Weekly Geopolitical Report

By Bill O'Grady

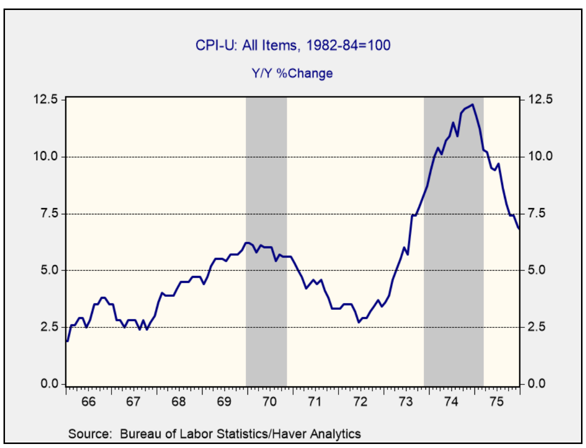
April 29, 2019

Reflections on Domestic Policy and American Hegemony: Part II

Two weeks ago, we introduced this report with a review of the basics of the reserve currency and the savings identity. This week, we will examine two important historical analogs, the Nixon and Reagan administrations.

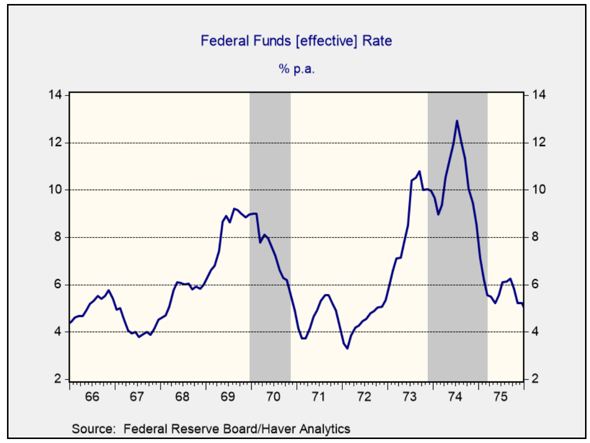
#1: The Nixon Analog

As President Nixon prepared for the 1972 presidential campaign, he faced a number of serious problems. First, inflation was increasing.



In 1967, inflation was 2.5%; by mid-1969, it was more than 5.0%. The Federal Reserve acted to quell inflation by raising the fed funds rate to nearly 9.2% by August 1969.

As the chart below shows, the increase in interest rates led to a recession, ending the long economic expansion that began in March 1961. The recession, which ran from December 1969 to November 1970, was not an especially harsh one, but Nixon knew that if he didn't boost the economy in 1971 his reelection chances would be significantly diminished.



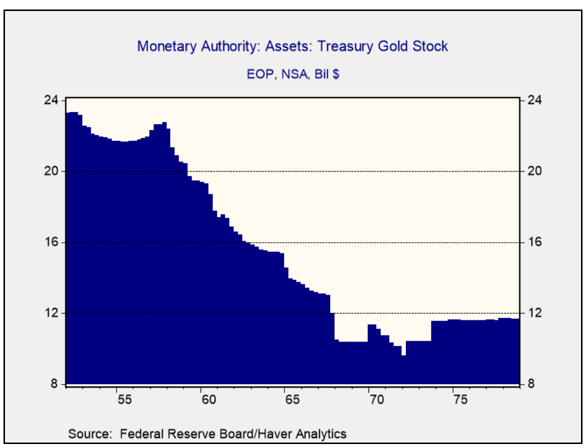
Nixon needed accommodative monetary policy and took controversial measures to assure that Federal Reserve Chair Arthur Burns complied. In the summer of 1971, Nixon and members of his administration hatched a plan to smear Burns by leaking to the press that the Fed chair was seeking a pay raise. At the same time, the administration told reporters that Nixon was considering a reorganization of the U.S. central bank to reduce the power of the chair by increasing the number of governors. Alan Greenspan was recruited to inform Burns that he needed to comply with the Nixon administration's goals for monetary policy if he wanted the stories to stop.[1] Burns acquiesced to the administration's goals.

