

CHAPTER 5

Currency War II (1967-1987)

"The dollar is our currency, but it's your problem."

U.S. Treasury Secretary John Connally
to foreign finance ministers, 1971

"I don't give a shit about the lira."

President Richard M. Nixon, 1972

tional Monetary Fund. Countries could only devalue their currencies with IMF permission and that would generally be granted only in cases of persistent trade deficits accompanied by high inflation. Although conceived in the form of a grand international agreement, the Bretton Woods structure was dictated almost single-handedly by the United States at a time when U.S. military and economic power, relative to the rest of the world, was at a height not seen again until the fall of the Soviet Union in 1991.

Despite the persistence of Bretton Woods into the 1970s, the seeds of Currency War II were sown in the mid- to late 1960s. One can date the beginning of CWII from 1967, while its antecedents lie in the 1964 landslide election of Lyndon B. Johnson and his "guns and butter" platform. The guns referred to the war in Vietnam and the butter referred to the Great Society social programs, including the war on poverty.

Although the United States had maintained a military presence in Vietnam since 1950, the first large-scale combat troop deployments took place in 1965, escalating the costs of the war effort. The Democratic landslide in the 1964 election resulted in a new Congress that convened in January 1965, and Johnson's State of the Union address that month marked the unofficial launch of the full-scale Great Society agenda.

This convergence of the costs of escalation in Vietnam and the Great Society in early 1965 marked the real turning away from America's successful postwar economic policies. However, it would take several years for those costs to become apparent. America had built up a reservoir of economic strength at home and political goodwill abroad and that reservoir now slowly began to be drained.

At first, it seemed that the United States could afford both guns and butter. The Kennedy tax cuts, signed by President Johnson shortly after President John F. Kennedy's assassination in 1963, had given a boost to the economy. Gross domestic product rose over 5 percent in the first year of the tax cuts and growth averaged over 4.8 percent annually during the Kennedy-Johnson years. But almost from the start, inflation accelerated in the face of the twin budget and trade deficits that Johnson's policies engendered.

As World War II wound down, the major Allied economic powers, led by the United States and England, planned for a new world monetary order intended to avoid the mistakes of Versailles and the interwar period. These plans were given final shape at the Bretton Woods Conference held in New Hampshire in July 1944. The result was a set of rules, norms and institutions that shaped the international monetary system for the next three decades.

The Bretton Woods era, 1944 to 1973, while punctuated by several recessions, was on the whole a period of currency stability, low inflation, low unemployment, high growth and rising real incomes. This period was, in almost every respect, the opposite of the CWI period, 1921-1936. Under Bretton Woods, the international monetary system was anchored to gold through a U.S. dollar freely convertible into gold by trading partners at \$35 per ounce and with other currencies indirectly anchored to gold through fixed exchange rates against the U.S. dollar. Short-term lending to particular countries in the event of trade deficits would be provided by the Interna-

Inflation, measured year over year, almost doubled from an acceptable 1.9 percent in 1965 to a more threatening 3.5 percent in 1966. Inflation then ran out of control for twenty years. It was not until 1986 that inflation returned to the level of just over 1 percent.

In one incredible five-year stretch from 1977 to 1981, cumulative inflation was over 50 percent; the value of the dollar was cut in half. U.S. citizens in this period made the same analytic mistake as their counterparts in Weimar Germany had in 1921. Their initial perception was that prices were going up; what was really happening was that the currency was collapsing. Higher prices are the symptom, not the cause, of currency collapse. The arc of Currency War II is really the arc of U.S. dollar inflation and the decline of the dollar.

Despite the centrality of U.S. policies and U.S. inflation to the course of WWII, the opening shots were fired not in the United States but in Britain, where a sterling crisis had been brewing since 1964 and came to a boil in 1967 with the first major currency devaluation since Bretton Woods. While sterling was less significant than the dollar in the Bretton Woods system, it was still an important reserve and trade currency. In 1945, UK pounds sterling comprised a larger percentage of global reserves—the combined holdings of all central banks—than the dollar. This position deteriorated steadily, and by 1965 only 26 percent of global reserves were in sterling. The British balance of payments had been deteriorating since the early 1960s, but grew sharply negative in late 1964.

Instability in sterling arose not only because of short-term trade imbalances but because of the global imbalance between the total sterling reserves held outside Britain and the dollar and gold reserves available inside Britain to redeem those external balances. In the mid-1960s there were about four times as many external sterling claims as internal reserves. This situation was highly unstable and made Britain vulnerable to a run on the bank if sterling holders tried to redeem sterling for dollars or gold en masse. A variety of techniques was orchestrated to support sterling and keep the sterling bears off balance, including international lines of credit, swap lines with the New York Fed, a UK austerity package and surprise currency market interventions. But the problem remained.

Three minor sterling crises arose between 1964 and 1966, but were eventually subdued. A fourth sterling crisis, in mid-1967, however, proved fatal to sterling parity. Numerous factors contributed to the timing, including closure of the Suez Canal during the 1967 Six-Day War between the Arabs and Israel and the expectation that the UK might be required to devalue in order to join the European Economic Community. Inflation was now on the rise in the United Kingdom as it was in the United States. In the UK, inflation was rationalized as necessary to combat rising unemployment, but its impact on the value of the currency was devastating. After an unsuccessful effort to fend off continued selling pressure, sterling formally devalued against the dollar on November 18, 1967, from \$2.80 to \$2.40 per pound sterling, a 14.3 percent devaluation.

