent about the international role of the dollar. To delink from the dollar, China may follow the path of Germany taken in the 1970s, which transformed the German mark into a serious competitor of the dollar as an international currency. By the late 1970s, the U.S. government had to issue bonds in German marks and Swiss francs (Carter bonds) to stabilize the dollar, which showed the endangered key currency status of the dollar.

China has already taken important steps. During the coronavirus crisis, the balance sheet of the People's Bank of China has grown much more slowly than the balance sheet of the Fed. In contrast to the Fed, China has signaled willingness to lean against speculative bubbles in the real estate sector and in financial markets. Since May 2020, the People's Bank of China has allowed the renminbi to appreciate against the dollar by more than 10 percent. China's holdings of U.S. Treasury bonds have gradually declined, from $1.3 trillion at the end of 2011 to about $1 trillion by the end of 2020. China is spearheading the development of a central bank digital currency including its own payment system. As the digital renminbi is being prepared for use in cross-border transactions, this may allow the renminbi to bypass the dominance of the United States in the international payment system.

The balance sheet of the People's Bank of China has grown much more slowly than the balance sheet of the Fed.

If the renminbi continues to appreciate, the temptation will rise for other East Asian countries to peg their currencies to the renminbi to maintain intra-regional exchange rate stability. If the Southeast Asian countries exchange their dollar reserves into renminbi, this could allow them to capture substantial revaluation gains against the dollar.

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The Economic Profession's *Artificial Narrative*

By Seth Levine and Elizabeth MacBride

The increasingly anachronistic capital versus labor debate.

The recent uproar over musician Dolly Parton's celebration of the gig economy revealed a problem with the English language today: A worker is no longer a worker. She sang in celebration of entrepreneurs:

> *"Working five to nine you've got passion and a vision*
> *'Cause it's hustlin' time a whole new way to make a livin'*
> *Gonna change your life do something that gives it meaning…"*

Some criticized the lyrics, saying they celebrated an "empty promise" of capitalism, as if people aiming to establish their own businesses were "workers," who needed to be protected from powerful corporations. Others grasped that there is more nuance in our economy than ever before and that, perhaps, Parton was on to something. In fact, her updated lyrics represent a shift in the primacy between capital and labor in the forty years since she penned the original, "9 to 5." Gone is the idea that getting ahead is only a "rich man's game… puttin' money in his wallet." Workers today have a different potential than they did in 1980 when she first sang:

> *"There's a better life and you think about it, don't you?*
> *It's a rich man's game no matter what they call it,*
> *And you spend your life puttin' money in his wallet."*

There are abusive corporations, and we do need a better social safety net so that people aren't at the mercy of the doctrine of shareholder primacy, but

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The New Builders: Face to Face With the True Future of Business
by *Seth Levine and Elizabeth MacBride (Wiley, 2021).*

that truth disguises a more complicated reality. The divide between capital and labor increasingly looks like an anachronism, a throwback to the language and illusory simplicity of another time. Yet still the media persists in pushing this false dichotomy—this mistaken idea that labor and capital are two separate and oppositional forces in our economy. Perhaps doing so is human nature. Or perhaps it simply sells more newspapers or generates more social media clicks. The media certainly thrives on conflict (real or imaginary) and, along with human nature to try to group things into black and white, the continued framing of our economy as somehow consisting of individual actors who exist solely on one side of the capital/labor line makes for easier narratives.

As with most things, the truth exists in the gray areas, in the nuance and the movement between groups. The American economy has always been uniquely entrepreneurial, from the discovery of the "new land," to the formation of our government, to the expansion of our country, and eventually the industrialization of our country. Entrepreneurs have long led the way.

Why don't we have universal health care, parental leave, or working infrastructure—all things that would, not incidentally, boost entrepreneurship and small business? We've been too busy fighting about a socialist takeover and the evils of capitalism.

Today, nearly sixty million people are entrepreneurial in some way. The vast majority inhabit the frontlines of the economy. They are freelancers or the late-night business starters that Parton sang about. They are freelancing on the side to earn money to support some other dream, or are stitching together lives for themselves by being their own boss. They are driving Ubers, delivering meals for GrubHub, and selling their crafts on Etsy. Never have more people had more access to expand their horizons through pursuing their entrepreneurial dreams. And they exist in the world of technology, where a single person at a kitchen table has the same power to bring an innovation to market as giant corporations did four decades ago.

Victor Hwang, CEO of Right to Start and a former vice president of entrepreneurship for the Kauffman Foundation, described the capital versus labor debate as "the biggest false narrative out there. It's an artificial narrative that we've created: employer versus employee; big versus small; corporation versus worker. All are false narratives and contribute to the incorrect notion that the most important fight in our economy exists between these supposedly oppositional forces."

But our economic and government funding debates are framed (often by the media) around the idea of capitalism versus socialism, corporations versus workers. That increasingly divisive conversation has some of the hallmarks of a deliberately engineered division, like the ones over climate change or gun rights. Right-wing groups with an interest in freezing the government into inaction figured out how to divide the country into two groups and get them fighting.

Why don't we have universal health care, parental leave, or working infrastructure—all things that would, not incidentally, boost entrepreneurship and small business? We've been too busy fighting about a socialist takeover and the evils of capitalism.

The conflict thrives in part because we don't have the right language to describe what's happening now. "These debates should be viewed as part of a larger discussion," Hwang said. "We should be striving to encourage highly innovative people and companies. What are the categories we need to develop? How do you classify someone's role in the economy?"

What we need is an economic system that empowers more people to be producers and entrepreneurs, solving problems and looking for opportunities to create change in their communities. Instead, we've built a system that supports incumbents, thrives on the status quo, and stifles innovation by deploying the tactics of division. It's a tension that stems from our neoliberal worldview that achieved an almost consensus in the late twentieth and early twenty-first centuries.

Beyond arguing that free markets and open trade make it easier and better to do business (which we generally agree with), the current system also implies that the only thing that matters in our economy is making big companies bigger (while, perhaps, allowing for the occasional upstart—but only those that have the potential to grow quickly and become big companies themselves).

Lost is the value of smaller businesses, operating in the economy's in-between spaces. We don't even effectively measure the impact of these firms. Wanting to know how the "economy" is doing, we look no further than the fate of the five hundred largest publicly traded companies (the S&P 500) or the thirty massive businesses that comprise the Dow Jones Industrial Average. No wonder people across Main Streets are scratching their heads as pundits describe the economy as thriving by citing the continued rise of the Dow despite millions of small businesses closing all around them.

In our book, *The New Builders,* we describe entrepreneurs as "builders." Builder is a word with Old English roots based on the idea "to be, exist, grow." In a century in which change is the *lingua franca,* builders own the value of their own labor, as a mechanism to build independence and, eventually, capital. The majority of these builders—the small business owners of America—create opportunities with the most limited resources. According to the Kauffman Foundation, 83 percent are formed without the help of either bank financing or venture capital. Yet small businesses are responsible for nearly 40 percent of U.S. GDP and nearly half of employment. Perhaps that's why *TIE* publisher David Smick termed them "the great equalizer" in his book of the same name.

The divide between capital and labor increasingly looks like an anachronism, a throwback to the language and illusory simplicity of another time.

Technology has fundamentally changed the landscape for businesses of all sizes and has the potential to enable a resurgence of our small business economy. Rather than pushing a false narrative that individuals need to choose between being a part of the labor or capital economies, we should be encouraging fluidity between the two. The more capital ownership we encourage—through savings, investment in their own businesses, and by encouraging more people to become investors of all kinds—the more we can drive wealth creation and open economic activity for generations to come. ◆

Continued from page 56

An informal renminbi block would emerge with the renminbi as an anchor and reserve currency for the smaller Southeast Asian countries. Sooner or later, even Japan may decide to join as economic and financial linkages with East Asia are strong. The resulting seigniorage gains would allow China to deal with the large stock of potentially nonperforming loans in its corporate sector.

Thus, the U.S. dollar may lose its key currency status in East Asia in the 2020s, as it lost its key currency status in Europe in the 1970s. This process may be already reflected in the international holdings of U.S. Treasury bonds. The share of foreign and international investors in holdings of U.S. Treasuries has declined from 43 percent in 2013 to less than 30 percent currently. Instead, the Fed is holding a growing share of the outstanding Treasuries, which is likely to increase inflationary pressure in the United States, thereby further undermining the international role of the dollar.

It remains to be seen whether the potential loss of exorbitant privilege will trigger a turnaround in U.S. fiscal and monetary policymaking. In the late 1970s, Fed Chairman Paul Volcker broke the backbone of inflation with decisive interest rate increases, accompanied by the structural reforms of the Reagan Administration. Yet by then, one decade of high inflation had substantially reduced U.S. government debt in real terms. From this point of view, the Fed is trapped, as a general government debt level of 130 percent of GDP seems to prevent a monetary tightening. China's leaders may have recognized the window of opportunity. But in order to achieve their goal, two more high hurdles have to be taken: China's financial markets have to be liberalized, and the renminbi has to be fully floated against the dollar. ◆

"Crypto" Is *Losing*

By Chi Lo

The issues are climate and trust. But the crypto community is fighting back.

Privately issued cryptocurrencies, notably bitcoin, have generated a frenzy of excitement, with the bitcoin mania even being (rightly) compared to the tulip mania in seventeenth-century Holland. What the crypto-aficionados have ignored is an imminent development—the world's monetary authorities, including the U.S. Federal Reserve and the European Central Bank, have started to explore the idea of developing central bank digital currencies.

