Tremors From the Nixon "Shokku"

BY SUDHIR SEN

Sunday, August 15, 1971. It is 8 o'clock in the evening, television prime time. Suddenly the president appears on the screen, tense and unsmiling as ever, and makes a three-point announcement: The gold window will be closed, a wage-and-price freeze will be imposed, and a blanket 10 per cent surcharge will be levied on imports — all to take effect immediately. The world is stunned. Almost instantly the shock waves cross the globe. A dazed Japan cries out against what it calls — in a memorable phrase — the "Nixon *shokku.*"

History has few examples of such a blitz-like turnabout and of such blatant disregard of promises and commitments publicly made and of international obligations solemnly undertaken. The twenty-six-year-old Bretton Woods agreement was cast overboard without the least qualm; the dollar, which for all those years had enjoyed the privileges of the world's foremost reserve currency, was delinked unilaterally from gold and set afloat. A Republican president, flouting the traditional free-market credo of his own party and spurning the assurances he had given the nation repeatedly, suddenly clamped down a wage-price freeze as the first step toward an elaborate system of controls. And without any prior consultation — not even with major trading partners — he arrogated to himself the right to impose a 10 per cent across-the-board surcharge on all imports. Thus was GATT in effect gutted by a major signatory. Together these measures ushered in an era of disorder and disruptions, one that has grown worse with the passage of time and as yet has no end in sight.

The drastic actions taken by Mr. Nixon were a glaring example of overreaction, unwarranted by circumstances of the time. And hastily introduced, they were cynically used. Their primary purpose was not to cure economic ills but to serve a purely political end: reelection. This was quite evident from what transpired next.

Only weeks after putting the economy under a freeze Mr. Nixon startled the nation with the announcement that the freeze would not last beyond three months. There was no suggestion of what was to follow and no hint that he even had given it much thought. Then came the so-called Phase Two of this dreary drama — an improvised, loophole-ridden plan for wage-price controls. But this too was short lived. Later in the year, as the presidential campaign heated up, Mr. Nixon declared that, if reelected, he would lift the controls at the earliest opportunity. He thus could stake a double claim to the status of hero: first, for the courageous act of *imposing* the freeze and controls, and then, when a disillusioned public began to groan under the burden, for the equally courageous commitment to *remove* them.

He was of course playing fast and loose with a giant economy, and the nation paid a heavy price. But from Mr. Nixon's own angle, the freeze-control game plan paid off handsomely. It effectively defused the economic issue, and, coupled with Henry Kissinger's "peace is at hand" declaration on the Vietnam war, it gave him a landslide victory.

Within a few months of his reelection the apparatus of wage-price controls was dismantled. There remained, however, a conspicuous exception: Control over oil prices was retained. This ill-fated decision, made mainly in the interest of the Northeastern states so heavily dependent on imported oil, became a source of much trouble and dogged the U.S. economy remorselessly for the rest of the decade. Altogether Mr. Nixon gave a persuasive demonstration of how *not* to operate wage-price controls or regulate an industrial economy in a democratic society. By undermining the strength of a free-market economy without booking the benefits of a sound and effectively enforced system of wage-price controls, he actually made the worst of both worlds. His only achievement was to give the very idea of control or regulation a bad name, programs to be eschewed at all cost.

How desperate was the situation in 1971 that led to such drastic action? Unemployment was at 6 per cent, considered intolerably high because the "full employment" goal laid down in 1945 permitted only 4 per cent. And inflation had soared to 5 per cent annually, which alarmed and unnerved many people, including key policy-makers in Washington. If ever a remedy was worse than the disease, so it was in this case. The freeze-control-decontrol debacle along with the unhinged dollar propelled the

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rate of inflation to double-digit levels and served to halve the value of the dollar. Similarly, the jobless rate has since fluctuated in a range much above the August, 1971, level.

To be more specific, the consumer price index rose 11.3 per cent in 1979 and 13.5 per cent in 1980. The first half of '81 saw some deceleration, due largely to an oil glut and relatively stable gasoline prices. Even then the CPI rose 9.6 per cent. As for employment, the number of jobs has gone up sharply over the last decade, to about 100 million, as the economy has tried to cope with the postwar "baby crop" now entering adulthood and "liberated" women eagerly seeking office jobs. But the goal of full employment, as defined earlier, proved more elusive than ever. In the mid-1970s, during the deepest postwar recession, the jobless rate soared to a peak of over 8 per cent, dropped briefly to 5-6 per cent, and climbed back up again. In 1981 it remained rather steady at 7 per cent.

