Long Reads

# When America Remade the World Economy

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NEW HAVEN – At 2:29 p.m. on Friday, August 13, 1971, US President Richard M. Nixon walked out of the White House, boarded Marine One, and traveled to Camp David, where several members of his administration were waiting for him. His chief-of-staff, H.R. Haldeman, had organized the meeting just one day before and given everyone instructions not to tell anyone – not even their families – where they were going. On arrival at Camp David, they were ordered not to phone anyone outside of the retreat.
Still, on the previous day, one of Nixon's top advisers had foreshadowed the significance of the gathering, suggesting that the weekend would bring "the biggest step in economic policy since the end of World War II." Similarly, another adviser, on his way out of town, let it slip to a journalist that, "This could be the most important weekend in the history of economics since Saturday, March 6, 1933," the day Franklin D. Roosevelt closed all the banks in America.

They were not exaggerating. Between Friday afternoon and Sunday evening, Nixon and six top officials (backed by nine senior staff members) made a series of momentous decisions that the president would then announce in a quickly arranged prime-time televised speech. Forty-six million Americans, a quarter of the population, tuned in, while finance ministers, central bankers, and market makers from London to Tokyo huddled around their radios.

What Nixon said rocked the US and global economies, sending shockwaves through America's allies in Western Europe and Asia that were as deep and unsettling as his announcement, the previous month, of his planned trip to China. That "Nixon Shock," as it came to be called, is the subject of my new book, *Three Days at Camp David: How a Secret Meeting in 1971 Transformed the Global Economy*.

## The Nixon Shock

In response to a simultaneous escalation of inflation and unemployment in the United States – America's first experience with "stagflation" – Nixon announced that his administration would freeze all wages and prices. The government would intervene in American businesses as never before in peacetime, a move that was even more stunning coming from a Republican president who had vehemently denied that he would ever take such measures. To pump up employment, Nixon also promised significant tax reductions and investment incentives that would be available only to US companies – an act of overt discrimination that enraged America's trading partners.

Even more consequential and long-lasting were the Nixon administration's decisions concerning the US dollar. The president announced a new arrangement to enhance US competitiveness at a time when imports and outsourcing were threatening American jobs, and when Congress was churning out highly protectionist legislation reminiscent of the 1930 Smoot-Hawley Tariff Act.

But Nixon's most drastic step was his decision to sever the link between the dollar and gold. He thus took a sledgehammer to the 1944 Bretton Woods Agreement, which had mandated that all dollars would be freely convertible into gold at a rate of $35 per ounce, and that other currencies would be firmly linked to the dollar.

Nixon's announcement duly led to a sizable devaluation of the dollar in international markets – the first official dollar devaluation since the end of World War II – and a dramatic strengthening of the West German Deutsche Mark and the Japanese yen.

## It Had to Be Done

As momentous as Nixon's decision was, the truth is that his administration had no choice but to cut the dollar loose from its gold anchor. America was running its first trade deficits since 1893, and dollars were flooding the world economy. With US inflation eroding the dollar's purchasing power, the administration feared that other governments would try to cash in their excess dollars for gold at the US Treasury, as they had a right to do under Bretton Woods. The problem was that America didn't have enough gold to make good on its commitment.

Throughout the previous 16 years, US dollar liabilities had been growing much faster than its gold reserves. In 1955, for example, US gold reserves were 160% greater than the volume of dollars held abroad. But by August 1971, America had only enough gold to cover 25% of those dollars. Under those circumstances, if any country had decided to demand a major conversion of dollars to gold, it could easily have triggered the equivalent of a bank run. Aside from the possibility of being humiliated, the US worried that breaking its commitments in the monetary arena would undermine confidence in its promises to come to its allies' military defense – an especially dangerous prospect at the height of the Cold War.

Nixon's team wasn't trying to move to floating exchange rates, though. Its goal, rather, was to introduce a fixed-rate system based on new parities: namely, a cheaper dollar and stronger counterpart currencies, especially the D-Mark and the yen. These currencies would underpin a new multilateral monetary agreement to replace the Bretton Woods system.

To force West Germany, Japan, and other US allies to negotiate immediately and seriously, Nixon imposed a 10% across-the-board import tariff. By undercutting a 25-year US crusade for lower trade barriers around the world, this policy shift shocked US allies as much as the closing of the Treasury's gold window had.

Nixon had at least three motives for bringing such pressure to bear on US allies. First, America was confronting increasing competition from West Germany and Japan, especially in manufactured goods. Rather than acknowledge its own problems, it attributed its declining competitiveness to an overvalued dollar and to West Germany and Japan's failure to open their markets to US exports as much as America had done for theirs.