China in this regard is the first mover. The People's Bank of China started experimenting with its official digital currency in major cities in 2017. The Central Bank of the Bahamas has gone even further, having fully issued a CBDC dubbed the "sand dollar" for circulation. Increasing regulatory control, due to central banks protecting their economic policy sovereignty and national governments controlling climate changes, is an imminent risk that cryptocurrencies face.

In particular, China's official digital currency is "anti-crypto." With Cryptocurrency, notably bitcoin, anonymity comes without any recourse or protection against theft, loss, or other forms of financial crime. This is creating

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The Chinese government is starting to rein in bitcoin mining as it begins to implement its climate targets at the provincial level. Even renewable energy-rich provinces do not want to accept bitcoin mining projects.

an inherent risk which the crypto market is trying to fix. Ironically, the solutions should bode ill for cryptos by destroying their untraceable anonymity.

The starting point for bitcoin, and cryptos in general, is the loss of trust in the government institutions behind money in the developed world since the 2007–2008 financial crisis. Bitcoin has emerged as a new type of institutional arrangement for players to agree on the value of money without the backing of public institutions such as central banks.

In the longer term, if this "crypto/bitcoin protest" forces countries to improve their economic management and strengthen their institutional frameworks, cryptos could be marginalized by CBDCs which will feature "controllable anonymity." China's CBDC, officially called Digital Currency Electronic Payment and dubbed e-CNY by the markets, also highlights the cryptos' inherent risks that could potentially lead to their demise when public trust in government institutions can be re-established.

BITCOIN'S ENVIRONMENTAL COST

Bitcoin's "mining" process, which determines its finite supply (฿21 million by 2040), comes at significant environmental cost in terms of massive electricity consumption, which has risen sharply over the years. The Cambridge Centre for Alternative Finance estimated that the bitcoin mining industry burned through about 143 terawatt-hours of electricity per year as of May 2021, or 0.6 percent of the world's total energy consumption. By comparison, Australia's main electric grid uses less than 200 terawatt-hours a year and the whole country of Argentina uses just 125 terawatt-hours annually. Under the global climate control initiatives, bitcoin mining faces an imminent risk of global regulatory crackdown.

This risk is especially prominent in China, where coal is the major source of energy (accounting for almost 60 percent of total) and power generation (accounting for 51 percent of China's carbon emissions in 2018). In its fourteenth Five-Year Plan in 2021, China set goals for its carbon emissions to peak by 2030 and achieve carbon neutrality by 2060. The heavy carbon emissions of bitcoin mining could undermine these carbon reduction efforts.

CHINA'S ANTI-BITCOIN MOVE

The Chinese government is starting to rein in bitcoin mining as it begins to implement its climate targets at the provincial level. Even renewable energy-rich provinces do not want to accept bitcoin mining projects. They would rather favor energy-intensive projects that fit in Beijing's development targets, and bitcoin mining is definitely not one of them.

In April 2021, Inner Mongolia shut down all cryptocurrency mining to meet its energy-saving targets. Other provinces are following suit. With China being the largest bitcoin mining country in the world, its crackdown is certainly negative for the fate of the cryptocurrency in China.

The People's Bank of China had already banned banks and retailers from dealing in bitcoin in 2013. Then in 2017, it shut down all domestic exchanges and banned initial coin offerings that created new bitcoins to fund new ventures. One may argue that the bitcoin industry will just move from China to somewhere else.

The Ponzi Scheme

Coinbase's 56 million users do not care that most of their transactions are not even settled through any blockchain at all. This is evidence of speculation, with the punters only interested in using bitcoin to get more dollars (the fiat currency that it is supposed to drive out). Hence the Ponzi game and bitcoin bubble: Buyers pile into bitcoin based on a captivating but fictitious story, hoping to sell it at higher prices to someone else. When the underlying story crumbles, the whole pyramid collapses.

—C. Lo

From a climate-control perspective, the regulatory risk in China will also likely happen in other countries seeking to ameliorate the risk of global warming. So bitcoin/crypto mining will have nowhere to go in the longer term, though the short-term impact on supply could squeeze bitcoin's price higher and prolong its bubble.

Despite China's ban, millions of Chinese still trade bitcoin through overseas exchanges, or through local brokers arranging peer-to-peer trades without an exchange, and/or using Tether as a trading conduit. This prompted the People's Bank of China to explore issuing an official digital currency beginning in 2014—the DCEP—and it has been experimenting with DCEP's circulation since 2017. Beijing even plans to use its e-CNY as a means of payments in the 2022 Winter Olympics that it will be hosting.

CBDCS ARE COMING

The trend is for global central banks to develop and offer CBDCs for both economic and political reasons that could marginalize cryptocurrencies. Economically, they want to protect their monetary systems and currencies to secure economic management sovereignty. China's stance is clearly anti-bitcoin, with the People's Bank of China aiming to replace cash with a centrally controlled e-CNY that will give it "controllable anonymity." This is a direct attack on cryptos' untraceable anonymity.

The fixed supply of bitcoin (and cryptos) is the biggest potential "economic apocalypse" that central banks want to avoid. A "bitcoin-ized" economy (that is, with the fixed-supply bitcoin replacing all fiat money) would deprive the central bank of the ability to implement countercyclical policies. It is simple economics: If you fix nominal variables (bitcoin in our case here), the real output has to adjust violently to absorb economic shocks.

Despite China's ban, millions of Chinese still trade bitcoin through overseas exchanges, or through local brokers.

A "bitcoin-ized" economy would deprive the central bank of the ability to implement countercyclical policies.

So in case of an economic recession, when bitcoin cannot expand, economic output would go into a free fall. It was this problem of rigid money supply that led to the demise of the gold standard and the Bretton Woods system as they deprived governments of the ability to counteract large negative economic shocks, financial crises, and price deflation. Does anyone still think bitcoin's fixed supply is a sure-fire benefit?

The environmental damage of bitcoin mining is just an additional reason for the global authorities to tighten regulatory control of cryptos. China shows vividly how quickly regulators could destroy the decentralized crypto market.

Politically, CBDCs will inject a new dimension of competing sovereign interests, wielding global influence in a future currency war. When a CBDC is generally accepted by the global community, it will boost the issuing country's currency dominance in the global reserves pool and thus help it advance its foreign policy claims.

Currencies are prized as reserve assets when they satisfy two conditions. First, the currency must be stable, liquid, and widely used in international transactions, and second, it must be backed by a country that has important linkages to the global system. An emerging megatrend is China's digital revolution, putting it on a path to satisfy these criteria, albeit slowly, in the long term. China is also inspiring, and putting pressure on, other countries to explore CBDC development.

CRYPTO SHOOTING ITSELF IN THE FOOT

The crypto community is fighting back by addressing bitcoin's security and huge energy consumption problems. New types of intermediaries such as custodian wallets have emerged. They allow holders to keep their cryptocurrencies at centralized intermediaries—crypto wallets—which in turn offer the familiar password-recovery and access-protection features found in online banking.

To reduce energy consumption, crypto developers are exploring different incentive systems and technological solutions to replace wasteful computation with

more energy-efficient models. Notably, systems based on proof-of-stake can establish a consensus faster, thus solving the transaction puzzle more quickly, by giving more weight to information presented by large coin-holders.

But this also means that the integrity of this system relies on the majority of a crypto-coin's holdings remaining in the hands of honest players. It does not really solve the problem of bitcoin/cryptos being abused by criminals. Furthermore, the information weights that the proof-of-stake systems rely on, in turn, depend on the coin balances being easily verifiable on a digital ledger without the need for external information. Holders' identities are inevitably needed for verification. Who has the legal identity of coin holders? The government!

The trust issue argues that the social contract supporting cryptos would be less compelling in places with strong institutions.

It is obvious that these solutions are replicating some of the features of the conventional financial system and need government's involvement, both of which bitcoin is supposed to eschew. The crypto community is shooting itself in the foot. This highlights another key issue: trust, which cryptocurrencies focus on attacking.

WEAK VERSUS STRONG INSTITUTIONS

The trust issue argues that the social contract supporting cryptos would be less compelling in places with strong institutions. When the public enjoys sound legal and economic systems, with effective government, good consumer protection laws, sound monetary policy, and government guarantees such as deposit insurance against bank failure, bitcoin's decentralized and untraceable anonymous design has little to offer.

Essentially, cryptos thrive under a weak institutional environment. When a strong democratic system deteriorates and its public institutions lose public trust, cryptos emerge, as seen in the rise of bitcoin after the financial crisis when crypto promoters capitalized on the fear and distrust of fiat money. The strong demand for bitcoin in advanced rich democratic systems reflects sheer speculation on the breakdown of the system or a Ponzi game more than anything.

This, in turn, argues that if governments and their agencies want to guard their economic policy sovereignty, they need to fix their acts to regain public trust. Viewing it positively, the "crypto protest" is a wake-up call for governments to change their economic management behavior to become more responsible and regain credibility and public confidence.

CRYPTO HAS NOT WON THE DAY

Digital currency exchange Coinbase went public in April 2021 to great fanfare. Crypto supporters argue that its successful listing established cryptocurrencies as a force to be reckoned with on Wall Street. Really?

Why do people still want this exchange and why are its shares still priced in U.S. dollars rather than in bitcoin? Blockchains should enable the world to eliminate the middleman and allow smooth direct trading. But ironically, Coinbase is the biggest crypto-trading middleman. Its successful listing and pricing in U.S. dollars show that the crypto community has failed to abandon the traditional state-controlled fiat money system and its middlemen.