The litany of woes caused by the floating dollar is long and tragic; attempts at alleviation have been amazingly clumsy, willful, and myopic. Last year the dollar recovered some of the ground it lost against other major currencies and appreciated by 20–25 per cent against the yen and the Deutschemark. Even so, its present exchange value is only slightly more than half of what it was a decade ago. What is more, today's dollar is artificially bolstered by an oppressively high rate of interest. Until a decade ago the prime rate used to be 4-6 per cent; for most of last year it was near or above 20 per cent. Here, then, is the ultimate anomaly: The floating dollar is being defended with absurdly high interest rates, producing a devastating effect in the U.S., more so in Western Europe, and most of all on the fragile economics of the developing nations.

SWINGS AND SWAYS

The roots of the trouble go back to the early 1960s. By then it was clear to the alert observer that the U.S. dollar had become an overvalued currency, though not through any fault of its own. After World War II virtually all currencies had undergone a baptism of fire and, often prodded by the International Monetary Fund, had been devalued in varying degrees. As a result the dollar, though treated as if it were good as gold, was thrown out of alignment.

I remember some of my animated discussions with knowledgeable people in New York at the time. The case I made then was for a modest devaluation of the dollar — somewhere around 20-25 per cent in order to forestall more drastic action at a later date. The reasoning was accepted but not the conclusion. Devalue the almighty dollar? Unthinkable! The world must adjust to the dollar, whatever its value, and not the other way round. This was the prevailing sentiment then and on through the '60s.

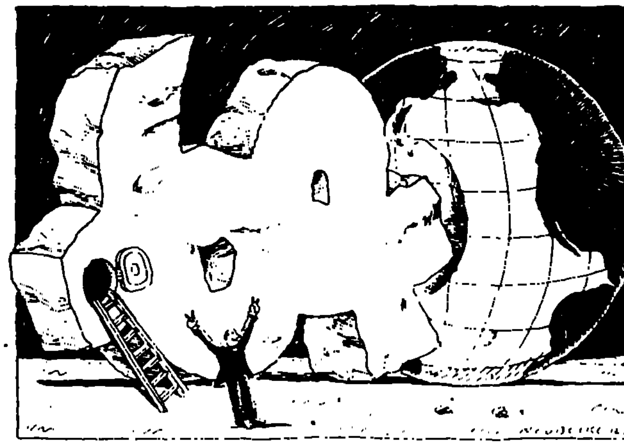
When, for example, West Germany staged an economic miracle and piled up large trade surpluses, it virtually was forced to *upvalue* its currency. A nation that was managing its economy well was penalized for good performance! However, Germany soon discovered that, contrary to text-book theories and its own earlier premonitions, the penalty was a blessing in disguise. A higher-valued national currency cheapened imports, attracted floating capital, reduced the value of dollar assets, and, on balance, helped rather than hindered the economy.

The first serious warnings about the dollar came from President De Gaulle in the mid-1960s. As the U.S. balance of payments continued heavily in deficit, he charged America with defaulting on its reserve-currency obligations, with inflating the world economy, and with making others finance the Vietnam war vicariously. The criticism was harsh but well founded. To rescue the Bretton Woods system he suggested at one stage that the official price of gold be doubled — from $35 to $70 an ounce. The U.S. refused outright to consider such a proposal on the grounds that, among other things, it would mean a bonanza for South Africa and — even more unthinkable — for the USSR. Piqued, and registering a vote of no-confidence in America's monetary management, De Gaulle decided to transfer France's gold holdings from New York to Paris.

It is odd to reflect how quickly the U.S. attitude swung from one extreme to the other. Having upheld rigidly — and glorified — the gold-backed dollar for years, it suddenly dumped the Bretton Woods charter and embraced a free-floating dollar as the essential cure for economic ills. Anxious leaders of the industrial nations met with Mr. Nixon at a hastily convened meeting in Washington to work out some formula to hold currency fluctuations within a reasonably narrow band. The outcome was the so-called Smithsonian agreement. It was greeted with a sigh of relief; hopes ran high that, thanks to the joint action contemplated, the floating exchange rates would not behave too erratically. But that agreement too was jettisoned before long. It now became abundantly clear that the United States was determined to manage its own currency *unilaterally* to suit its own needs, real or fancied.

This attitude hardened further in the waning days of 1973 when, spearheaded by the shah of Iran, the price of oil was quadrupled and the world began to be flooded with petrodollars. A glibly propagated thesis is that only a floating dollar could have coped with that flood, that the OPEC blow would, in any case, have ended the golden era of Bretton Woods. Plausible as it may sound, it is in effect an ex post facto rationalization of events.

