Weekly Geopolitical Report

By Bill O'Grady

August 9, 2021

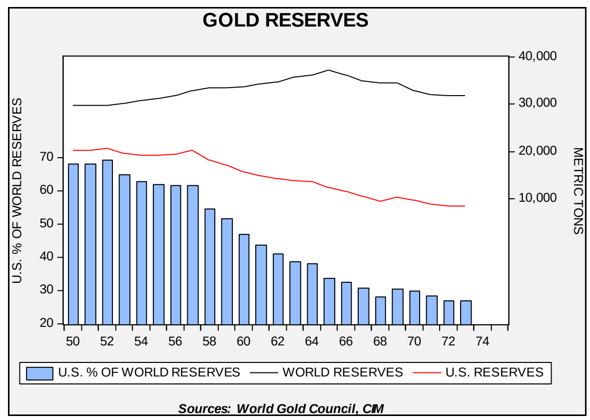
August 15, 1971

Next week, we will observe the 50th anniversary of President Nixon's decision to exit the Bretton Woods agreement. This choice was part of a broader package of policy actions designed to deal with a series of issues, including inflation, unemployment, and a balance of payments problem. As is often the case, the focus of attention from Nixon's address to the nation was probably on the announced wage and price freeze. But, his decision to end the link to gold was monumental. We have discussed this issue before,[1] but in light of the impending anniversary, it seemed right to revisit it again.

This report begins with a review of the problems Nixon faced and how he addressed them. To put the issue into context, we examine two trilemmas: 1) Robert Mundell's trilemma, which frames exchange rate, capital account, and monetary policy; and 2) Dana Rodrik's trilemma, which analyzes the relations between global economic integration, domestic politics, and the nation-state. From there, we look at the world Nixon wrought, what remains, and what is struggling to be maintained. As always, we close with market ramifications.

Nixon's Problems

In 1971, President Nixon faced reelection in November 1972. The economy had been in recession the year before, and although the recession had ended, the economy was still struggling. The year prior, CPI inflation had risen to 6.2%, the highest since the Korean War. To stem inflation, the Fed raised the fed funds rate to 9.2%, the highest in the modern era. Although the recession had officially ended, the unemployment rate remained stuck around 6%, well above the 3.7% level seen pre-recession. That was just the domestic economy; the current account had slipped into deficit and gold reserves, the backbone of the Bretton Woods system, had fallen to dangerously low levels.



In the early 1950s, the U.S. held nearly 70% of the world's gold reserves. The concern at the time was a global dollar shortage. But, as the Marshall Plan kickstarted the European recovery and Japan's reconstruction developed, foreign nations improved their trade position with the U.S. Bretton Woods allowed nations to exchange their dollars for gold at $35 per ounce and, as the above chart shows, reserves had dwindled. There was growing concern that the U.S. would not have enough gold to meet the demand. Gold trading in London began to rise above $35 per ounce as concerns increased about the U.S. commitment to Bretton Woods.

[1] See *WGRs*, "Weaponizing the Dollar: Part I (8/12/2019) and Part II (8/19/2019)."

Starting in the early 1960s, the U.S. tried several measures to shore up the gold supply. In our aforementioned WGR series (linked in the footnote on the previous page), we discussed "Operation Goldfinger," which was a plan to scour the U.S. for gold, even looking to extract the metal from seawater. In the 1960s, the U.S. issued bonds denominated in foreign currencies, called "Roosa bonds,[2]" which were bonds given in exchange to satisfy currency swaps. By issuing the bonds, the U.S. could delay providing the foreign exchange or gold. These bonds were often rolled over. But, in the end, the "Triffin dilemma" could not be overcome. This dilemma notes that if a reserve currency is issued by a specific country, it will eventually find itself facing a problem. To support global growth by issuing an ample level of the reserve currency, the issuing nation must run an ever-larger current account deficit. Large current account deficits can undermine foreigners' confidence in the currency, leading to it no longer being accepted as the reserve currency. So, the current account deficits necessary to supply the world with the reserve currency eventually undermine confidence in the currency.

In August, 50 years ago, Nixon took his closest advisors out to Camp David to discuss these concerns. Included in the meeting were Fed Chair Arthur Burns, Treasury Secretary John Connally, and the Treasury Undersecretary for International Monetary Affairs Paul Volcker. Something needed to be done or the president's reelection was in doubt. Persistent inflation argued for austerity, as did the decline in gold reserves. If the Federal Reserve raised interest rates and taxes were raised or spending cut, inflation would have declined and gold would have flowed back to the U.S. However, it was almost certain that a recession would have occurred, meaning Nixon would have probably been a one-term president. Therefore, the meeting in Maryland was called to try to figure out how to resolve these problems and preserve Nixon's reelection.