Worst still, Coinbase's 56 million users do not care that most of their transactions are not even settled through any blockchain at all. This is evidence of speculation, with the punters only interested in using bitcoin to get more dollars (the fiat currency that it is supposed to drive out). Hence the Ponzi game and bitcoin bubble: Buyers pile into bitcoin based on a captivating but fictitious story, hoping to sell it at higher prices to someone else. When the underlying story crumbles, the whole pyramid collapses.

The crypto community is fighting back by addressing bitcoin's security and huge energy consumption problems.

If the success of Coinbase's listing signals anything, it is that the state, not crypto, has won the battle and retained control of the financial system of fiat money. ◆

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vice president—had a lot of political experience, a lot of thoughtful policy inclinations, and a lot of impressive professional relationships.

When Nixon became president, the Democrats had been in power for eight years. Even many moderates were convinced that the Great Society programs had grown too big too fast, and that it was time for a change. Therefore, Nixon had his pick of people who had served in the Eisenhower Administration—such as Arthur Burns, George Shultz, and Paul McCracken, the latter two at junior levels—plus a crop of younger people who had arisen since then, such as Paul Volcker and Peter Peterson.

I think he picked a cabinet and advisors based less on ideology than on sheer quality. You ask whether the interplay was a reason for success? I think so, because he was exposed to all sides of the issues. He at least knew what the alternatives could be, what the weak spots of his approach were. Also, in this case the success was due as well to Henry Kissinger, who helped manage the foreign relations fallout. In the book, I devote a lot of time to him, too.

Smick: Today's global economic and financial systems seem a hundred times more complicated than those that existed in 1971. Yet the story you tell is one of uncertainty. The various figures in the group were forced to feel their way in the dark, uncertain of the exact direction they would eventually take: fixed or floating? Dirty floating? In all their preparation, no one gave much thought to the potential for hyperinflation to overwhelm the system.

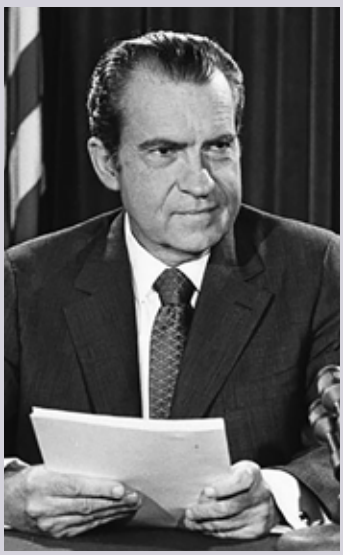
Is this a situation not dissimilar to what could be unfolding today? By 1972, with the agreement in place, U.S. fiscal and monetary policies were high octane. To what extent does the picture you paint show the need for policymakers today to be both humble and nimble? The global system is just too unpredictable.

Washington pulled off something quite dramatic: it saved the global economy by changing it.

Garten: That's a great question. There are many parallels between August 1971 and August 2021. The acceleration of inflation is certainly one of them. So is the growth of fiscal and trade deficits. In 1971, the fires of protectionism were growing; today, the proponents of free trade are in retreat, and the growth of national industrial policies may portend trade barriers of a kind we haven't seen to date. In 1971, the dollar was being challenged by the West German mark. Today you could make the case that the European Union and China are looking for ways to circumvent dollar supremacy, especially when it comes to sanctions, or that the Chinese RMB will challenge the dollar, or that central bank digital currencies and crypto currencies will.

But as you point out, perhaps the biggest similarity is the difficulty of navigating the future when it comes to the global economy, no matter how skillful and experienced the policy officials are, no matter how deeply the issues have been studied. There are just too many variables, and there is no way that we can predict human behavior. That's all the more reason to try to build in early warning systems, cushions and buffers, contingency planning, and coordinating mechanisms. It's why the Fed should not be overly restricted in its fire-fighting capabilities.

Going back to Nixon's team, it was a great advantage to have had Paul Volcker, who wanted fixed rates, and also George Shultz, then director of the Office of Management and Budget, who wanted currencies to float, because they brought to Washington



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Ben Cartwright, Call Your Office!

Nixon and his team announced the end of the dollar-gold link on Sunday night, August 15, 1971, when the president broke into the primetime show *Bonanza* on television. The allies had been notified an hour or two before. It was at the height of the Cold War, and the links between the United States and its allies were much tighter than they are today.

After the announcement, it took four months of acrimonious negotiations to get everyone to agree to what the United States wanted.

—*J. Garten*

The Fixer

"Kissinger, along with Nixon, was the chief intellectual architect for the overall shift in American foreign policy from a position of single-handed dominance over the free world to one in which political and economic power and responsibility would have to be shared. …

"It fell to Kissinger to manage the implementation of Nixon's foreign policy—including the strategy that served as an umbrella for future negotiations on international economic and financial policies in the aftermath of the Camp David weekend.…

"Kissinger's most important contribution was to bring the negotiations to a harmonious end and to avert a permanent rift among the allies. This was no small feat because in the aftermath of Nixon's abrupt, unilateral decisions over the Camp David weekend, America's allies would emerge shocked and angered."

—*J. Garten, in* Three Days At Camp David

Then-National Security Adviser **Henry Kissinger** *did not attend the Camp David meeting—he was in Paris in secret peace negotiations to end the Vietnam war.*

the range of possibilities, and they sensitized one another to how the future might unfold.

Smick: The book presents a fascinating portrait of hyper-nationalist John Connally, a kind of bull in the china shop figure when dealing with the Europeans and Japanese. Nixon counterbalanced the Connally bombast with the astute sophistication of Paul Volcker, George Shultz (who later succeeded Connally as Treasury secretary), and others. But Connally was the bullying "shock" to the global system that led to change. You suggest that in a sense, the bullying, hyper-nationalistic Donald Trump is the John Connally of our day, which gives President Joe Biden a tremendous opportunity now to forge a new international economic and financial statecraft. That's a very interesting thought. Please explain further. What vision on this front should Biden be pursuing?

Garten: Before I wrote the book, I would have said that the United States ran roughshod over its allies after Camp David, and that it should have pursued a more cooperative multilateral approach when it came to the dollar. After all, Nixon and his team announced the end of the dollar-gold link on Sunday night, August 15, 1971, when the president broke into the primetime show *Bonanza* on television. The allies had been notified an hour or two before. It was at the height of the Cold War, and the links between the United States and its allies were much tighter than they are today.

Trump set a very dangerous precedent in his rabid bullying of Powell.

After the announcement, it took four months of acrimonious negotiations to get everyone to agree to what the United States wanted—a series of negotiations in London, Paris, Rome, the Azores, and Washington that I discuss at length in the book. The December 1971 agreement, called the Smithsonian Agreement, didn't last, but it eventually led to a regime of floating rates that everyone could still agree on.

When I finished writing the book, however, I concluded that Washington pulled off something quite dramatic: it saved the global economy by changing it. It did so because it took advantage of a system that no longer worked and proposed the outlines of change. It is almost an unprecedented accomplishment to change the global system in the absence of a war that destroyed what came before. But this time, Washington did it.

This got me to thinking that Biden has a similar opportunity. In my view, at least, President Trump damn near destroyed the international system. With his extreme America-first approach, his rampant protectionism, his disdain for international organizations and international law, his totally transactional approach to foreign policy, and much more, he forced everyone to look into the abyss.

Biden arrived when there was a hunger for a new global order, not the precise order that Obama left, but something much more future-oriented, something that will have to focus much more on global issues such as public health, cybersecurity, and climate, even as the traditional challenges of dealing with great powers remain.

There is something else, too, that Biden could initiate—a focus on America's vulnerabilities to a wide variety of crises—from pandemics to droughts, to cyber attacks, to supply chain disruptions, to financial debacles. The novel thing here would be to recognize that global interdependencies are now our number-one national security threat. We need to develop broader warning systems, broader cushions, and broader capacity to recover quickly. It's a huge subject, and we are woefully unprepared psychologically and operationally. It falls to Biden to define a new order and get others to buy in. It's an enormous challenge, to be sure. But he has the chance, because Trump left such wreckage in his wake.

I know I haven't answered your question as to precisely what Biden should do, because I'm not that smart. But in demonstrating that the United States must work closely with its allies to accomplish anything abroad, and in slowly pushing America to lead the global effort on vaccines, in making climate such a big deal, and in acknowledging the enormous challenge that China poses, I think he's taken the right critical first steps in his first few months.

It was a great advantage to have had Paul Volcker, who wanted fixed rates, and also George Shultz, then director of the Office of Management and Budget, who wanted currencies to float, because they brought to Washington the range of possibilities, and they sensitized one another to how the future might unfold.

Smick: Your portrait of Fed Chair Arthur Burns is also fascinating. Burns had worked for Nixon. They were close. You wrote that Nixon said of Burns, "I want someone at the Fed I can control." But while Burns was serving as Fed chairman, there were tensions between the two before Burns finally relented.

Please explain what happened behind the scenes. It is of course striking to see the comparisons between the struggle by central banks to remain independent in 1971 compared to their very similar struggles today. Nixon was suspicious of central bank independence. At one point, you say he proposed adding seats to the Federal Open Market Committee (similar to Biden's proposal to add seats to the Supreme Court) to force Burns to ease before the 1972 presidential election.

To what extent is Fed Chair Jerome Powell today in a similar position to Burns—if he pushes a policy not favored by the White House, he will experience a reign of terror most likely from relentless attacks from unnamed media sources, including partisan sources on Capitol Hill beyond the administration's control? Is it true that the more things change, the more they stay the same?

Garten: Another great question. Nixon, of course, wanted Burns to bend to his wishes and keep interest rates low. It was a complicated relationship between the two, because while Burns was running an independent Fed, he desperately wanted Nixon's approval.