Second, the administration believed that the US was no longer powerful or rich enough to shoulder the full burden of managing the global economic system. In effect, America was declaring the end of the era of the Marshall Plan and its determination to begin forcing its allies to share responsibilities for managing the global economy. Hence, in his epic history of the Federal Reserve System, William Greider noted that, "If historians searched for the precise date on which America's singular dominance ended, they might settle on August 15, 1971."

And third, Nixon was worried about losing the next presidential election, and wanted to demonstrate to Americans that he could steer the US economy to a better place.

## Nixon's Monetary Shock Troops

Around the table at Camp David's Aspen Lodge that weekend was an exceptionally talented group of men representing an impressive range of passionate opinions. Nixon was the undisputed captain, but economics wasn't his thing. His primary focus was on creating a new US foreign policy, one that would be more stable and less expensive to maintain. But in the trade-off between inflation and jobs, the latter was much more important politically. The global monetary system was causing too much tension among the allies, so something had to be done.

Aside from the president, the most powerful man at Camp David was Secretary of the Treasury John Connally, a stridently nationalist three-term former Democratic governor of Texas. Described by Henry Kissinger as "a man of swaggering self-assurance," Connally was Nixon's battering ram. Once asked about his overall philosophy, he replied, "It's simple. I want to screw the foreigners before they screw us."

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Connally's wingman was Paul Volcker, the under-secretary of the Treasury for international monetary affairs, who would later become a legendary chairman of the Federal Reserve. Volcker was the only one in the group who understood how the intricate plumbing of the international monetary system worked. He, too, wanted the dollar to be devalued; but he also envisioned a quick return to fixed exchange rates. Though gold would be gradually phased out as an anchor of the monetary system, he hoped to see stronger rules and institutions that would expand global commerce.

Also at the table was Fed Chair Arthur Burns, who was convinced that traditional fiscal and monetary policies could not control inflation, because the problem was being propelled principally by costly wage settlements resulting from aggressive bargaining by powerful industrial unions. While arguing for wage and price controls, he backed devaluation but, like Volcker, also favored fixed exchange rates, owing to his concerns about the chaos that could ensue if the dollar's gold backing was removed.

Burns wanted the Fed to be independent, but he also craved Nixon's friendship. Striking this balance would prove to be impossible. (In the event, many financial experts eventually concluded that Burns's submission to Nixon's demands for low interest rates was largely responsible for the soaring inflation of later years.)

The only true conservative in the group was George P. Shultz, the director of the Office of Management and Budget, who would later emerge as one of America's most admired contemporary statesmen. He hated wage and price controls and wanted to see a totally new monetary system based on floating exchange rates (implying the elimination of gold as an official asset in world finance). Shultz kept arguing his case, but he was outvoted, whereupon he fell in line like a good soldier.

Finally, there was Peter Peterson, the assistant to the president for international economic affairs, who later co-founded and chaired the Blackstone Group. Less fixated than the others on money and trade, he thought that America needed a long-term industrial policy to achieve technological dominance, as well as major new programs to retrain workers for the coming era of advanced automation. His ideas were glossed over by the group.

These men, together with a small staff, talked for three days about the direction America would take, and about precisely what Nixon would announce to the world on Sunday night. Despite their philosophical differences, they emerged as a coherent team and unanimously supported Nixon and Connally.

A strong subtext to their deliberations was the idea that America remained committed to the spirit and institutions of an open world economy and the rule of law. By the end of the weekend, Nixon's team knew that their immediate objective was to launch negotiations on a major currency realignment, a significant liberalization of trade, and more sharing of the military expenses needed to confront the Soviets in the Cold War. But there was internal disagreement on the precise negotiating targets, the weighting of trade-offs, and the vision for longer-term arrangements. The Camp David meeting (and all the secret studies and preparation that preceded it) thus demonstrated the limits of governments' ability to anticipate developments in the world economy. Under such uncertainty, the key to success is to consider all the contingencies, maintain flexibility, and remain coordinated.

## The Fallout

Nixon's team certainly was not oblivious to the turmoil that would follow from the changes agreed during the weekend. The trade and financial arrangements that the US was uprooting had driven the phenomenal post-war recoveries in Western Europe and Japan, serving as the glue that held the free world together. As soon as Nixon announced the changes that Sunday, he called Kissinger, his national security adviser, to help keep America's alliances intact. Kissinger and Nixon proceeded to do precisely that, sometimes behind the scenes, and sometimes in high-profile face-to-face meetings.

The Camp David meeting led to a new world order. For the first time in the post-war era, America's allies and trading partners agreed to share more of the economic burdens of leadership. Yes, the wage and price freezes led to years of government control and ended in disastrous economic distortions that contributed to years of inflation. But of greater long-term significance were the negotiations that Nixon's speech set in motion, which resulted in a system of floating exchange rates, the opening of major global trade negotiations (the so-called Tokyo Round), and continuous allied discussions of ways to share defense costs more equitably.