The president and his advisors met from Friday into Sunday. Nixon's plan had two key features. In an address to the nation on August 15, 1971, he announced a series of actions and proposed legislation. To address domestic inflation, he announced Executive Order 11615 implementing a 90-day wage and price freeze. A surcharge of 10% on imports was also part of the plan. A jobs act was proposed along with a series of tax adjustments. But the blockbuster announcement was the suspension of exchanging dollars for gold; Nixon had closed the gold window. Although the president described the action as "temporary," it was never reimplemented. Bretton Woods was over and exchange rates were no longer fixed.

The Problems of Trilemmas

President Nixon's primary reason for taking these steps was to ensure reelection, but he was facing not only the immediate problems of inflation and the drain on gold, but also two trilemmas. The first is known as the monetary trilemma and was formulated by Robert Mundell and Marcus Fleming. They postulated that a country can have only two of three positions and must choose between a fixed exchange rate, an independent monetary policy, or unregulated capital flows. If it has a fixed exchange rate, it either must have capital controls or give up monetary policy independence. That's because unregulated capital flows and a fixed exchange rate forces monetary policy to adjust to maintain those outcomes.

[2] Named after Robert Roosa, the Treasury Undersecretary for Monetary Affairs during the Kennedy administration.

Bretton Woods worked by fixing exchange rates and enforcing capital controls. This allowed governments to operate independent monetary policies.

However, Nixon's problem was that unlike all other governments, he had to defend a gold price. And so, in theory, the U.S. lost its policy independence. As noted earlier, Nixon could have saved Bretton Woods but only through austerity policies which would have certainly led to his defeat in 1972.

There was an additional problem. The U.S. financial system was heavily regulated. The dollars that had moved overseas were being lent at higher interest rates than what were available at American banks, which were restricted by Regulation Q. This difference created the Eurodollar market. Financial market participants were working to evade restrictions on international investing. They began moving dollars out of the U.S. to foreign banks to capture higher interest rates. American banks were noting that they were facing deposit disintermediation. As that pressure increased, maintaining Bretton Woods would become increasingly difficult.

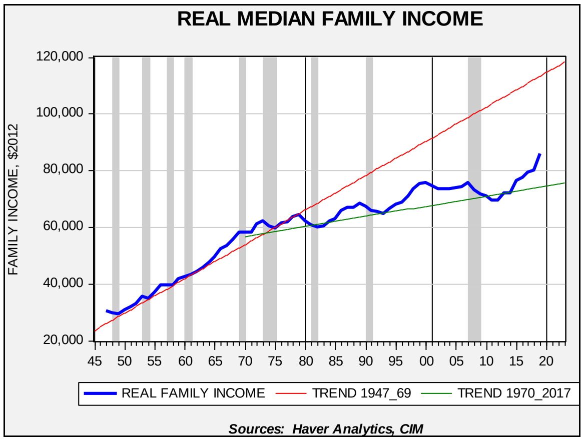
Nixon's resolution to this trilemma was floating exchange rates. Fiscal policy remained stimulative and, over time, restrictions on international capital flows were removed.

The second trilemma comes from Dana Rodrik, who postulated that there is a political trilemma for governments as well. In this trilemma, governments can choose two of the three conditions: they can be deeply integrated in the world economy, they can have democratic political systems that respond to domestic conditions, or they can continue as a nation-state. But, they can't have all three. Bretton Woods was designed to support that nation-state and domestic politics but hampered international economic integration. A nation can be integrated into the world economy and have a nation-state but must contort democratic politics to the needs of foreign capital. In this outcome, the goals of voters are subsumed to globalization. The third outcome is to jettison the nation-state; domestic politics exists within globalization. This, on a somewhat smaller scale, is the European Union.

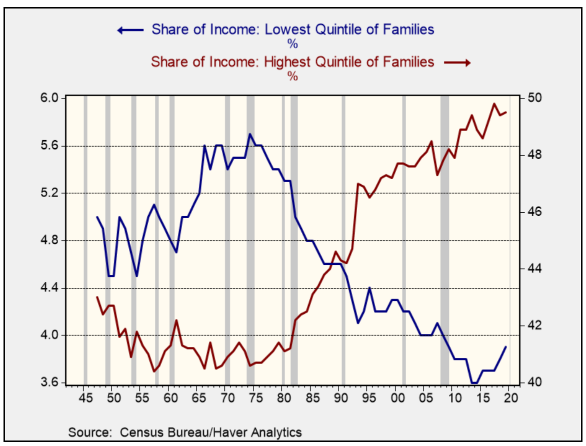
What Nixon Caused

Although Nixon didn't stay in office long enough to see how his policies solved the second resolution, the U.S. opted for deep integration into the global economy and maintained the nation-state and the cost of limits to democratic politics. This outcome occurred because the gold/dollar standard of the Bretton Woods era transformed into the Treasury/dollar standard. Foreign nations preferred to build their economies around export promotion and were willing to swap their dollars for Treasuries. Since the U.S. could make Treasuries rather easily, the constraints that gold enforced were no longer binding. Later, when some elements of the political class pushed against NAFTA or in favor of trade restrictions, their efforts mostly failed.