When Burns balked at Nixon's pressure in 1971, someone on Nixon's staff planted a rumor in the press that the administration was planning to enlarge the Fed board and pack it with Nixon's candidates, thereby creating a situation in which Burns could be outvoted when it came to interest rate decisions. At the same time, rumors were planted that Burns was seeking a salary raise at a time when he was also advocating wage and price controls. After allowing Burns to twist in the wind for a few weeks, Nixon himself said at a press conference that these rumors were totally unfounded. But Burns felt the shot across his bow.

You ask whether Chairman Powell is in a similar situation. Of course, he was when Trump was president. In fact, Trump's unabashed public criticism of Powell was unprecedented, and despite Powell's impeccable performance under pressure, it's a wonder that markets didn't go totally berserk. Under the Biden Administration, there is no chance whatsoever that the president or Treasury secretary, Janet Yellen, would publicly criticize the Fed chairman.

But the very big danger is this: Come 2024, if Trump or someone like him is elected, all bets are off. Trump

set a very dangerous precedent in his rabid bullying of Powell. And it's much too easy in that situation to envision a disaster for the U.S. and world economies. After all, the Fed is key to confidence in the dollar by virtue of its independence, competence, and *de facto* role as the world's central bank.

Smick: You make the case that the developments that came out of that crucial weekend are unfairly connected to a rise in inflation—that developments in the oil market and other things brought about a large amount of the hyper-inflationary pressure. Can you elaborate?

Garten: What I tried to say is that the delinking of the dollar from gold was not the sole or even major cause of hyperinflation in subsequent years. Floating rates *per se* do not create inflation, as the last few decades demonstrate. In the early 1970s, there were many other factors such as out-of-control wage settlements, soaring energy and food prices, and the failure of the Fed to raise interest rates.

I'm not saying that exchange rates played no role. For example, once the dollar was delinked from gold, its value sank *vis-á-vis* the deutschemark and yen. That was the intended outcome, ratified by the market. I think you can make this case, too: Since oil was priced in dollars, as the dollar sank after August 15, 1971, OPEC saw its revenue decline, and it therefore increased the dollar price of each barrel, adding to price increases.

We need a vibrant democracy at home to promote our values abroad, but what's happening now within America is terrifying to me. Depending on the elections of 2022 and 2024, our democracy could be eroded to the point of destruction.

But this is only a part of the story, because the United States had price controls for a few years after the Camp David meeting. I just think that making the collapse of the gold-dollar link the principle cause of hyperinflation is going much too far. Besides, in the end the United States had no choice. It didn't have enough gold to back outstanding dollars, and it had no feasible way of obtaining enough gold. So the commitment had become null and void anyway.

Smick: Take a guess. What would the participants at this historic weekend think of cryptocurrencies if they were around today? A part of a future global currency system? A Las Vegas gambling attraction?

Garten: Here is my guess. Connally would see a Chinese conspiracy and ask Volcker to come up with a counterstrategy. Kissinger would do the same. Volcker would have rolled his eyes and said that cryptocurrencies were not a currency, but he would have wanted to carefully investigate central bank digital currencies—and might do so faster than the U.S. Fed seems to be doing. Burns would have focused on the absence of a sound regulatory framework, but I can see him arguing all sides of the crypto issue. Shultz would have been more positive: If this is where markets are headed, he might have said, then let's see how we can go with the flow.

Smick: Toward the end of the book, you evaluate the decisions made at Camp David. One of your criticisms is that in response to a fear that the United States was losing its competitiveness, Nixon and his team relied too much on currency and trade policy. What did you mean?

Garten: One of the things that was freaking out the Nixon team was the disappearance of the U.S. trade surplus. In fact, in 1970, the country faced its first trade deficit since the late nineteenth century. Men like Connally were much more obsessed by trade than by finance. That was true of Congress, too. They all saw trade as jobs, pure and simple. They saw exchange rates in simple terms—a cheaper dollar was good for exports and made imports more expensive. In other words, it was good for employment. So they thought the right policy was devaluation and forcing other countries to open their markets.

At Camp David, only one person argued that this wasn't enough and that the United States needed to invest in advanced technology and in job training to help workers deal with the revolution in automation. Only one person looked at that dimension of long-term advantage. That was Peter Peterson, then assistant to the president for international economic affairs, who happened to be the only person there who came from industry (and who would many years later co-found the Blackstone Group). But I think

Peterson was right. After all, since 1971 we have never ceased having ever-larger trade deficits. At the same time, we never really invested in ourselves as much as we should have. How interesting is it that we are in the midst of this same debate today. It took China to get us there.

Smick: If a member of Congress not familiar with international economics asked you why what happened August 15, 1971, matters today, in three or four sentences what would you tell them?

Garten: I would put it this way: At the end of World War II, the United States emerged as the only nation in the free world that was standing, and it had overwhelming power and influence. This situation couldn't last, because Western Europe and Japan, with enormous U.S. help, recovered from the war.

Some twenty-five years after the war, the United States needed to free itself of many of the military and economic burdens. Politically and militarily it retrenched, starting with the ignoble exit from Vietnam. Economically it retrenched, too, and cutting the dollar loose from gold was the key policy. That changed the global economy as we knew it, and it ushered in a world of currencies whose worth was only in the eyes of the beholder.

That, in turn, created a world economy characterized by two powerful trends. On the one hand, the global market became more unstable, more prone to crises, and more characterized by hyper-complexity. On the other hand, it was a world in which globalization could proceed at warp speed, with trade, investment, and the spread of technology and ideas growing at a tremendous pace.

Both trends are with us today. They are the legacy of the decisions made at Camp David on August 13–15, 1971. On balance, I think Camp David was thus a net plus.

Smick: Near the end of your book, you write reflectively, "Nixon may have been revealing his doubts about America's destiny, or at least his anxiety that the United States was in a heated, economically competitive race for the first time in his life and that it was not entirely clear the country recognized it." You quote Nixon himself saying pessimistically, "[Our competitors] still have a sense of destiny and pride, a desire to give their best. … [W]hen people get out of a race they lose their spirit; and it can never be recovered. You must have a goal greater than self…". Did you include this passage because of recent polling that shows that today's U.S. high school graduates are hyper-narcissistic with diminished expectations of the future and, in some cases, deep pessimism about democracy, capitalism, and the future in general?

Did Nixon ultimately get it right? Or do America's best days still lie ahead?

I hate this question, because I hate the answer. I am deeply pessimistic about the country, at least for the next decade.

Garten: I hate this question, because I hate the answer. I am deeply pessimistic about the country, at least for the next decade.

But let me start with Nixon. In many ways, the outlook in 1971 was much better than it is today, even with the Soviet menace. There was much cause for optimism. Nixon and Kissinger were opening China. They were negotiating arms control agreements with Moscow. Even when it came to the events I write about in my book—the hammer blow that the Nixon Administration delivered to the world economy—Nixon's goal was to open the global economy, to expand international trade and investment, and to deal with the energy, food, and other global issues of the day in cooperation with America's allies. If you look at the people around Nixon, the only one who wasn't an internationalist was Connally. In addition, even though Nixon had to deal with a Democratic-led Congress, he achieved a massive consensus when it came to global monetary and trade policy because Congress was full of moderates on both sides, not to mention many respected statesmen.

Today, I don't see how the vicious internal political divisions are going to narrow. How is the disinformation going to stop? How are the public and Congress going to depend again on facts and decent analysis?

We need a vibrant democracy at home to promote our values abroad, but what's happening now within America is terrifying to me. There are so many issues, starting with the movement in states to restrict voting. There is failure to agree on the big issues such as dealing with rampant gun violence, or with the existential threat of climate change. But the even bigger thing I fear is that we will never have a major election that is not uncontested, perhaps violently so, no matter what the vote count is. Depending on the elections of 2022 and 2024, our democracy could be eroded to the point of destruction.

In the quote that you cited above, Nixon is saying we have to have a vision larger than self. Right now, I'm afraid, that's a pipe dream for us. ◆

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dramatic enlargement of world markets. The European Community became a more integrated—and enlarged—European Union with a single currency. Developing and transition economies became much more important factors, with opportunities as well as perils. The Bush and Clinton budget packages disciplined U.S. deficits and ushered in a decade of strong domestic growth with modest inflation.

Inevitably, the rapid expansions led to dislocations, triggering a new round of financial crises in Latin America, East Asia, and Russia. The team of Robert Rubin, Alan Greenspan, and Larry Summers orchestrated case-by-case problem-solving—working within the existing international economic system—without redesigning the institutional order. But their firefighting led to adaptations, especially for the International Monetary Fund and World Bank. Collapsing exchange rates in developing economies prompted experiments to manage flexibilities through a variety of interventions and modified floats. China even won praise for managing a fixed rate. Economic historians might conclude that the methods of the 1990s more closely approximated those of Nixon in 1971 than those of Baker in the late 1980s; the Clinton team prioritized packages to deal with immediate problems over Baker's model of combining actions with systemic redesigns.

The Clinton Administration encountered, however, a new type of systemic question: an anti-globalization movement catalyzed by civil society activists. The causes were diverse. The shocks of financial crises in developing countries raised anxieties about global capital flows and the costs of capitalism. NAFTA, the completion of the Uruguay Round and the creation of the World Trade Organization, and China's rise—including negotiations to accede to the WTO—stimulated complaints about the costs of adjustment and "unfair" competition. Environmental groups feared destruction of habitats and species, pollution, and rules that failed to value natural wealth. Traditional protectionists gladly embraced their new allies in protests.