It is now established as fact that the shah of Iran, in rocketing the oil price, acted neither abruptly nor single-handedly but with the blessings of President Nixon and Henry Kissinger, his high-powered emissary. Their overriding concern was to build Iran into a military bastion in order to "protect the oil fields" from the USSR, and therefore to equip the shah lavishly with sophisticated weapons financed with his fast-rising oil revenues. The floating dollar provided a golden opportunity; under the old monetary order they would never have dared such a disruptive move. Moreover, the eroding dollar gave the shah and OPEC at least the semblance of justifica-


Robert Neubecker

tion for hiking the oil price in stages to protect the purchasing power of the dollars they obtained for a barrel of oil.

It should not have been beyond the wit of the leaders of the industrial West to design an effective plan to deal with OPEC surpluses while moderating exchange rate fluctuations. This was the primary objective of the first Economic Summit that met at Rambouillet, France, in 1974. But the lure of billions of petrodollars was too strong for U.S. banks to resist. They were bent on handling them within the "free-market" system and were, accordingly, given a free hand.

Finally, the floating dollar, coupled with the mountain of liquid funds — mostly Eurodollars — opened up a vast paradise for speculators, who, in this case, embraced above all multinational banks and mammoth corporations. Sophisticated departments equipped with computers and manned by highly paid currency experts were set up to monitor the exchange markets and to carry out operations on an unprecedented scale. Soon some had an overwhelming stake in the new international monetary *disorder*; and speculators periodically have set up waves of buying and selling dollars and other currencies, convulsing the world money markets.

FLUCTUATING ATTITUDES

Meanwhile, the official attitude toward the fluctuating dollar has itself undergone some curious fluctuations. John B. Connally, while serving as Treasury secretary in the Nixon administration, bluntly told the Western allies that maintaining the dollar's value was *their* business, not the U.S.'s. His successor, George P. Schultz, openly stated at one stage that he wanted the dollar to depreciate even more in order to help U.S. exports. There was also a phase of "benign neglect," when the dollar seemed to slide steadily without finding a bottom; the head of the Swiss Central Bank charged angrily that the neglect was "malignant." W. Michael Blumenthal, as Treasury secretary in the Carter administration, publicly expressed his elation as the yen appreciated against the dollar and thereby triggered a new wave of dollar-dumping. He was counting on a cheaper dollar to stem the tide of imports from Japan, to stimulate U.S. exports, and to improve the balance of trade, thereby helping to pay the swelling oil-import bill.

It was not until the Carter administration was almost halfway through its term that it realized the damage a weak dollar was doing to the nation's economy — how the sinking dollar had become an engine of inflation. Then came a series of jolts, or "Carter *shokku*," in November, 1978, July and October, 1979, and March, 1980, respectively. All of them brought hikes in the discount rate and a tightening of the monetary screw; all aimed at protecting the dollar. But the problem already was too intractable to be subdued by such measures.

Those who cheerfully wrote the epitaph to the Bretton Woods system would do well to ponder the remarks made by President Lyndon Johnson in 1968 at the annual meeting of the IMF and the World Bank, just three years prior to the Nixon coup.

> The institutions that we created at Bretton Woods and the cooperation we built on these institutions led to the highest sustained rate of growth in the history of the world. Total world income today is \$2.5 trillion.
>
> So by working together — in monetary policy, in economic policy, in development policy — we can realistically hope to increase world output by 5 per cent a year over the next decade. This is what we averaged over the past six years.
>
> If we fail to strengthen our international financial institutions — if we stand still or if we falter in our effort to encourage economic development among the poor nations — total world income will grow by far less.

Despite all the boastful claims for the floating dollar, there is growing nostalgia for the good old days. A seventeen-member Federal Gold Commission is now studying the whole question; owing to inordinate delays in setting up the commission and its slow-motion progress, the deadline for submitting the report to the Congress has been extended from October 7, 1981, to next spring. The "supply-siders" are advocating openly, some even clamorously, an early restoration of a gold link for the dollar. Mr. Reagan too leans — with a vague yet strong yearning — in the same direction. Thus it seems that the U.S. is coming almost full circle ideologically after ten years of aimless wandering.

Repairing the damage will not be easy, however. Moreover, the portents at the moment are far from reassuring, largely because of some formidable roadblocks that Ronald Reagan has, almost thoughtlessly, set up for himself — by slashing individual taxes at the wrong time, by pushing budget deficits skyhigh, by shackling the Federal Reserve with monetarism, by banning the Fed's intervention in currency markets in support of the dollar except in grave emergencies, by insisting on a big leap in military spending, and by keeping the interest rates far too high for much too long. The stage has been well set indeed for future turbulence. And not too far down the road one can confidently predict some convulsive "Reagan *shokku*." |WV|