Having secured a compliant Federal Reserve, President Nixon took another aggressive step on August 15, 1971, by

[1] Mallaby, Sebastian. (2016). *The Man Who Knew: The Life and Times of Alan Greenspan*. New York, NY: Penguin Press. (pp. 140-144)

enacting a wage and price freeze. On the fed funds chart, note that the policy rate was around 5.5% when the freeze was announced. The rate fell to 3.3% by February 1972, with the real fed funds rate falling to -0.2%. Monetary policy, under the guidance of a chastened Arthur Burns, had clearly become accommodative.

The price freeze announcement was accompanied by an even more monumental decision to end the Bretton Woods system, which was an arrangement of fixed dollar exchange rates. This system was created near the end of WWII to maintain the gold standard; it promised the holder of a dollar that one could swap that dollar for gold at the fixed price of $35 per ounce. The system had worked rather well during the 1950s but trade deficits with Europe rose as U.S. policy focused on perpetual full employment in the 1960s, and those nations began accumulating dollars. U.S. gold reserves, the lynchpin for the Bretton Woods system, were cascading lower.



Nixon faced a dilemma. Gold standard orthodoxy would argue that the U.S. should have embraced austerity by raising interest rates and reducing fiscal spending which would have weakened economic growth but signaled to the world that the U.S. intended to cut inflation and lift confidence in the dollar. Such actions would stem the outflow of gold by reducing imports (which are sensitive to aggregate demand) and bolstering confidence in the dollar. Foreign investors would have certainly preferred interest-bearing dollars to non-interest bearing gold. However, austerity would have almost certainly led to recession and significantly undermined Nixon's reelection chances.

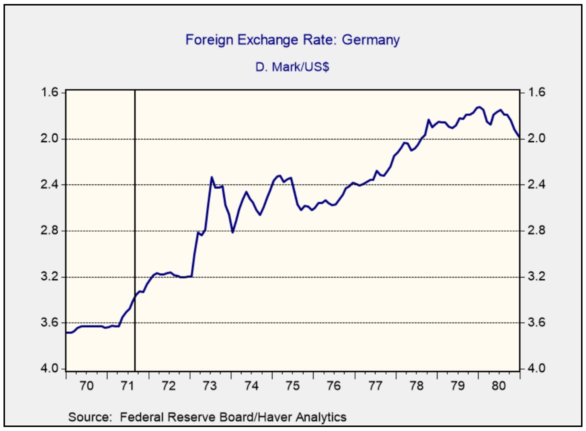
Or, Nixon could have embraced heterodoxy and continued to support economic growth by jettisoning the gold standard and Bretton Woods. Which is exactly what he did.[2] Nixon ended the policy of swapping gold for dollars (closing the gold window) and essentially allowed the dollar to float.

The importance of ending the dollar/gold link cannot be understated. As we note below, it was perhaps the most fundamental change in international finance in history. Some semblance of the gold standard had dominated international finance for over a century and gold was foundational for international finance for nearly 500 years.

What followed was perfectly logical. The dollar weakened after it began to float. Dollar weakness, Nixon import surcharges and pent up price pressures had all been masked by the price freeze; once it was lifted, price levels rose sharply.

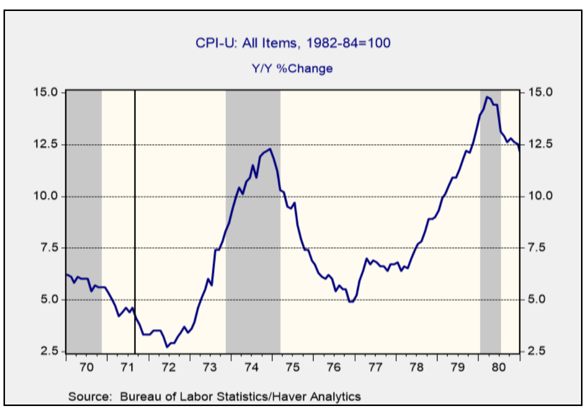
---

[2] Ibid, pp. 145-146.



This chart shows the dollar/D-mark exchange rate; the scale is inverted so the lower the number, the stronger the D-mark. From August 1971, when the gold window closed (shown as a vertical line on the chart), until early 1980, the German currency appreciated 48.9%. The Japanese yen appreciated in a similar fashion.