When I became U.S. Trade Representative in 2001, the global trading system was buffeted by both anti-globalizers and developing economies that objected to the balance of rights and responsibilities in the WTO. These objections had stymied efforts in the late 1990s to launch a new negotiating round in the WTO. Then the shock of 9/11 raised the prospect of withdrawal behind borders. New security measures added frictions to cross-border movements of goods, people, and money.

George W. Bush's administration sought to counter these currents and events with a trade strategy of competitive liberalization. This plan, similar to the U.S. moves in the 1980s, combined national and systemic interests; dealmaking would contribute to systemic change. Congress granted new authority to negotiate free trade agreements with individual partners, regional trade areas, and a global accord. In 2001, the administration led the launch of the Doha Round in the WTO while completing China's and Taiwan's accession to the WTO, and in 2004 the United States got the WTO negotiations back on track after a breakdown. The administration advanced a new cohort of free trade agreements—eventually with seventeen new partners—to encourage countries that wanted to liberalize, develop new rules for cutting-edge topics, support reformers in developing markets, deepen economic ties with friendly countries, and keep up momentum for liberalization with Congress. The administration envisaged that successful experience with free trade agreements (with their higher standards) would provide a foundation for regional

George W. Bush's administration sought a trade strategy of competitive liberalization.

Bush 43 and China

During the George W. Bush Administration, the exchange rate question emerged in a different guise: China's fixed exchange rate, which the United States had welcomed during the Asian financial crisis of the late 1990s, became undervalued. U.S. Treasury Secretary Hank Paulson started the process of China's adjustment, which continued through the Obama years.

—R. Zoellick

Hank Paulson,
U.S. Treasury Secretary, 2006–2009

The global financial crisis of 2008 forced Washington to recognize the transformation from a G-7 to a G-20 world economy.

accords. The original twelve members of the Trans-Pacific Partnership, for example, included six countries with which the United States had completed free trade agreements, and the terms of the TPP drew from the U.S. design—making the U.S. withdrawal under President Donald Trump especially ironic and self-defeating. The U.S. free trade agreements with twelve countries in the hemisphere could someday offer the foundation for free trade in the Americas.

During the Bush 43 Administration, the exchange rate question emerged in a different guise: China's fixed exchange rate, which the United States had welcomed during the Asian financial crisis of the late 1990s, became undervalued. U.S. Treasury Secretary Hank Paulson started the process of China's adjustment, which continued through the Obama years.

The 2000s also reminded Americans that the international economic system includes movements of people as well as of goods, services, capital, and ideas. Immigration—legal and illegal—will be an important economic and political factor in future international regimes.

The global financial crisis of 2008 forced Washington to recognize the transformation from a G-7 to a G-20 world economy. Developed countries, especially the United States, triggered the great recession, and the travails of the European Union and the euro extended the downturn. Developing economies, with some help from the World Bank, adjusted relatively well. China's huge stimulus—and its demand for commodities—offered considerable support.

President Bush convened the first G-20 summit as he was leaving office in 2008, and UK Prime Minister Gordon Brown organized a multi-faceted G-20 response in 2009. In addition to macroeconomic support and assistance from multilateral institutions, the G-20 focused principally on reforms in financial supervision and banking systems. The efforts on trade sought to resist protectionism and maintain trade finance, but could not reenergize the engine of liberalization. The sluggish U.S. recovery led to a pause, and then under Trump, a sharp American retreat on trade.

The Covid-19 pandemic of 2020 added yet another factor to the international economy: the demands of biological security. Extraordinary fiscal and monetary responses cushioned the losses in developed economies, and some countries invested in the rapid development of vaccines. Nevertheless, the global system is likely to face "K-shaped" recoveries, with the least protected, economically and medically, struggling the most.

The pandemic has accelerated trends in technological development, especially through digital and data services; the inability to develop international rules and standards on these topics will add friction to the global economy.

The Biden Administration is already in the midst of a negotiation about the international tax policy implications of digital business models. International competition and antitrust policies are also in flux. China's economic power, barriers, and increasing reliance on state controls and enterprises has provoked counter moves; security tensions are triggering decouplings in technology sectors. And the U.S. administration's reluctance to lead in shaping new trade policies for the digital economy is causing systemic drift. On top of all these transitions, intensified international efforts to deal with climate change, especially the shift away from carbon-based energy sources, augur another major structural shift.

FIVE PRINCIPLES

Jeff Garten's *Three Days at Camp David* tells the inside story of dramatic decisions and introduces a larger account about how, over the course of fifty years, U.S. officials tried to adapt the international economic order. I draw five principles from the American experience of international economic leadership.

First, at times the United States has had to compel changes in the international economic system it helped

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create, guide, and protect. Leadership requires recognizing changed conditions that make the old order unsustainable. Ironically, the guardian of the system must then break norms and disrupt expectations.

In *The World in Depression, 1929–1939,* economist Charles Kindleberger traced the breakdown to the lack of enlightened leadership. In the 1920s and 1930s, Kindleberger explained, Britain had the experience of world leadership, but no longer the strength to respond to crisis, while the United States had the capacity, but not the experience and sense of responsibility.

In 1971, Nixon recognized the need for a big change; Baker engineered another major shift in the late 1980s. During the 1990s and 2000s, the United States tried other adaptations. But the United States cannot establish a revised system on its own; international economic regimes require mutuality. In the 2020s, we will see whether China will apply its economic power to support adaptation, advance an alternative model, or just be the source of systemic fragmentation.

Second, when the United States has moved boldly to compel change, it has also needed to negotiate a revised system. The Nixon team used the August 1971 shock as an opening round in a bargaining process. The rebuilding took a number of years in part because Nixon's advisors could not agree on the features of the new order. Baker had a more coherent design in mind from the start, so he was better able to consult, negotiate, incorporate other preferences, and build a new G-7 coalition. Transactional fixes alone will not promote systemic resilience. And a zero-sum logic of deal-making, as practiced by Trump, risks destroying the old order without substituting a new one.

Third, American-led adaptations of the international economy have been most successful when they recognize power shifts—whether driven by economics, technologies, or militaries. Nixon needed a new arrangement that reflected the post-war recoveries in Europe and Asia. Baker perceived new dynamics among the G-7 economies. The growth of developing economies required greater recognition of their problems—and potential to contribute. East Asia's export-led growth created a new force, which is now becoming a giant regional market. The collapse of the Soviet empire left a vacuum, and the rise of China has created a new pole of growth and the prospect of "globalization with Chinese characteristics."

The U.S. administration's reluctance to lead in shaping new trade policies for the digital economy is causing systemic drift.

Ronald Reagan would launch the next stage of transfiguration in global systems based on the American capacity for revival.

Fourth, the United States should prefer flexible international economic systems that can accommodate technological change, innovation, and growth. Nixon failed to recognize this American asset; he thought he was devising a new power balance that compensated for U.S. decline. Reagan and Shultz believed America's adaptive capacities would revitalize the domestic economy and spur global change.

Finally, U.S. strategists have to keep an eye on political support at home. Domestic economic conditions can both constrain and empower Washington's international reach. Garten's tales show the predominance of politics in Nixon's calculations. Ford, Carter, and George H.W. Bush struggled with recessions that ultimately undermined their strategies. Reagan and Clinton leveraged America's prosperity, although trade politics restrained their internationalism. George W. Bush and Obama coped with, in Bush's words, "isolationism, protectionism, and nativism" amidst long wars and then a crash and great recession. Trump declared political war on America's own international creation.

President Joe Biden knows that his fortunes depend primarily on the country's recovery from the pandemic and related economic turmoil. His early international moves are extending his domestic agenda transnationally on Covid-19, climate, and immigration. It is too early to say whether he will initiate a major adaptation of the international economy. If he does, Biden should consider the five principles one can draw from Jeff Garten's history. ◆

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signed an accord that spelled the end of Fed subservience on interest rates. The price of the Treasury's submission was McCabe's resignation. Truman replaced him with a Treasury official, William McChesney Martin, whom he expected to be his agent. Instead, Martin became the poster boy of central banking independence, and the modern era was born.

The accord did not spell the end of executive pressure. Post-Truman, interference took two forms. The first was secretive and forceful. The second is what I'll call soft monetary suasion. In the mid- to late 1960s, President Lyndon Johnson subjected Martin to overt pressure, bludgeoning him to underwrite his wars on poverty and in Vietnam. Martin's accommodation weakened the dollar overseas, leading, eventually, to Nixon's Sunday night surprise.

Powell is essentially using the playbook from the Bernanke-Yellen years. Yet this crisis is palpably different. The mortgage bubble had its origins in finance, and the banking sector was so damaged that a decade of Fed stimulus barely budged the inflation rate. The recent economic crisis was caused by a bug.

Nixon himself, the following year, ordered his Fed chief, Arthur Burns, to loosen policy to assure his re-election—sparking the more serious inflation of the 1970s. In a 1979 address, Burns, by then deposed, lamented that central bankers around the world were failing because democratic leaders were unwilling to alienate voters.

Since Nixon, strong-arming has gone out of a favor. (Donald Trump was an exception.) The greater threat to independence is from "soft suasion," or the use of a crisis to sustain a sense of a shared mission between the Fed and the administration. The perceived mission involves a third party—fear of upsetting markets and triggering a so-called taper tantrum.

It's fair to expect the Fed to play the good soldier during a genuine crisis. But the common definitions for crisis—an "emotionally significant event" or a "decisive moment"—connote a temporal occurrence. In the modern era, Fed co-option seems to be institutionalizing. The crises never end.

