Goldmoney Insights® Special Edition

The Golden Revolution, Revisited: Chapter 6

This Insight is the ninth in the serial publication of the new, *Revisited* edition of my book, *The Golden Revolution* (John Wiley and Sons, 2012). (The first instalment can be found here.) The book is being published by Goldmoney and will also appear as a special series of Goldmoney Insights over the coming months. This instalment comprises the first chapter of Section II.

The Window Closes

"In the past seven years, there has been an average of one international monetary crisis every year. Now who gains from these crises? Not the workingman; not the investor; not the real producers of wealth. The gainers are the international money speculators. Because they thrive on crises, they help to create them."

PRESIDENT RICHARD M. NIXON, AUGUST 15, 1971, SPEECH
ANNOUNCING SUSPENSION THE DOLLAR'S GOLD CONVERTIBILITY

Treasury Secretary Connally was on vacation in Texas at the beginning of August 1971 when Treasury Undersecretary Paul Volcker requested his urgent return to Washington. A major global monetary crisis had been brewing for months, as one country after another sought to exchange some portion of its dollar reserves for gold, as was allowed under the Bretton Woods system of fixed exchange rates that had been

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in place since 1944. By July 1971, the US gold reserve had fallen sharply, to under $10 billion, and at the rate things were going, it would be exhausted in months.

Secretary Connally coordinated economic, trade, and currency policy. Nixon thus tasked him with organizing an emergency weekend meeting of his various economic and domestic policy advisers. At 2:30 p.m. on August 13, they gathered in secret at Camp David to decide how to respond to the incipient run on the dollar.

With the various attendees seated in the President's Lounge of Aspen Cabin, the president initiated the proceedings with a request that Volcker provide an update on recent events. The air of crisis grew thick as Volcker reported one country after another requesting to exchange dollar reserves for gold. Indeed, that very morning, the British had placed a request to exchange $3 billion in dollar reserves for gold. Something had to be done. Fast.

It quickly became clear that nearly all participants, including both Connally and Volcker, were in favor of suspending gold convertibility and floating the dollar versus other currencies. The primary dissenter was Arthur Burns, chairman of the Federal Reserve, who felt that almost any other action was preferable to abandoning the venerable gold standard that had provided the monetary foundation for more than a century of astonishing global economic development, including, of course, that of the United States. He also felt that suspending convertibility would send an obvious signal of US economic weakness around the world, although, of course, this was precisely why there was an accelerating run on the dollar in the first place.

Rather, Burns favored dramatic policy action on the domestic front to restore global confidence in the dollar, including sharply higher interest rates if necessary. But everyone in the room knew that, were interest rates to spike higher, this would most probably cause a sharp recession, implying that Nixon was unlikely to be reelected the following year. [1]

In a final, desperate appeal to the emotions of those in the room who appeared to already have made up their minds, Burns suggested that "Pravda will headline this as a sign of the collapse of capitalism." Yet his objections, however passionate, were overruled by the other participants. The next day, notwithstanding a further consultation with Burns, the president made his decision to close the gold window, effectively ending the Bretton Woods era of fixed exchange rates by executive order.

1 Burns's specific recommendations at Camp David may have been rejected, but the key aspects of his plan to restore confidence in the dollar, including sharply higher interest rates, anticipated the series of steps that future Fed Chairman Paul Volcker would take in 1979–1981, when another run on the dollar ensued.

On Monday, he announced the end of dollar convertibility as one of several bold measures—collectively termed the Nixon Shock—intended to shore up a deteriorating US economy. In doing so, he blamed the "international money speculators" for causing the series of monetary crises and claimed that, by suspending convertibility, the speculators would be "defeated."[2]

Contemporary observers of the time and historians to this day consider this speech to have been a major political success. Not only did it create the impression that the president was in charge of the situation but also it created a villain that no American could help but love to hate: the international money speculator. But as with so many political speeches, it had little in common with the truth, as we shall see.

"EXORBITANT PRIVILEGE": THE REAL REASON WHY BRETTON WOODS COLLAPSED

The dollar has been a floating, fiat currency ever since Nixon's August 15 executive order closing the gold window. But while Nixon chose to blame speculators for the gold-backed dollar's demise, the truth is rather different. Bretton Woods did not collapse because of speculation—after all, it was foreign governments, not only speculators, that were draining the US gold reserve—but because of unsustainable US monetary and fiscal policies that had been in place since the early 1960s.

Beginning in 1961, Jacques Rueff, French economist and informal policy adviser to President Charles de Gaulle, published a series of papers predicting that a steadily deteriorating US balance of payments position would eventually lead to a collapse of the Bretton Woods system of gold convertibility and fixed exchange rates to the dollar. As such, he recommended that the system be converted back into something more along the lines of the classical gold standard, in operation from 1880 to 1914, under which balance of payments deficits between countries were regularly settled in gold itself, rather than in the currency of any one country in particular.[3]

As Rueff explained it, the rapidly growing, export-oriented European economy of the late 1950s and early 1960s was accumulating dollar reserves at a rate that would invariably cause economically destabilizing money and credit growth, leading to inflation. The solution to this situation under the classical gold standard would have been straightforward: countries running chronic trade surpluses would steadily

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2 This account of the events immediately preceding Nixon's infamous suspension of convertibility on August 15, 1971, is provided with permission by Joanne Gowa, author of *Closing the Gold Window* (Ithaca, NY: Cornell University Press, 1983).

