Economics focus | Tricky Dick and the dollar

Does Richard Nixon have anything to teach Barack Obama about economic diplomacy?

THE "Nixon shock" is not the name given to President Richard Nixon's resignation in 1974 amid the Watergate scandal, his bombing of Cambodia during the Vietnam war or his audacious visit to communist China. It refers instead to a bundle of economic policies unveiled to an unsuspecting world on August 15th 1971. The president imposed a freeze on wages and prices for 90 days to break inflation, ended the convertibility of dollars into gold, and slapped a "surcharge" or tariff of 10% on imports.

Nixon is not usually a source of inspiration for left-leaning pundits such as Paul Krugman of the *New York Times*. But like 130 congressmen, who this month signed a letter to Timothy Geithner, America's treasury secretary, he is calling on the White House to emulate Nixon and impose a "surcharge" on imports from China. The tariff is supposed to force China to strengthen its currency, the yuan, against the dollar, just as Nixon's surcharge prompted America's trading partners to renegotiate their exchange rates four months later.

Mr Krugman argues that China's weak yuan is costing America roughly 1.4m jobs. Its cheap currency gives its exporters an edge in the American marketplace. China then squirrels its dollar earnings away in American securities rather than spending them on American goods. In normal circumstances these asset purchases would lower interest rates, boosting American borrowing and spending. But America, like other rich countries, is now caught in a "liquidity trap". Interest rates are as low as they can go. By saving dollars rather than spending them, China is draining demand from the world economy.

China's foreign-exchange reserves now total $2.4 trillion, of which about 70% are thought to be in dollars. In 1971 the central banks of America's trading partners had amassed a rather smaller hoard, of about $40 billion. But that was enough to buy the gold in Fort Knox three times over, if America upheld its commitment to sell the metal at $35 an ounce. Britain's request to exchange dollars for gold on August 13th 1971 was the last straw. "Although the US government attached no great importance to the gold as such, a run on this gold would have been a sorry spectacle," wrote George Shultz and Kenneth Dam, two prominent economic officials in the Nixon administration, in their book "Economic Policy Beyond the Headlines". On August 15th Nixon, in effect, announced that America was now unwilling to do what it would soon be incapable of doing—converting dollars into gold at the agreed exchange rate.

Messrs Shultz and Dam argue that the import surcharge was intended as "an attention-getter and a bargaining chip". It allowed John Connally, Nixon's treasury secretary and a Texan, to stride down the corridors of international finance "with both guns blazing". In the face of this bravado America's trading partners duly backed down. By December they agreed to let the dollar fall (by a trade-weighted average of 6.5%) and the surcharge was removed. Nixon was able to present the humbling of the dollar as a political victory. But were Barack Obama to emulate him, would he really enjoy the same result?

The obvious difference is that in 1971 America was locked into a system of fixed parities. By pegging to the dollar, a currency was automatically fixed to everything else. Since July 2008 China has pegged the yuan to the greenback. But over that period its currency has swung up and down against those of its trading partners and competitors. On a trade-weighted basis the yuan is back to where it was when the financial crisis started. Indeed, compared with China's emerging-market competitors in its big export markets, the yuan is about 12% more expensive today than it was before the collapse of Lehman Brothers, according to a measure (the "third-country" effective exchange rate) calculated by the Hong Kong Monetary Authority. By this indicator China's currency is about 25% above its level in 2005.

The second difference is related to the first. Because everybody was pegged to the dollar in 1971, everybody had to pay the surcharge. Nixon dismayed everyone but discriminated against no one. China's critics today, on the other hand, urge Mr Obama to slap a tariff on Chinese goods alone. This will reduce the demand for Chinese imports, which constitute about 15% of America's total. But there is no guarantee that customers will switch from Chinese goods to American ones instead. They are more likely to buy from China's rivals in Asia. The surcharge may change the composition of America's trade deficit, without necessarily changing its size.

Nixon goes to China

The Nixon shock holds lessons for China as well as Mr Obama. Like China today, Germany in the 1960s disavowed any responsibility for the world's imbalances, insisting that the solution lay with tighter policies in deficit countries rather than looser policies in surplus countries. (Germany is still singing a version of that song.) But by holding fast to the dollar, Germany ended up importing America's laxity. It could not insulate itself from the loose monetary policy engineered to help Nixon win the 1972 election. German prices rose by over 5% in 1971. China, too, risks a loss of macroeconomic control if it continues to peg to the dollar. Its money supply grew by about 35% in the year to February. That kind of surge may be a precursor to inflation.

The advocates of a surcharge argue that China will not act unless it is forced to do so. They point to defensive remarks by Wen Jiabao, China's prime minister, arguing that the yuan was not undervalued and would remain "basically stable". But the demise of the Bretton Woods system suggests that official statements can be a poor guide to future policy. The decision not to revalue is "final, unequivocal and for eternity". That's not a Chinese official in 2010, but a German official in the Nixon era—just five months before the Deutschmark was revalued by 9.3%. ■