Fed Chairman Alan Greenspan initiated the interagency fusion by avidly hobnobbing with cabinet members and presidents. His successor Ben Bernanke worked closely with the Treasury, but that was during a genuine crisis—the mortgage collapse. Since then, the Fed has not reestablished its prior distance. Suasion is barely necessary—the sense of shared mission has been internalized. Co-option might have been expected during the pandemic, but it has morphed into a follow-on mission to support a Biden New Deal.

To the extent the Fed is coopted, this will heighten politicization in the fraternity of central banks globally. This may be what other governments want—but it will not be to their long-term benefit. Although America's financial preeminence is challenged, its still-unique status as a reserve currency and (tottering) leader of the democratic world mean the Fed has a unique responsibility to maintain international stability.

Were the Fed to abandon the hard-won gains of 1951, it could lead to a serious echo of the inflationary epidemic, ultimately international, that flowed from the Nixon shock. Today, the pandemic has receded, the economy is growing (the Fed estimates) at 7 percent for the year, and the United States is adding a half-million jobs a month. Yet the Fed has maintained an interest rate of approximately zero. Moreover, it is monetizing Treasury issues faster than Snyder ever dreamed of.

Fed Chair Jerome Powell is essentially using the playbook from the Ben Bernanke-Janet Yellen years—invisibly low interest rates and massive bond purchases. Yet this crisis is palpably different. The mortgage bubble had its origins in finance, and the banking sector was so damaged that a decade of Fed stimulus barely budged the inflation rate. From 2010–2019, annual money [M2] growth remained under 6 percent. The recent economic crisis was caused by a bug. The vaccine for the bug inoculated the economy, such that the Fed's medicine delivered dramatically different results. Now we have 26 percent money growth (in the year to February 2021), and further growth this year. More money means inflation and that is what we got.

As of May, consumer prices were up 5 percent in a year and core inflation at its highest in three decades. Fed policy is geared toward workers, yet inflation is eating up wage

So confident is the administration of Fed support that the administration forecasts negative short-term real rates for a decade.

gains, which are negative in real terms. Meanwhile, asset prices—the unsolved riddle of modern central banks—are on a tear. Housing prices are roaring, junk bonds have touched record low yields, bitcoin is insane. In the wake of such news, the Fed plans to continue buying $40 billion a month in mortgage-backed securities and to maintain free money for another two years.

Once, with Congress gridlocked, Bernanke plausibly argued he was the only game in town. Today, Congress is flirting with record deficits. Powell and Treasury Secretary Yellen are effectively teammates in the same game. Powell has cheered the Biden stimuli and financed it, since March 2020, with a nearly $3 trillion expansion of its balance sheet. The two officials use the same lingo ("transitory" for inflation, "anchored" for expectations). So confident is the administration of Fed support that the administration forecasts negative short-term real rates for a decade.

Biden is within his rights to spend; he was elected. The central bank, by design, is not responsible to voters. One of its two statutory functions, maintaining stable prices, requires a modicum of independence. Maybe inflation will recede, or maybe it will become a habit. No one knows, not the opiated bond market bulls and not government economists. Uncertainty is a permanent truth, but the Fed's stance implicitly weights its own forecasts above the knowable facts. Chairman Powell might consider the courage of his unsung predecessors. In 1951, his agency would observe, policymakers feared another Depression, but "The primary postwar problem turned out to be inflation." ◆

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for imports drove up the global price of distillate and crude oil. Weeks earlier, the *New York Times* reported that Giscard had publicly criticized the Department of Energy plan to his cabinet.

At the time, U.S. officials were engaged in a desperate effort to prevent Japan and European nations from calling a special meeting through the International Energy Agency to examine U.S. regulations. The *New York Times* reported that the Japanese government called the U.S. actions "regrettable," while the IEA's chairman claimed the U.S. measures were "tantamount to snatching money out of Europe's currency reserves." The *New York Times* authors added

> *European officials complain that the Carter Administration is effectively enlarging the price control shield that already protects United States consumers against world oil prices and that, other countries argue, encourages Americans to use more than their fair share of the world's limited energy resources.*

Eighteen months later, President Ronald Reagan ended the price control program begun by President Nixon nine years before. By then, however, substantial damage had been done to markets and to international relations.

U.S. production declined from 9.2 million barrels per day to 6.8 million barrel per day between 1971 and 1980.

One of the unintended consequences of the three days at Camp David, then, was the utter and complete reconstruction of the global petroleum system for the sole purpose of protecting the U.S. consumers. These include the destruction of trust among U.S. allies. While Garten is correct to praise the primary achievements of the weekend, the benefits must be tempered by the costs to the energy system. ◆

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President Trump severely disrupted the world economy in 2017–2020. He applied tariffs of 10–30 percent on more than half a trillion dollars of U.S. imports and threatened to double that coverage. He invoked "national security" to justify trade restrictions against America's closest allies. He launched trade wars against adversaries and friends alike, and veered sharply toward a new Cold War with China.

Trump left the Trans-Pacific Partnership, one of the largest trade agreements ever negotiated, and forced needless (and largely useless) renegotiations of two others. He jeopardized the future of the World Trade Organization by neutering its Appellate Body, blocking the succession of its leadership and ignoring some of its fundamental rules. He pulled out of the Paris Agreement on climate change and the World Health Organization. He thus struck at the heart of the contemporary global economic order.

Donald Trump was the reincarnation of John Connally, or at least his closest replication in half a century. Connally too was a xenophobe, acting unilaterally and bullying America's closest allies. He too blamed the foreigners for America's problems and offered no U.S. contributions to the proposed reforms. He too cared nothing for the extant global economic order. He too quite explicitly pursued "America First" in crude and often embarrassing ways.

Could the contemporary "Trump shocks" nevertheless produce positive results, similar to those that eventually emerged from the "Nixon shocks" of fifty years ago? In particular, can the United States itself get back on track as President Biden is rightly pursuing as preamble to new international initiatives? Can the traditional alliances be restored? Can bilateral confrontation between the United States and China revert to sufficient cooperation to provide the global leadership essential for the functioning of a stable and prosperous international economic order?

Just as Nixon and Connally warned the world that the United States would be conducting a much more aggressive foreign economic policy after 1971, Trump warned the world that U.S. policy would be much more aggressive from here. In both cases, both domestic politics (the growing impact of globalization on jobs and incomes) within the United States, and international economics (the recovery of Europe and rise of Japan then, the rise of China now), propelled the changes. To convert the Trump assaults into supporting constructive global economic reforms, the other key countries must heed the warnings and respond accordingly, even as they face the more cooperative and less confrontational variant offered by President Biden and hopefully his successors from both parties, let alone a renewal of Trumpism (with or without Trump himself).

Most importantly, the allies need to stand firmly with the United States to defend and revitalize the global order in the face of rising China.

Two sets of steps are needed, just as the Nixon shocks were transformed in positive directions by both monetary and trade reforms. One is for the traditional allies, mainly Europe and Japan but also middle powers such as Canada and Australia, to take a larger share of global economic leadership responsibilities, as they have already been doing, at least temporarily, to fill the Trump vacuum. They need to contribute more real resources to the provision of global public goods, including the common defense. They need to take at least some of the initiatives needed to restore the institutional foundations of the liberal international economic order, including more accurate reflection of global economic power in the governance of the International Monetary Fund and a better dispute settlement mechanism in the WTO.

Most importantly, the allies need to stand firmly with the United States to defend and revitalize the global order in the face of rising China. This includes adapting its rules and norms as may be necessary to accommodate legitimate concerns of the new superpower.

The ability of the United States to restore its essential leadership role will turn importantly on the extent to which others will increasingly share that leadership with it. Their doing

The Trump Comparison

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Could the contemporary "Trump shocks" nevertheless produce positive results, similar to those that eventually emerged from the "Nixon shocks"?

—C.F. Bergsten

so, along with major policy changes by the United States itself, will enable the United States to reinstate a sustainable domestic political foundation for a constructive foreign economic policy. Such increased sharing was in fact required and achieved to a lesser degree with the currency adjustments and trade reforms of the 1970s and 1980s.

The second step, and even more crucial, is the need for China to recognize that some of its trade, investment, and technology policies are unacceptable to most of the world. These policies must be modified to prevent potentially lethal threats to the openness of the global system on which China itself is heavily dependent. Trump's crude use of tariffs got China's attention, but was predictably ineffective in getting it to adopt meaningful policy changes. In pursuing a much more nuanced and skillful approach, the United States is almost certain to continue pressing until the underlying tensions are resolved. This is where the restoration of allied relationships will be crucial: China desperately fears being isolated internationally, and multilateral pressure, deftly applied, will be far more effective than unilateral attacks in eliciting positive responses.

Trump's assaults on the global order, like Nixon's before him, can thus be turned in constructive directions if his successors use the leverage and messaging they provide to steer the world more skillfully toward more sensible, and thus more widely shared, objectives. The alternative is to risk continuation, and even further escalation, of Trump's abdication of U.S. global economic leadership and severe erosion in the liberal international order. Down that path lie substantial threats to global economic stability, a new Cold War with China, and further declines in America's global standing. We must hope that history will repeat itself in this highly unusual and counterintuitive manner. ◆

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On the basis of the price stability-oriented monetary policy of the Bundesbank, the deutsche mark evolved to become the anchor of such arrangements.

In hindsight, one might argue that the collapse of the Bretton Woods system worked as a catalyst for developments in Europe, which culminated in the creation of the European Monetary Union and the birth of a new currency, the euro. In this context, the Nixon declaration has proven to be a highly symbolic act.

WHAT FUTURE?

