The economic troubles of Richard Nixon and Donald Trump (first part)

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Beyond their political party affiliation, Richard Nixon and Donald Trump are alike in more than one sense. Both have a tendency to make controversial and even false statements, engage in not-so-friendly talks with the media, racist comments, sexist comments aimed at Hilary Clinton, among others. Nixon is perhaps best known today for the infamous Watergate scandal, whereas Trump has already shown signs of starring his own Russiagate. The list could go on.

More importantly than personality traits, two other similarities between Nixon and Trump that stand out are of an economic nature. The first is the straightforward observation that their election was preceded by a dollar overvaluation. The second is that at least one key policymaker during their term is a Democrat (John Connally in the Nixon administration, Janet Yellen in Trump's).

In this note we focus on the first of these two similarities, and leave the second for next week.

Nixon, the end of Bretton Woods and dollar devaluation

Richard Nixon took office in January 1969, a period when the so-called Bretton Woods system of fixed (nominal) exchange rates was in place. The set of rules agreed upon at BW in July 1944 were followed by virtually all Western countries until mid-August 1971, when Nixon called it off.

During the BW negotiations two plans were proposed. The English and the Americans took the lead in the talks, represented by their two main economists. On the American side Harry Dexter White designed a plan in which his country's currency (which was pegged to gold) was key in the functioning of the system. On the British side John Maynard Keynes designed a plan in which the key currency would be the 'bancor' ('bank gold' in French), which resembles modern day Special Drawing Rights.

Since most aspects of the White plan prevailed over those of the Keynes plan (which for many was a better alternative), the dollar was the centerpiece of the new monetary order. Overall from the mid-forties up to the late fifties the system seemed to work well, despite some relatively minor instances in which some balance of payments imbalances were manifest.

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However, during the decade of the 1960s the economic authorities of the United States somehow began to feel discomfort of the system they had conceived. One of the most compelling arguments of the inconveniences of BW is that advanced by Robert Triffin, therefore called the Triffin dilemma. His logic is that the BW system provoked an excessive demand for dollars outside of the United States, which provoked a dollar appreciation and, as a consequence, a loss of competitiveness. This in turn led to continuous trade deficits that eventually weighted on national production.

In reaction to these long term trends, Nixon gathered a group of collaborators[1] (most of them with a background in economics) at Camp David in early August, and confidentially discussed with them the options available to tackle the balance of payments problem. The least unattractive option was to impose a unilateral suspension of gold-dollar convertibility, which led to the end of the BW system. This was announced on national television on a Sunday after the meeting took place.

With the end of gold convertibility in the third quarter of 1971 the dollar was finally able to devalue, thus solving the competitiveness problem in the U.S. (at least temporarily). In order to avoid a strong burst in inflation, the Secretary of the Treasury John Connally proposed price controls and an import surcharge. Nixon agreed[2] and this was effectively done until 1973, when price controls expired.

During these tumultuous times (late 1971 to early 1973), intense negotiations took place among finance ministers in order to agree on the new exchange rate parities. When price controls came to an end, the dollar devaluation accelerated. With this accelerated dollar depreciation oil exporting countries (whose prices were set in dollars) suffered important losses. They soon retaliated with a major oil embargo that led to the energy crisis.

Trump, the end of the Great Moderation and dollar devaluation

The why and how of the economic conditions of 1970s decade are still a matter of intense debate among economists, but this is a subject that deserves a note of its own. For the purposes of the present note, it suffices to say that following the second oil shock, the Federal Reserve took a strong lead to successfully 'slay the inflationary dragon' (this is in part discussed in a previous note).

Once inflation had come under the control of central banks, a new era of inflation targeting and 'non-accelerating inflation rates of unemployment' (NAIRU) began. This era is commonly known as the Great Moderation.

Two of the main policymakers that have worked long and hard to keep inflation in check are former Federal Reserve chairmen Paul Volcker and Alan Greenspan. Their legacy is no doubt

[1]The list includes, among others, John Connally (Treasury secretary), Paul Volcker (then undersecretary of the Treasury), Arthur Burns (chairman of the Fed), George Schultz (director of the Office of Management and budget), Paul McCracken and Herbert Stein (president and member, respectively, of the Council of Economic Advisers), and others.

[2]For more details on this see Irwin (2013).

the low inflation/low growth environment in which several Western economies now live. Their hawkishness has been a key in the deflation-prone regime that Ben Bernanke and Janet Yellen took over in 2006 and 2014, respectively.

This rather long period is characterized by moderate inflation, restricted government spending (at least as compared to the pre-1980 years), low economic growth, an overvalued dollar, outsourcing to cheap labor countries, increasing use of machines and artificial intelligence replacing workers, and heavier debt loads.

This is the 'mess' Donald Trump claims to have inherited. However, contrary to what he suggests, such mess has a long term explanation whose origins can be traced back to policy decisions carried out by the Reagan administration (with whom he likes being compared).

Perhaps the most natural and clearly intuitive solution to the problems of our day is to reverse the trend by pursuing policy in the opposite direction (that is, aiming for a weaker dollar). The Trump administration is already taking steps in the direction of reflation (which will eventually lead to a dollar devaluation), although the basis for this slow-motion recovery were set a few years back by the Obama administration.

What is clear is that reflation is underway, and that this may have some positive effects, particularly so if this evolution implies a dollar devaluation that tends to revert the current account deficit problem in the United States.

However, not everything is so rosy, for we must bear in mind that sudden changes in the direction of policy-making in the past have been accompanied by other important changes in the rest of the world. This was the case when Nixon suspended gold convertibility. This may also be the case under the Trump administration. We know the consequences of the Nixon shock, but those of a Trump shock are still unknown.

References

Irwin (2013) *The Nixon shock after forty years: the import surcharge revisited* in World Trade Review.