3 Jacques Rueff compiled his essays into two major books on the topic of Bretton Woods: *The Age of Inflation* (1964) and *The Monetary Sin of the West* (1972).

accumulate foreign currency, which they would then periodically exchange for gold, thereby maintaining stable exchange rates and limiting domestic money and credit growth. Countries running chronic trade deficits, however, would have to provide the gold. In the event that gold reserves ran low, a country would be forced to raise interest rates to stem the outflow. By increasing the domestic savings rate and weakening domestic demand, the trade balance would swing from deficit into surplus, and, in time, the gold reserve would be replenished.

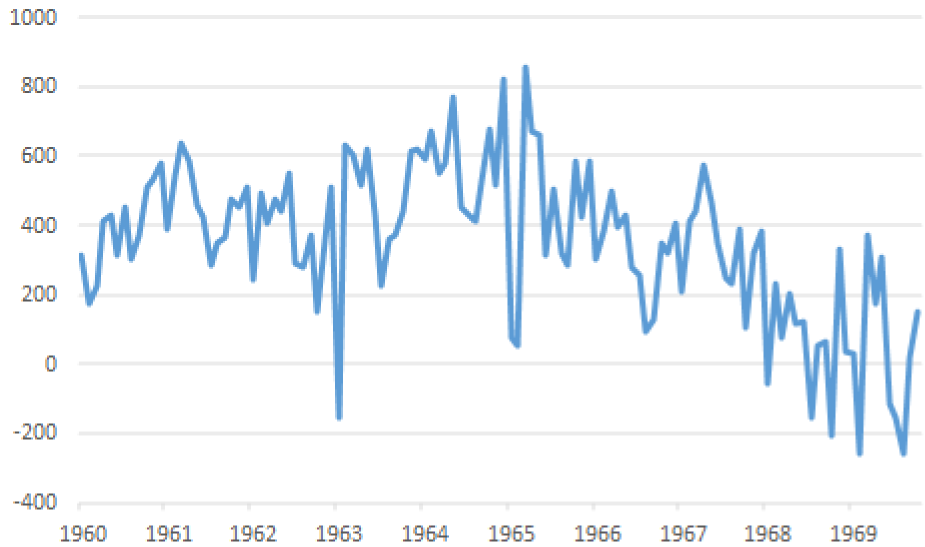
Under Bretton Woods, however, the balance of payments was not regularly settled in gold but rather in dollars. This allowed the United States, in theory, to create as many dollars as required to purchase as many imports as desired, as these would be absorbed by the central banks of the exporting nations as reserves. As exchange rates were fixed, countries did not have the option of allowing their currencies to rise versus the dollar as a way to slow or reduce the growth of dollar reserves. Reserves would thus grow indefinitely. For the United States, this was akin to being given an unlimited line of credit by its trading partners.

French Finance Minister (and, later, president) Valéry Giscard d'Estaing famously described this theoretical ability to print unlimited dollars for unlimited imports as an "exorbitant privilege." Of course, just because one has such a privilege does not mean that one will abuse it, but beginning in the 1960s, the US began to do just that. Among other things, in the early 1960s, the US:

- was in process of building the interstate highway system, the world's largest construction project in history to that time
- entered and subsequently escalated a war in Southeast Asia, fought primarily in Vietnam
- dramatically increased domestic social welfare spending as part of President Lyndon Johnson's "Great Society" programs

Although perhaps not so egregious by the modern standards of US government budget deficits, taken together these "guns and butter" projects led to a massive increase in the federal budget, which, in turn, stimulated global economic activity generally and contributed to a large swing in the US external trade position from surplus to deficit.

Figure 6.1 The US merchandise trade balance in the 1960s



Source: Federal Reserve.

As a direct result, dollar reserve balances around the world began to grow at an accelerating rate. Giscard d'Estaing was only one of many European government officials who expressed a sense of unfairness regarding the Bretton Woods system, not only in theory but also, increasingly, in practice. Indeed, even de Gaulle himself weighed in on the matter in a press conference in early February 1965 in which he stated that, "Any workable and acceptable international monetary system must not bear the stamp or control of any one country in particular."[4]

De Gaulle then pointed out that the only standard that fits this description is that of gold, which "has no nationality" and which, of course, has historically been regarded as the pre-eminent global currency. With the dropping of this bombshell, the formal European assault on Bretton Woods began. As Time magazine noted, "Perhaps never before had a chief of state launched such an open assault on the monetary power of a friendly nation."[5]

This article was written more than six years prior to the proximate crisis that led Nixon to close the gold window. It is obvious that speculators were not behind d'Estaing's or de Gaulle's comments. Nor were they behind the following actions, as detailed in the same Time article:

4 As quoted in, "Money: De Gaulle v. the Dollar," *Time*, February 12, 1965.
5 "Money: De Gaulle v. the Dollar," *Time*, February 12, 1965.