For advocates of fixed exchange rates, what started in 1971–1973 and persists to this day is a "non-system." They demand a new arrangement. Representatives of forty-four countries met at Bretton Woods in 1944. It is hard to imagine that roughly two hundred countries could be brought together and agree on a new system.

Was a gold exchange standard really established in 1945?

The United States and its currency continue to play an important role, but are far removed from the position they embodied in 1945. As a challenge to the U.S. dollar, the euro has played a relevant but limited role so far. The future of this young currency is accompanied by many uncertainties. This is even more true for the renminbi.

The chances of an agreement on a new global system like that of Bretton Woods remain vague at best. A new system is more likely to emerge in an evolutionary process in which flexible exchange rates between the dollar, the euro, and probably the renminbi could provide a kind of competition in stability. Most other countries might consider fixing the relationship of their currencies to one of these three anchors. And who knows the future of cryptocurrencies?

Considering the dramatic changes the world has undergone since 1971, the present system (or non-system) has not performed so badly. It is hard to say whether a new grand design would be better equipped to survive in an environment of further rapid change. ◆

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These protectionist pressures continued to rise along with the dollar until U.S. Treasury Secretary James Baker helped engineer the Plaza Agreement in 1985. G-7 finance ministers and central banks agreed to concerted measures to reduce the value of the dollar on foreign exchange markets. As the dollar fell, protectionist pressures receded.

Although the U.S. current account deficit widened even more dramatically in the 1990s, the dollar was remarkably stable and the economy performed well—which kept protectionist pressures at bay.

By the late 1990s, however, China had replaced Japan as a country of concern. The U.S. trade deficit with China grew from $83 billion in 2000 to nearly $260 billion in 2007. The bilateral trade imbalance with China did not go unnoticed and once again attention was put on the exchange rate. Whereas Japan's trade surplus had been driven by private outward capital flows, China's trade surplus was related to government foreign exchange intervention. After China fixed the value of the renminbi against the dollar, China's foreign exchange reserves began to explode, growing from less than $200 million in 2000 to $1.6 trillion by 2007, and later peaking at nearly $4 trillion in 2014.

This reserve accumulation indicated that China's central bank was buying dollars and selling renminbi, which kept its currency undervalued and boosted exports. As imports from China began to surge, some U.S. producers started complaining that China's currency policies were giving the country's producers an unfair advantage. This got the attention of members of Congress. Starting in 2003, Senators Charles Schumer (D-NY) and Lindsey Graham (R-SC) introduced legislation to impose a 27.5 percent tariff on goods from China until it revalued its exchange rate. (That number was a simple average of fifteen and forty, which were two contemporary estimates of the renminbi's under valuation.) More than one hundred similar bills were subsequently introduced, but all died in committee.

American policymakers feared that the United States was losing its "competitiveness."

President George W. Bush's administration did little to challenge China's currency policy, at least in public. The Treasury Department never named China as a "currency manipulator," but officials quietly pushed for a change in policy. In July 2005, China began to allow the renminbi to appreciate steadily against the dollar, arguably too slowly and too late. Then the global financial crisis of 2008 struck.

President Nixon liked the idea—"the import duty delights me"—because it was a way of striking back against other countries and extracting concessions from them.

Among the confluence of factors that led to the election of President Donald Trump in 2016, some have speculated that the "China shock"—the surge of imports during the 2000s that displaced an estimated million American workers in manufacturing—played a contributing role. Trump put trade at the center of his agenda and, like the Nixon Administration, attacked the trade deficit as demonstrating that other countries were "taking advantage" of the United States. He said he would like a weaker dollar and spoke about how tariffs would help make America great again.

Yet the administration did not intervene directly in currency markets nor impose a general import surcharge. Rather, China was hit with stiff tariffs because "trade wars are good, and easy to win." The steel industry also received protection, as had happened under previous administrations.

These actions did not reduce the trade deficit, although few economists thought that they would. But they did reveal how much the world had changed from 1971. When President Nixon acted, other countries retreated—and never seriously considered retaliating against the United States. When President Trump acted, the retaliatory blowback against U.S. exports was immediate and the complained-about foreign economic policies were unchanged.

Despite the bravado, the Trump presidency showed that the United States no longer had the power to dominate international economic policy the way it once could. ◆

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rise as long as forecast inflation was within their "comfort zone." The result, in a process of intertemporal disequilibrium which I have set out in numerous articles in this magazine over the past twenty-odd years, has been a succession of bubbles and Ponzi games which central banks and governments have needed in their attempts to stave off, or respond to, financial crisis and depression, and a very unwelcome concentration of wealth.

The miserable end point of this process must be one in which all private assets have been bought by the government or its agent, the central bank, and the only asset left in the hands of the public is a zero-interest (at best) perpetuity, the government's money. (Inevitably, private cryptocurrencies will be prohibited, but probably only after bubbles in them have produced appallingly large and socially destructive wealth transfers. Central bank digital currencies meanwhile will bear increasingly negative rates and risk putting the allocation of credit entirely in the government's control).

That is bad enough! But a particularly dangerous Ponzi game in government finance is now brewing, most worryingly in the United States. Budget deficits, intended as a substitute for ever-lower real interest rates in providing the boosts to aggregate demand made necessary on a recurring basis by intertemporal disequilibrium, must be ongoing and indeed ever bigger. So too must public debt. Thus to prevent unsustainability, real interest rates must continue to go ever lower.

Real interest rates in the United States are now more negative than before the pandemic caused budget deficits, largely financed by the Fed, to explode upwards. If they had not behaved thus, much more of the famous accumulated saving of the private sector would remain saved because of fears of future tax increases or government default. The problems of an unequal—and inequitable—distribution of wealth and of potential financial instability will remain and worsen.

Even that is not all. While the classical gold standard at least meant, if countries stuck with it, that hyperinflation was not possible, government default—or "going off gold" to avoid it—was far from uncommon. But such events as occurred were typically not the result of aggregate-demand-management decisions. They came in countries in which members and clients of governments of dubious democratic legitimacy and accountability were using public resources to feather their nests, often behind the mask of "correcting" distributional inequity. In the absence of the gold-based constraint, such circumstances (for example in Zimbabwe and Venezuela) do lead to hyper-inflation.

The primary economic harm of Richard Nixon's presidency was not that macro policy was used for nest-feathering purposes. But, freed from a link to gold and supported by a politically compliant Fed, a decade of fiscal incontinence was allowed to produce shockingly and corrosively high inflation.

A particularly dangerous Ponzi game in government finance is now brewing, most worryingly in the United States.

Now, with an administration bent on redistribution via massive budget deficits, inflation targeting by a genuinely independent central bank would, whatever havoc it has caused over the past quarter of a century, be a valuable bulwark against a repeat, and worse, of the 1970s. But the Fed has gone woke and is forgetful of its core duties and responsibilities. Its current "make-up" inflation strategy could be dangerous even if its parameters were clearly spelled out. But they are not. And that absence of clarity makes the strategy peculiarly susceptible to being "tweaked" for political purposes, whether the Fed's own wokeism or the administration's redistributional intent.

Could these nightmares have been avoided if macroeconomic thinking had taken a different turn after Camp David? The monetarist doctrines of the 1970s and 1980s at least attempted to provide an anchor for inflation expectations—albeit a shifting anchor given institutional and technological changes in the money supply and demand—while recognizing that a productivity disturbance should lead to a disturbance in the price level (a prescription regarded with horror in the Woodfordian inflation targeting orthodoxy).

But neither monetarist nor inflation-targeting approaches could cope if things ever went wrong. And when the world became more dynamic and more capitalist again in the 1990s—a development that should have been of great and lasting benefit to the world—they did go wrong. They went wrong precisely because monetary policy and macroeconomic thinking failed to recognize the intertemporal essence of capitalism. The clue should have been in the name: the relationship among the anticipated rate of return on investment, the *ex ante* real rate of interest and the rate of household time discount; and the need to accommodate and encourage destructive creation. Some of those elements were implicit in 1802 in Henry Thornton's *Paper Credit* and in 1959 in the Radcliffe Report—which was comprehensively rubbished by monetarists. Those elements have too long been ignored. And the world is now going to have to pay a calamitous price. ◆

LETTER FROM BERLIN

German Election Scorecard

The bursting of the Greens' Baerbock bubble and the emergence of the CDU's Laschet. But the Greens aren't going away.

By Klaus C. Engelen

Developments in early summer may hint at the outcome of this year's German federal elections in September.

Delegates to the Green Party conference, most connected digitally over a weekend in mid-June, adopted an election manifesto that calls for fast-tracking the switch to carbon neutrality over the next twenty years and vowing to turn Germany into a "socio-ecological market economy." Annalena Baerbock and her co-leader Robert Habeck were confirmed with 98 percent.

According to Matthew Karnitschnig, the Berlin correspondent of *Politico,* "All she had to do was look in the camera, wave at the small audience and walk off the stage with a big smile that said 'mission accomplished.' Instead, Annalena Baerbock, Germany's Green candidate for chancellor, dropped an s-bomb. *'Scheisse!'* she declared into her still-open microphone after delivering a 45-minute convention speech to party faithful Saturday. Baerbock was apparently aggravated about flubbing a line in her address. … That beginner's mistake was one of several to plague the forty-year-old candidate in recent weeks, sowing doubt over whether she's really ready for prime time."

BUBBLE BURSTING

For the Greens, who entered Germany's political arena in 1980, April 19, 2021, was supposed to be a historical day. In a well-orchestrated media coup, the Greens presented their co-leader Baerbock as the party's candidate to succeed Angela Merkel as chancellor in September's national elections. Baerbock has been a member of the Bundestag since 2013. She convinced her fellow party leader Habeck (51), a former state minister of Schleswig-Holstein for environment and agriculture, to leave her the big job of running for the chancellor position. The two co-leaders of the Greens came into office in 2018 and were able to turn the formerly fragmented party into an effective campaign machine with one big goal: to govern again.

