The Nixon Shock *and the* Trading System

BY DOUGLAS IRWIN

The difference between the Nixon and Trump experiences.

The famous August 1971 weekend at Camp David that Jeffrey Garten brings to life is best remembered for the closing of the gold window, effectively marking the end of the Bretton Woods system, and the imposition of wage and price controls.

An often overlooked but key part of the Nixon Shock was the decision to impose a 10 percent surcharge on all foreign goods imported into the United States. The purpose of the surcharge was not to protect domestic firms from foreign competition, a traditional objective of import duties. Rather, the goal was to move the exchange rate—an attempt to force other countries, mainly Japan, to revalue their currencies against the dollar.

Although the surcharge was temporary (it was removed in December 1971), the incident illustrates the recurring connection between exchange rates and trade policy that we see play out to this day.

The backstory to U.S. President Richard Nixon's decision to impose an import surcharge was the slide in the U.S. trade balance from surplus to deficit. American policymakers feared that the United States was losing its "competitiveness" *vis-à-vis* other countries, particularly Japan and Germany. Those countries had been clients whom the United States sought to rebuild after World War II, but had now become competitors in the production of manufactured goods.

Douglas Irwin is the John French Professor of Economics at Dartmouth College.

Although the trade deficit was miniscule, its appearance was considered an alarming development at the time. The dollar had become overvalued due to the increase in domestic prices and the slower productivity growth in the United States relative to its trade partners. The impact on the trade balance could not be relieved by a devaluation because the dollar was the world's reserve currency. As the anchor of the international monetary system, other countries could revalue or devalue their currencies against the dollar, but the United States could not devalue the dollar against other currencies. And other countries were reluctant to revalue their currencies against the dollar because they did not want to jeopardize the competitive position of their export industries.

Global Blowback

When President Nixon acted, other countries retreated—and never seriously considered retaliating against the United States. When President Trump acted, the retaliatory blowback against U.S. exports was immediate.

—*D. Irwin*

OFFICIAL WHITE HOUSE PHOTO BY SHEALAH CRAIGHEAD

President **Donald Trump** *joins G7 leaders during a working session on global economy, foreign policy, and security affairs in August 2019 in Biarritz, France.*

U.S. Treasury Secretary John Connally—who memorably stated that "the foreigners are out to screw us; our job is to screw them first"—proposed the surcharge and was the driving force behind its adoption. President Nixon liked the idea—"the import duty delights me"—because it was a way of striking back against other countries and extracting concessions from them. The president thought that "the border tax is not too damned aggressive, just aggressive enough."

The announcement of the surcharge unleashed massive selling of the dollar on foreign exchange markets. Japan's central bank intervened massively to prevent the yen from appreciating but soon gave up. The 10 percent surcharge "worked" and other countries revalued their currencies in the Smithsonian Agreement of December 1971. You remember it—that's the one that President Nixon hailed as "the most significant monetary agreement in the history of the world."

An often overlooked but key part of the Nixon Shock was the decision to impose a 10 percent surcharge on all foreign goods imported into the United States.

As the dollar fell, protectionist pressures receded. The U.S. trade balance shifted back to surplus, temporarily. But, for better or worse, the world economy entered a new era. Floating exchange rates became the standard, a shift that had enormous implications for international capital mobility. In support of fixed exchange rates, countries maintained capital controls under the Bretton Woods system. With the shift to flexible exchange rates, such controls were no longer necessary, and they were relaxed. The rise of international capital mobility led to much larger trade imbalances across countries, starting in the 1980s.

The relationship between exchange rates and trade policy soon reappeared. The appreciation of the U.S. dollar in the early 1980s led to a growing current account deficit and rising protectionist pressures in the United States as exports sagged and imports soared, forcing domestic firms into tougher competition from other countries. The Reagan Administration did not impose a general import surcharge, although Congress and the Congressional Budget Office explored the idea. Instead, a variety of *ad hoc* industry-specific protectionist measures were adopted. Antidumping and countervailing duties were imposed in response to industry complaints, and the administration negotiated export restraints to protect the automobile, steel, and textiles and apparel industries. Like in 1971, many of these measures were aimed at Japan.

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editor@international-economy.com

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These protectionist pressures continued to rise along with the dollar until U.S. Treasury Secretary James Baker helped engineer the Plaza Agreement in 1985. G-7 finance ministers and central banks agreed to concerted measures to reduce the value of the dollar on foreign exchange markets. As the dollar fell, protectionist pressures receded.

Although the U.S. current account deficit widened even more dramatically in the 1990s, the dollar was remarkably stable and the economy performed well—which kept protectionist pressures at bay.

By the late 1990s, however, China had replaced Japan as a country of concern. The U.S. trade deficit with China grew from $83 billion in 2000 to nearly $260 billion in 2007. The bilateral trade imbalance with China did not go unnoticed and once again attention was put on the exchange rate. Whereas Japan's trade surplus had been driven by private outward capital flows, China's trade surplus was related to government foreign exchange intervention. After China fixed the value of the renminbi against the dollar, China's foreign exchange reserves began to explode, growing from less than $200 million in 2000 to $1.6 trillion by 2007, and later peaking at nearly $4 trillion in 2014.

This reserve accumulation indicated that China's central bank was buying dollars and selling renminbi, which kept its currency undervalued and boosted exports. As imports from China began to surge, some U.S. producers started complaining that China's currency policies were giving the country's producers an unfair advantage. This got the attention of members of Congress. Starting in 2003, Senators Charles Schumer (D-NY) and Lindsey Graham (R-SC) introduced legislation to impose a 27.5 percent tariff on goods from China until it revalued its exchange rate. (That number was a simple average of fifteen and forty, which were two contemporary estimates of the renminbi's under valuation.) More than one hundred similar bills were subsequently introduced, but all died in committee.

American policymakers feared that the United States was losing its "competitiveness."

President George W. Bush's administration did little to challenge China's currency policy, at least in public. The Treasury Department never named China as a "currency manipulator," but officials quietly pushed for a change in policy. In July 2005, China began to allow the renminbi to appreciate steadily against the dollar, arguably too slowly and too late. Then the global financial crisis of 2008 struck.

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Among the confluence of factors that led to the election of President Donald Trump in 2016, some have speculated that the "China shock"—the surge of imports during the 2000s that displaced an estimated million American workers in manufacturing—played a contributing role. Trump put trade at the center of his agenda and, like the Nixon Administration, attacked the trade deficit as demonstrating that other countries were "taking advantage" of the United States. He said he would like a weaker dollar and spoke about how tariffs would help make America great again.

Yet the administration did not intervene directly in currency markets nor impose a general import surcharge. Rather, China was hit with stiff tariffs because "trade wars are good, and easy to win." The steel industry also received protection, as had happened under previous administrations.

These actions did not reduce the trade deficit, although few economists thought that they would. But they did reveal how much the world had changed from 1971. When President Nixon acted, other countries retreated—and never seriously considered retaliating against the United States. When President Trump acted, the retaliatory blowback against U.S. exports was immediate and the complained-about foreign economic policies were unchanged.

Despite the bravado, the Trump presidency showed that the United States no longer had the power to dominate international economic policy the way it once could. ◆