Inflation became a serious problem.



Nixon was reelected in November 1972, defeating the Democratic candidate, George McGovern, in a landslide. At the time of the election, inflation was 3.7%. About a year later, CPI was growing at a rate of nearly 12.5%. The price freeze and ending Bretton Woods accomplished President Nixon's goal of winning the election in 1972. However, the U.S. economy and the global financial system were set on a new path, one we doubt Nixon fully appreciated when he made these policy decisions in 1971.

The impact on international finance was unprecedented and thus unexpected. Closing the gold window was similar to debt repudiation. Under Bretton Woods, foreigners holding dollars or dollar assets were led to believe that, at last resort, they could demand gold. After the Bretton Woods system ended, foreign holders could no longer have the deal that existed before. It would be a bit like if a Eurozone nation unilaterally told its bondholders they would no longer receive euros for payment but would instead receive a new national currency. Under the gold standard, creditors would dominate when a nation had a balance of payment problem that it couldn't fix. Creditors would force the country to sell off assets or use currency depreciation to force down the prices of the debtor nation's assets and allow creditor nations to buy up important assets within the debtor nation.

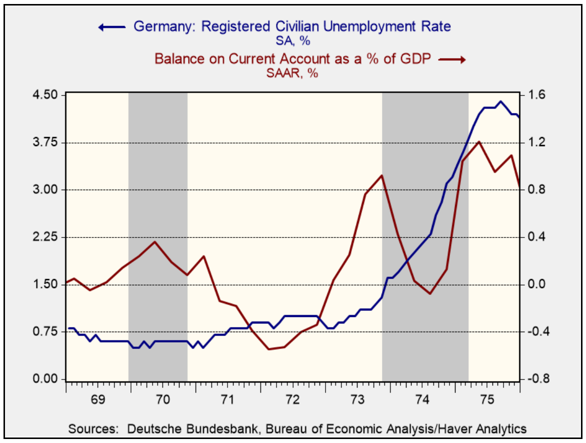
Instead, Nixon inverted the creditor/debtor relationship. By changing the international reserve system from a dollar/gold basis to a dollar/Treasury basis,[3] the U.S. government could finance budget deficits with the primary global reserve asset and essentially force foreigners to finance U.S. spending. In this process, creditor nations had lost most of their power and the U.S. increased its power, even while it increased its fiscal and current account deficits.

The international economy needs a steady infusion of the reserve currency to function. Because the dollar is that currency, as previously noted, the U.S. must run current account deficits to maintain the supply of dollars on global markets. ***By ending the Bretton Woods system, Nixon extended***

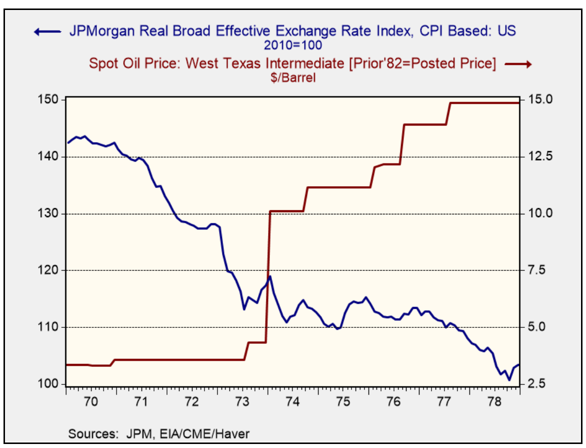
[3] Hudson, Michael. (2003). *Super Imperialism: The Economic Strategy of American Empire* (2nd ed.; 1st ed. 1972). Sterling, VA: Holt, Rinehart & Winston. (Chapter 15)

American hegemony by effectively turning Treasuries into gold. It was an impressive exercise of power.

The economic adjustment of Nixon's reflation was forced on the rest of the world. As noted above, the dollar weakened.[4] The chart below shows that as the dollar weakened, the U.S. current account deficit narrowed and German unemployment rose.