Ultimately, serious protectionism in the US was averted, and floating rates gave the world a flexible tool to navigate what would become a more intense phase of globalization. The new system eliminated the central and highly constraining role of gold in the world financial system while still preserving the dollar as the world's preeminent currency.

To be sure, abandoning fixed exchange rates came with costs. The world economy became riskier, more complex, and more prone to crises. There were hardly any global banking crises during the 1950s and 1960s; but from the Latin American debt debacle in the late 1970s to the financial crash of 2008, massive upheavals have since been a regular feature of the global system.

Moreover, novel hedging instruments were created in response to the new exchange-rate fluctuations, leading to a surfeit of ever-more complex variations of swaps, options, and derivatives (even derivatives of derivatives). A large swath of the global marketplace became a de facto casino.

Because currencies were no longer backed by tangible assets, value became abstract. The worth of a dollar or euro or yen came to be based wholly on the credibility of the issuing country's government, central bank, and other laws and institutions. Most importantly, the Nixon team's weekend at Camp David showed that the US could unilaterally change how the world was organized. The events of August 13-15, 1971, both transformed the global economy and saved it. Had the dollar not been freed from gold, US protectionism would have gotten out of hand, trade would have suffered a fatal blow, and the neo-isolationism that had been growing in America as a result of the Vietnam War would have gone mainstream.

In this sense, the Camp David meeting was a resounding success. As economic historian Harold James notes, between 1970 and 1980 trade in goods and services grew from 12.1% to 18.2% of global GDP. At the same time, consciousness of global interdependence soared, leading to the establishment of the G7 and enhanced coordination on such global issues as energy, food, population, and relations between developed and developing economies.

## Parallels and Differences

There are many parallels between August 1971 and today. Now, as then, inflation looms and wage rates are increasing, and these two phenomena are once again wreaking havoc on our understanding of the trade-offs between prices and employment. Likewise, the US budget and trade deficits are growing again, causing concerns about debt and the future costs of servicing it.

Moreover, America is again emerging from a long costly war, desperate to focus on overwhelming problems at home even as critical global problems demand its attention. It is also facing a major adversary, though China is far more formidable than the former Soviet Union ever was. And foreign relations are becoming increasingly difficult. In 1971, US allies were nervous about America's role in the world, wary of it being either too engaged or not engaged enough. The same is true today. Japan is as sensitive about being isolated and bullied as it was 50 years ago, and reaching a consensus among diverse European countries poses a major challenge, just as it did in 1971, even though the European Union is far more integrated economically than its predecessor, the European Community. And just as West Germany was key for Nixon, today's unified Germany plays an outsize role in US strategic considerations.

But, while the world is facing another transition from the end of an era to the beginning of a new one, there are also major differences between 1971 and now. We are witnessing fiscal and monetary activism on a scale not seen in our lifetimes. Nationalism is growing in place of globalism. With the US political system mired in extreme dysfunction, global power is becoming increasingly diffuse. Digital payments and cryptocurrencies are challenging fiat currencies, with unknowable consequences for the infrastructure of the global financial system.

Moreover, today's policy agenda is even more formidable than it was in 1971. For starters, America and its allies must refashion the trade regime to deal with the systemic threat from China's state-oriented system, with its rampant and often opaque subsidization of key industries.

In addition, the growth of public-sector investment in strategic industries such as health, energy, and high-tech manufacturing means that governments around the world will be acutely sensitive to others' attempts to gain an advantage from currency depreciation. Most likely, a new set of monetary accords will be needed.

After all, the post-pandemic era will be shaped by debilitating national debts around the world, which could lead to new financial crises if interest rates rise. The dollar's preeminent status could be threatened not just by China and Europe's efforts to relax America's tight grip on the global financial system, but also by a new world of central bank digital currencies.

In 1971, America could act unilaterally. The Nixon administration's overwhelming focus was on forging an agreement with a few developed countries, principally West Germany, Japan, and the United Kingdom. By contrast, America today needs many more partners to meet its strategic objectives. The G7 world has given way to one in which the G20 is the predominant global economic grouping.

As the US addresses the current challenges confronting the global economy, let us hope that it can muster talent of a similar quality and variety that Nixon did. Once again, it will need to push for arrangements conducive to more trade and investment, while also keeping its alliances intact. The challenge America faces today is essentially the same as it was a half-century ago, only far more daunting.

## JEFFREY E. GARTEN

Jeffrey E. Garten is the author of *Three Days at Camp David: How a Secret Meeting in 1971 Transformed the Global Economy*, published last month by HarperCollins. He is Dean Emeritus of the Yale School of Management where he teaches courses on the global economy. He previously served in the Nixon, Ford, Carter, and Clinton administrations, and was a managing director of Lehman Brothers in the 1980s and the Blackstone Group in the 1990s.

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