Globalization benefits some and harms others. For those working in import-competing industries, there were significant job losses. Since the end of Bretton Woods, we have seen a stall in the growth of median real household income.

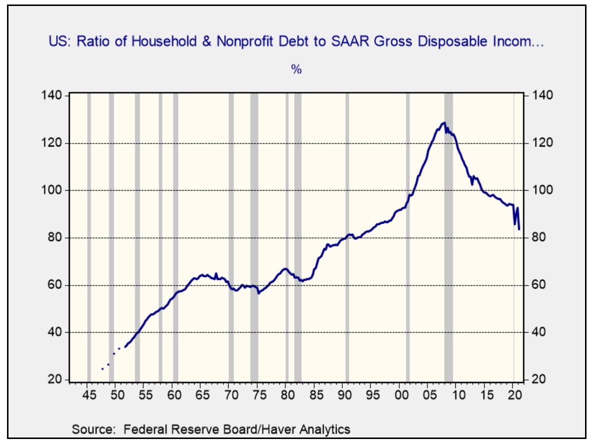


Had real median family income maintained the trend from 1947 to 1969, incomes could be $115,800. The latest data available is for 2019; in that year, real family income was 75.9% of the 1947-69 trend.



This chart shows how globalization affected income distribution. The blue line shows the share of income to the lowest quintile compared to the highest. In the early 1970s, the lowest quintile captured about 5.5% of total income, while the top quintile gathered about 40%. In 2019, the lowest captured 3.9% (up from 3.6% in 2014), while the top quintile held 49.5%.[3]

The resolution of the two trilemmas essentially led to governments adjusting policy to support globalization. Multilateral trade deals, the end of restraints on international capital flows, and outsourcing led to lower inflation but higher levels of inequality. U.S. households attempted to maintain their standard of living through borrowing, and foreign purchases of Treasuries for reserve purposes acted to keep interest rates low.



This chart shows household borrowing relative to after-tax income. During the 1980s, debt levels more than doubled, peaking in 2008 and coinciding with the Great Financial Crisis. Since then, households have deleveraged at the cost of slow economic growth. Central banks cut interest rates to spur economic activity, but it is hard to grow during periods of deleveraging. Essentially, the Great Financial Crisis signaled that the Nixon resolution was no longer sustainable.

Political developments bear this out. Populist movements on the left and right are strengthening. Our expectation for some time has been that deglobalization is likely. As voters press to regain control over economic policy, using Rodrik's trilemma, we are heading toward a political solution similar to Bretton Woods. This solution would mean less global integration and greater control over the domestic economy along with a resurgence of nationalism.

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[3] Interestingly enough, the bottom 50% gained at the expense of the three middle quintiles.

The events of August 15, 1971, highlight that sometimes political decisions made with short-term goals in mind have notable long-term consequences. We doubt that Nixon set out to completely change the global monetary system or create a world where Treasuries would replace gold. He simply wanted to contain inflation and boost employment in the short run to win reelection. And, Nixon didn't fully build out the post-Bretton Woods world. It took Reagan and Volcker to restore confidence in the dollar and solidify the dollar/Treasury reserve system.

However, the lesson to be gleaned from Nixon's action is that short-term decisions made by present-day administrations may have larger than expected outcomes. We are seeing a steady rise by voters in the West to regain control of economic policy. Simple decisions about trade policy, actions to enforce domestic regulations on foreign investment, and monetary policy designed to support growth at all costs could trigger changes to the current economic environment that were not intended.

Ramifications

In our opinion, the one variable to watch is the dollar's overall exchange rate. The dollar/Treasury standard preserved the ability of foreign governments to use export promotion to develop and grow. In fact, if Bretton Woods had been maintained, it is doubtful that export promotion would have been as successful as it has proven to be. As the U.S. rethinks its policies on global integration, nations that have relied heavily on exports could be at significant risk. China's discussion of a dual circulation economy may be in response to those concerns. Germany could be especially vulnerable and will likely respond by using the EU to maintain export growth, straining that trading bloc.

If the U.S. moves to reduce its foreign integration, the need to maintain the dollar's exchange rate will lessen. The world could be facing a situation as described by Nixon's Treasury Secretary John Connelly, who described the dollar to foreigners as "our currency but your problem."

If the U.S. embarks on a policy to deliberately weaken the dollar,[4] then gold, cryptocurrencies (to the extent they remain legal), foreign equities, and commodities should do well. At long last, inflation will likely result, meaning financial assets will generally suffer.

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[4] See *WGRs*, "Weaponizing the Dollar: The Nuclear Option, Part I (9/16/2019) and Part II (9/23/2019)."