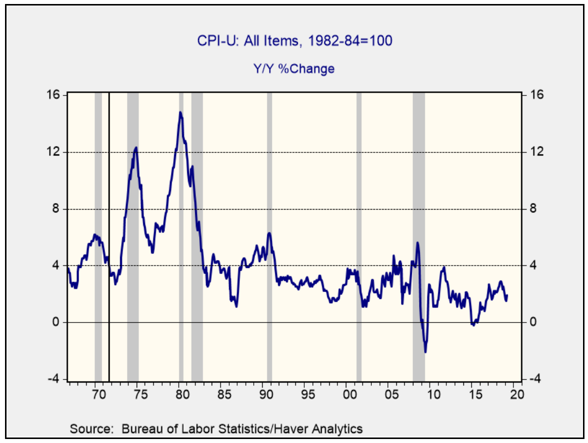
However, Nixon did not win on all fronts. OPEC retaliated against dollar depreciation by pushing oil prices higher.



Still, for the most part, Nixon was able to exercise American power to fundamentally change international finance and trade to better suit U.S. goals.

#2: The Reagan Analog

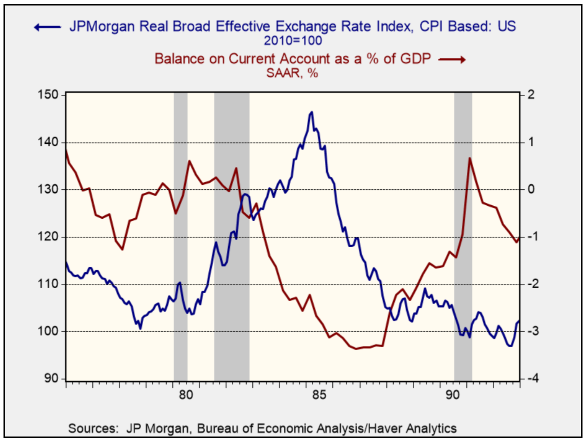
Nixon's policy changes did force much of the adjustment on foreign economies but that didn't prevent inflation from becoming a persistent problem.



As the chart shows, by the early 1980s, yearly CPI exceeded 15%. The aggregate demand management policies that had developed during the Great Depression proved incapable of addressing the inflation problem. In response, President Carter began the process of deregulating the economy to reduce supply costs and also allowed Fed Chair Paul Volcker to implement monetary austerity. Deregulation was soon coupled with globalization. Deregulation and globalization became the key elements of supply side economics, which attempted to bring inflation down by expanding supply. The program worked but it did likely cost President Carter a second term. President Reagan continued and expanded supply side policies.

An unexpected side effect of monetary austerity and supply side economics was dollar appreciation. The rise in the dollar contributed to a widening current account deficit.

[4] When foreign governments complained, Nixon's Treasury Secretary John Connelly quipped, "It's our currency but it's your problem."



Although Reagan represented a definitive shift toward relying more on markets and less on government intervention,[5] the dollar's strength was having serious negative effects on the U.S. and world economy. As the above chart shows, the U.S. current account was sliding into a deep deficit. The Mexican debt default occurred in 1982, partially caused by high U.S. interest rates but also by the dollar's strength; borrowers in Mexico and across Latin America had taken out loans in dollars and the cost of debt service rose with dollar appreciation.

In response, the Reagan administration used America's hegemonic power to force the currency adjustment upon foreign economies. The Plaza Accord in 1985 was an agreement with Germany, France, the U.K., Japan and the U.S. to work in concert to weaken the dollar. Japan engaged in expansionary fiscal and monetary policy that triggered asset booms in equities and land and led to a nasty crash in the early 1990s that the country has arguably never recovered from. Again, this is an example of the U.S. using its hegemonic power to force some of the adjustment to domestic policies upon foreign economies.

Part III

Next week, we will conclude this report by analyzing the actions of the Trump administration.

Bill O'Grady
April 29, 2019

[5] For details on the Reagan/Thatcher revolution, see: Yergin, Daniel and Stanislaw, Joseph. (1998). *The Commanding Heights: The Battle for the World Economy*. New York, NY: Simon and Schuster.

This report was prepared by Bill O'Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, SEC Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, fundamental company-specific approach. The firm's portfolio management philosophy begins by assessing risk, and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.