- France converted $150 million into gold in January 1965 and announced plans for convert another $150 million.
- Although done quietly, rather than to the fanfare coming from France, Spain exchanged $60 million of its dollar reserves for gold.[6]

President Johnson responded to the accelerating drain of the US gold reserve by easing the requirement that the Federal Reserve System hold a 25 percent gold backing for dollar deposits. While this no doubt bought some time, the die had been cast. Following de Gaulle's opening barrage, the demise of Bretton Woods and of the gold-backed dollar was probably inevitable. Perhaps, had US politicians been willing or able to make some tough fiscal choices in the late 1960s, things might have been different. But Johnson, Nixon, and the dictates of domestic US political expediency determined otherwise. In the end, as Nixon himself put it, it would take seven years and seven crises to finally sever of the gold-dollar link.

It is an interesting historical curiosity that, notwithstanding Rueff's prescience and de Gaulle's pontification, it was, in fact, West Germany that de facto torpedoed Bretton Woods with a decision to allow the mark to float on May 11, 1971 (although it should be noted that this was done in consultation with France and other European Community member nations). In doing so, West Germany signaled in no uncertain terms to all countries around the world that the mark would henceforth be an alternative to the dollar as a reserve currency, and one with a highly competitive, rapidly growing economy behind it. The "gold-laden truckloads" as also noted in the Time article above had been rolling for years. But it was not speculators at the wheel in summer 1971; rather, European governments had finally lost patience with inflationary, unsustainable US fiscal and monetary policies and were voting with their vast reserves of accumulated dollars, and with their gold.

CLOSING THE GOLD WINDOW AS AN EXAMPLE OF INTERNATIONAL MONETARY REGIME CHANGE

One theme of this book that reappears from time to time is monetary regime change, an important part of the monetary cycle of history described in the Introduction. Nixon's closing of the gold window is an example of regime change. The dollar remained the world's reserve currency, but convertibility to gold was suspended. The definition of the dollar changed.

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In this case, regime change became necessary because US domestic political objectives came into conflict with its international obligations under the Bretton-Woods arrangements. The United States was unwilling to implement the more restrictive fiscal and monetary policies that would be required to stem the outflow of gold. Arthur Burns strongly preferred that course of action, believing it was in the long-term US interest to maintain convertibility, but he was quite clearly outnumbered by Nixon's other advisers.

In her classic study on this episode, Closing the Gold Window, economic historian Joanne Gowa traces the origins of the debate that occurred and decisions that were taken in August 1971 at Camp David. What she finds is that there was a clear, long-held bias within the Nixon administration favoring domestic economic freedom of action over any international monetary constraints. When the two came into conflict, as they did when the gold reserves neared exhaustion, the former naturally won out over the latter.

As she explains in her book:

[T]he single most important factor explaining the breakdown of Bretton Woods was the…nationalist outlook on the appropriate relationship between the United States and the international monetary system…As a consequence, the monetary system would be supported only as long as it did not infringe more than marginally on US autonomy.

That the two did not collide irreconcilably before 1971 was a result partly of the noninflationary course US domestic macroeconomic policy adhered to until the mid-1960s, partly of the vigorous demand for dollars abroad in the early years of the Bretton Woods system, and partly of the more recent series of ad hoc arrangements concluded between the United States and other governments to insulate the monetary system from the effects of a long series of US payments deficits.[7]

In other words, the Bretton Woods regime was doomed to fail, as it was not compatible with domestic US economic policy objectives which, from the mid-1960s onward, were increasingly inflationary. There is a clear parallel with today. The dollar remains the preeminent global reserve currency. The United States is also once again following highly inflationary policies in an attempt to support the domestic economy following a massive, housing-related credit bust. Meanwhile, in recent years, numerous economies, including the BRICS (Brazil, Russia, India, China, South Africa), have

7 Joanne Gowa, *Closing the Gold Window* (Ithaca, NY: Cornell University Press, 1971), p. 103–107.

experienced relatively high rates of domestic price inflation as a direct consequence of US economic policy, shifting their incentives away from a further accumulation of dollar reserves.

As in the late 1960s, US domestic economic objectives are taking precedence over global monetary arrangements, that is, the dollar's position as the preeminent reserve currency. It is only a matter of time before either US policy must change or, alternatively, other countries must act to reduce their accumulated, inflationary US dollar holdings. Today's regime has thus become unstable, although the monetary shoe is on the other foot this time around. It is other countries' domestic policy objectives—in particular their desire to maintain domestic economic and financial stability and contain inflation—that are in conflict with the current global monetary regime.