The Australian

America takes us back to the seventies

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FORTY years ago, on May 10, 1971, Germany allowed the Deutschmark to float, precipitating the end of the international monetary arrangements reached at Bretton Woods in 1944.

Exactly 10 years later, US interest rates rose to more than 20 per cent, as Federal Reserve chairman Paul Volcker started the wrenching process of bringing inflation, then approaching 14 per cent, under control.

With China and the US at loggerheads over exchange rate policy, those anniversaries are as rich in contemporary significance as they are important in themselves. Bretton Woods collapsed because there were no constraints on US monetary expansion.

That the US could shift the costs of that expansion on to the rest of the world made American recklessness a global problem. And because the adjustment was so long deferred, its costs were ultimately punitive.

Exchange rates in the Bretton Woods system were fixed relative to the US dollar, which was itself convertible into gold at a fixed price of $US35 an ounce. Initially set in 1946, a general adjustment in rates was forced by the sterling crisis of 1949. There followed a long period of relatively stable exchange rates, lasting until 1967.

But that stability masked mounting tensions. When the system began, the great fear was of a "dollar shortage", but rapid recovery in Europe's exports and burgeoning US foreign investment swelled European dollar holdings. In early 1960, American monetary liabilities to foreigners overtook US gold reserves, suggesting an increase in the gold price was inevitable and so unleashing, in October of that year, the first major speculative attack on the greenback.

The Kennedy administration, however, had other priorities. With harvest failures forcing the Soviet Union to sell gold, pressures on the gold price eased, but the underlying problems remained. 1965 proved the turning point, as Lyndon Johnson struggled to finance both escalation in Vietnam and the "great society". As expansionary monetary policy drove official interest rates below the level consistent with price stability, US inflation expectations, which had fluctuated around 1 per cent, climbed towards 5 per cent, increasing doubts about prevailing exchange rates.

Johnson sought to convince the Europeans to bear a higher share of the costs of the US security shield, including by not converting their holdings of dollars into gold while the conflict in Vietnam persisted.

But Charles de Gaulle, who had balanced the budget, extricated France from Algeria and slashed public debt, scorned Johnson's approach and castigated Bretton Woods for allowing the US to pursue economic policies that were "abusive and dangerous".

The dollar's role as the only real reserve currency, which central banks had little choice but to hold, was an "exorbitant privilege", which removed any constraint on American monetary expansion.

Cold War Germany, however, had little choice but to be a more pliant ally, and in 1967 initiated a long pattern of accommodation by agreeing not to convert its mounting dollar holdings into gold. With Germany's acquiescence bringing some relief, the Fed instigated a half-hearted tightening, but it was insufficient to bring US inflation under control and hence ease the long-run pressures on the dollar.

This did not unduly concern Richard Nixon, whose treasury secretary, James Connolly, told a worried delegation of Europeans that as far as the administration was concerned, the dollar "is our currency, but your problem".

Rather, with re-election in mind, Nixon urged the Fed's new chairman, Arthur Burns, to "err towards inflation", which is exactly what he did. The resulting monetary expansion weakened the dollar, but the American position remained that it was primarily up to the Germans to revalue.

Unsurprisingly, the Germans regarded this as yet another attempt to shift on to their exporters the costs of the symptoms while failing to tackle any of the causes. Faced with rising speculative inflows, on May 10, 1971 the Germans, along with the Dutch (whose currency was tied to the Deutschmark), finally pulled the plug.

Mean-minded at the best of times, closed-minded when things were going badly, Nixon determined to teach the Europeans a lesson. On July 15, 1971, Washington and Beijing dramatically revealed the secret Kissinger-Zhou talks. With China's re-entry on to the world stage giving him the political cover he needed, exactly four weeks later, on August 15, 1971, Nixon administered the "Nixon shock", suspending the convertibility of the dollar into gold, imposing a 10 per cent import surcharge, and freezing US wages and prices.

A hastily convened international conference tried to put the pieces back together again. But it too did little more than buy time, during which unabated US monetary expansion helped feed a worldwide price surge that ultimately caused the oil price shocks of 1973 and 1979.

Faced with those shocks, Gerald Ford and then Jimmy Carter made muddled attempts to control inflation, but lacked the courage to bear the costs curbing 15 years of inflation expectations entailed.

Yet again, it was far easier to blame foreigners, going from malicious Arab sheiks to intransigent Germans and xenophobic Japanese.

It was Ronald Reagan who made the difference. Though no paragon of fiscal rectitude, he understood the risks of accelerating inflation and provided Volcker with the support the Fed needed to put the clamps on the money supply. Despite vocal scepticism from such eminent Keynesians as Paul Samuelson and James Tobin, the result was the beginning of a return to price stability.

Forty years after the collapse of Bretton Woods, all this appears extraordinarily distant. At least in the advanced economies, floating exchange rates, the removal of capital controls and central bank independence have reshaped the monetary system for the better.

Yet the fundamentals of US economic policy, with ever-growing budget deficits and "quantitative easing" that has flooded the world with dollars, seem little sounder now than they were then. The "exorbitant privilege" remains, though in altered form.

And then as now, it is all too easy for the US to blame rising foreign economies, in this case China, for its woes, rather than tackle their root causes.

No doubt, China's economy is deeply flawed, not least because of a distorted exchange rate.

And just as the US would benefit from dealing with its problems, so removing those distortions would be in China's interests. But it would not necessarily be in the immediate interests of China's rulers; and unlike the Germany of the 1960s, those rulers are no more inclined to buckle to American pressure now than they were when Nixon went to China.

The risk, therefore, is of stresses compounding, as the flaws in China's political economy aggravate those of a US still unwilling to live within its means.

As that happens, the tumultuous years leading to the collapse of Bretton Woods may come to seem like a haven of tranquillity.

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