Thanks to their dynamic young candidate for chancellor, the Green party rose in national polls to almost 30 percent and at times overtook Armin Laschet's CDU. During the spring, a Green chancellorship seemed within reach.

As *Politico's* Karnitschnig reported, Baerbock "couldn't have hoped for a better launch of her campaign. Her face was on cover of Germany's biggest magazines. She was *the* get on the primetime talk shows that Germans watch obsessively. With the governing Christian Democrats tripping from scandal to screw-up and back again, the Greens looked like the adults in the room. In some polls, the Greens even surpassed the long-dominant Christian Democrats, triggering speculation that Baerbock might even succeed Angela Merkel as chancellor. It didn't take long for the wheels to come off."

For the German media, the Baerbock fairy tale was a great publishing opportunity. On April 24, 2021, Baerbock appeared on the cover of *Der Spiegel.* The magazine rolled

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out the story of "two against one," and how Baerbock will conquer the chancellory for the Greens. She faces Armin Laschet and Olaf Scholz, who represent the former big tent parties CDU and SPD. As *Der Spiegel* puts it, "Two lawyers against a political scientist with a focus on international law. Two governing professionals against a parliamentarian with no executive experience. Two representatives from Germany's traditional big-tent parties against the candidate of a party hoping to become the next big-tent party."

The magazine's editors support the view that "Germany finds itself at a crossroads: The pandemic has mixed everything up and many erstwhile certainties have now been called into question. … In September, an unsettled, unnerved country will be going to the polls. The pandemic could largely be under control by then, but the climate crisis certainly won't be."

And on the CDU/CSU's claim to the chancellery: "For the first time since 1949, the chancellor will not be up for reelection. There will no incumbent bonus. The era of Angela Merkel is coming to an end … It is a completely new situation for the country, and the outcome is open. But it looks as though there is no getting around Annalena Baerbock."

Here one could ask why the journalists at *Der Spiegel* didn't look more closely at Baerbock's résumé. When Baerbock's professional background, as was to be expected, received deeper scrutiny, a string of embarrassing lapses—failing to declare thousands of euros in income and manipulating her resume—came to light and the Green bubble started bursting. She also got into trouble with some of her statements about what she will do in the government, which were shortened to toxic threats such as, "Baerbock wants to do away with budget flights and no more €29 tickets to Mallorca."

Der Spiegel: "Germany finds itself at a crossroads: The pandemic has mixed everything up and many erstwhile certainties have now been called into question."

The June 10, 2021, *Sonntagsfrage Bundestagswahl* by pollsters Infratest Dimap puts the CSU/CSU Union at 28 percent voter support, the Greens at 20 percent, followed by the Social Democrats at 14 percent, the Alternative für Deutschland at 12 percent, the Free Democrats at 12 percent, the Linke at 7 percent, and others at 7 percent.

Politico: "With the governing Christian Democrats tripping from scandal to screw-up and back again, the Greens looked like the adults in the room."

A BIG WIN

There was an unexpected big win for the Christian Democrats in Merkel's home state of Saxony-Anhalt that contradicted the predictions of most pollsters, who were expecting big wins for the right-wing Alternative für Deutschland. This was an important development, since it demonstrated that a strict CDU policy of non-cooperation with the far-right AfD can mobilize voters to strengthen the conservative alliance as bulwark against the far right. *Der Spiegel International* wrote: "With just a few months to go before the German general elections, the conservatives took a big step in the right direction by winning the state vote in Saxony-Anhalt on Sunday. The right-wing populist AfD failed to live up to expectations." Former rival for the CDU chair Friedrich Merz, who is now working in Laschet's campaign as a heavyweight economic policy and business expert, claims that "without the nationwide trend, this result would not have been possible."

THE HARD LINE WORKS

The CDU currently governs Saxony-Anhalt in a coalition with the Social Democrats and the Greens. For Laschet, the outcome of the last state election before the national elections was a big boost.

The dreadful specter of a right-wing AfD pulling ahead of the CDU and damaging the standing and functioning of the state did not become reality. This gives the governing CDU more confidence with respect to the coming national election. They can count on voters in the eastern states to help in the fight with the far right. In some states, the AfD has been under surveillance by the German domestic intelligence service since January 2021, a factor for voters to take into account.

In Saxony-Anhalt, the center-right CDU under its popular state governor Reiner Haseloff won 37.1 percent, a 7.3 percentage-point improvement from the 2016 elections. The AfD came in second with 20.8 percent, 3.5 percentage points lower than in 2016. According to voter flow statistics, 16,000 former AfD voters have moved to the CDU. Together with former voters of SPD and Linke, Haseloff's CDU could count 45,000 voters who in 2016 gave their ballots to other parties. In addition, 61,000 new CDU voters probably were mobilized by the threat that the far-right AfD would come in first.

The Linke (Left) suffered a historically low vote count of 11 percent, a loss of 5.3 percentage points. The SPD received 8.4 percent of the vote, 2.2 percentage points lower than in 2016. With only 5.9 percent, the Greens finished at the bottom of the list, which shows the weak position of the Greens in Germany's eastern states. After a decade of not being represented in the state's parliament,

the business-friendly Free Democrats returned with 6.4 percent, part of a country-wide FDP upward movement. On the federal, state, and communal level, the FDP was able to broaden its voter base thanks to sharp criticism of the German pandemic lock-down.

DISUNITY COST VOTERS

In October 2018, Chancellor Angela Merkel told her fellow Christian Democrats that she would not seek re-election as party chairwoman, a position she has held since 2000, and also would not seek a fifth term in 2021. Since then, the power base in the German political system has changed significantly.

For decades, the conservative CDU/CSU alliance at the center of Germany's party spectrum—to quote *Der Spiegel's* assessment—worked like an "election campaign machine—highly disciplined with its sights fixed on the goal: power. In the 2021 election year, though, it's the other way around. The Greens seem like a machine that is just warming up. In the case of the CDU and CSU, you almost have to wonder if they still have enough fuel."

Did the movers and shakers in the CDU and CSU not realize what it will mean campaigning in the next elections in a more difficult political environment, without being able to mobilize political capital in terms of the trust and credibility of an Angela Merkel who governed with four different coalitions for sixteen years?

Eurointelligence: "The burst of the Baerbock bubble allows the Greens to focus on the issues, rather than having to sell what turned out to be an unprepared candidate. If the Greens come out of these elections in a strong second place, they would have done very well.

There was the failed CDU leadership of Annegret Kramp-Karrenbauer, who was not able to enforce the party rule of strict non-cooperation with the AfD in the eastern state of Thuringia. She took over the German defense ministry when Ursula von der Leyen rose to become president of the European Commission.

Then came the battles among Laschet, Merz, and Norbert Röttgen, the contenders for the CDU party chair on route to win the chancellor candidacy for the CDU/CSU. Party members and potential voters could see the deep divisions in the alliance.

As governor of North Rhine-Westphalia, Germany's largest state by population, Laschet was from the beginning in a pole position. Merz, an old rival of Merkel's and a former head of the U.S. Blackrock investment fund giant's subsidiary in Germany, came with strong backing from the business side with the promise to halve the voters of AfD in the eastern states. Röttgen, as chairman of the Bundestag's Foreign Affairs Committee, brought foreign policy and security experience into the leadership race.

On January 16, 2021, in the second ballot at the party convention, Laschet was elected CDU chairman, supported by 53 percent of the delegates. In April, he announced that he would like to be the common chancellor candidate for the CDU/CSU, at the same time as Markus Söder, the CSU head and governor of Bavaria, put his hat in the ring. Söder pointed to his much better standing in the opinion polls.

This led to a bitter and bruising standoff until the early morning of April 20, 2021, when Laschet won the backing of senior party members in a 31–9 vote of the CDU executive board.

A few days before, the ARD-DeutschlandTrend pollsters found that 44 percent of German citizens and 72 percent of CDU/CSU party supporters favored the Bavarian governor as the best and most promising chancellor candidate in the coming national elections. By contrast, only 15 percent of German citizens and 17 percent of CDU/CSU party members favored the governor of North Rhine-Westphalia who, in the refugee crisis of 2015, stood behind Merkel but showed weak leadership when the Covid-19 pandemic spread in his state.

A separate opinion poll by INSA for the tabloid *Bild* came out with a forecast that the CDU/CSU bloc with Laschet would struggle at a 27 percent level of support in the fight for the succession to Merkel, compared with a much stronger support level of 38 percent if Söder were the contender.

DON'T WRITE OFF THE GREENS

The editors of the Brussels-based *Eurointelligence* who follow the Baerbock drama warn: "Do not underestimate the strong support the [Green] party enjoys. What we have seen in the last two months is that Baerbock is not ready for the job of chancellor. The Greens have not prepared for high office. The burst of the Baerbock bubble allows the Greens to focus on the issues, rather than having to sell what turned out to be an unprepared candidate. Most of the Greens are focused on the issues anyway, not the candidate. If the Greens come out of these elections in a strong second place, they would have done very well. Baerbock could be a foreign minister in the next coalition. Habeck would be the finance minister. Perhaps even more important would be the possibility that Katrin Göring-Eckardt could replace Frank-Walter Steinmeier, a Social Democrat, as German president. The point is that there are bigger issues at stake for the Greens than whether their inexperienced co-leader is going to become chancellor this year." ◆