The first significant crack in the Bretton Woods facade had now appeared after twenty years of success in maintaining fixed exchange rates and price stability. If the UK could devalue, so could others. U.S. officials had worked hard to prevent the devaluation of sterling, fearing the dollar would be the next currency to come under pressure. Their fears would soon be realized. The United States was experiencing the same combination of trade deficits and inflation that had unhinged sterling, with one crucial difference. Under Bretton Woods, the value of the dollar was not linked to other currencies but to gold. A devaluation of the dollar therefore meant an upward revaluation in the dollar price of gold. Buying gold was the logical trade if you expected dollar devaluation, so speculators turned their attention to the London gold market.

Since 1961, the United States and other leading economic powers had operated the London Gold Pool, essentially a price-fixing open market operation in which participants combined their gold and dollar reserve resources to maintain the market price of gold at the Bretton Woods parity of \$35 per ounce. The Gold Pool included the United States, United Kingdom, Germany, France, Italy, Belgium, the Netherlands and Switzerland, with the United States providing 50 percent of the resources and the remainder divided among the other seven members. The pool was partly a response to an outbreak of panic buying of gold in 1960, which had temporarily driven the

market price of gold up to \$40 per ounce. The Gold Pool was both a buyer and a seller; it would buy on price dips and sell into rallies in order to maintain the \$35 price. But by 1965 the pool was almost exclusively a seller.

★ The End of Bretton Woods

The public attack on the Bretton Woods system of a dominant dollar anchored to gold began even before the 1967 devaluation of sterling. In February 1965, President Charles de Gaulle of France gave an incendiary speech in which he claimed that the dollar was finished as the lead currency in the international monetary system. He called for a return to the classical gold standard, which he described as "an indisputable monetary base, and one that does not bear the mark of any particular country. In truth, one does not see how one could really have any standard criterion other than gold." France backed up the words with action. In January 1965, France converted \$150 million of dollar reserves into gold and announced plans to convert another \$150 million soon. Spain followed France and converted \$60 million of its own dollar reserves into gold. Using the price of gold in June 2011 rather than the \$35 per ounce price in 1965, these redemptions were worth approximately \$12.8 billion by France and \$2.6 billion by Spain and at the time represented significant drains on U.S. gold reserves. De Gaulle helpfully offered to send the French navy to the United States to ferry the gold back to France.

These redemptions of dollars for gold came at a time when United States businesses were buying up European companies and expanding operations in Europe with grossly overvalued dollars, something De Gaulle referred to as "expropriation." De Gaulle felt that if the United States had to operate with gold rather than paper money, this predatory behavior would be forced to a halt. However, there was fierce resistance to a pure gold standard in the late 1960s—as in the 1930s, it would have necessitated a devaluation of dollars and other currencies against gold. The biggest beneficiaries of a rise in the dollar price of gold would have been the major gold-producing nations,

including the repugnant apartheid regime in South Africa and the hostile communist regime in the USSR. These geopolitical considerations helped to tamp down the enthusiasm for a new version of the classical gold standard.

Despite the scathing criticisms coming from France, the United States did have one staunch ally in the Gold Pool—Germany. This was crucial, because Germany had persistent trade surpluses and was accumulating gold both from the IMF as part of operations to support sterling and through its participation as an occasional buyer in the Gold Pool itself. If Germany were suddenly to demand gold in exchange for its dollar reserve balances, a dollar crisis much worse than the sterling crisis would result. However, Germany secretly assured the United States it would not dump dollars for gold, as revealed in a letter from Karl Blessing, president of the Deutsche Bundesbank, the German central bank, to William McChesney Martin, the chairman of the Board of Governors of the Federal Reserve. Dated March 30, 1967, the "Blessing Letter" provided:

Dear Mr. Martin,

There occasionally has been some concern . . . that . . . expenditures resulting from the presence of American troops in Germany [could] lead to United States losses of gold. . . .

You are, of course, well aware of the fact that the Bundesbank over the past few years has not converted any . . . dollars . . . into gold. . . .

You may be assured that also in the future the Bundesbank intends to continue this policy and to play its full part in contributing to international monetary cooperation.

It was extremely comforting for the United States to have this secret assurance from Germany. In return, the United States would continue to bear the costs of defending Germany from the Soviet troops and tanks stationed in the woods immediately surrounding Berlin and throughout Eastern Europe.

Germany, however, was not the only party with potential gold claims on the dollar, and in the immediate aftermath of the 1967

sterling devaluation the United States had to sell over eight hundred metric tons of gold at artificially low prices to maintain the dollar-gold parity. In June 1967, just one year after withdrawing from NATO's military command, France withdrew from the Gold Pool as well. The other members continued operations, but it was a lost cause: claims on gold by overseas dollar holders had become an epidemic. By March 1968, the gold outflow from the pool was running at the rate of thirty metric tons per hour.

The London gold market was closed temporarily on March 15, 1968, to halt the outflow, and remained closed for two weeks, an eerie echo of the 1933 U.S. bank holiday. A few days after the closure, the U.S. Congress repealed the requirement for a gold reserve to back the U.S. currency; this freed the U.S. gold supply to be available for sale at the \$35 price if needed. This was all to no avail. By the end of March 1968, the London Gold Pool had collapsed. Thereafter, gold was considered to move in a two-tier system, with a market price determined in London and an international payments price under Bretton Woods at the old price of \$35 per ounce. The resulting "gold window" referred to the ability of countries to redeem dollars for gold at the \$35 price and sell the gold on the open market for \$40 or more.

The two-tier system caused speculative pressures to be directed to the open market while the \$35 price remained available only to central banks. However, the U.S. allies reached a new, informal agreement not to take advantage of the gold window by acquiring gold at the cheaper official price. The combination of the end of the Gold Pool, the creation of two-tier system and some short-term austerity measures put in place by the United States and United Kingdom helped to stabilize the international monetary system in late 1968 and 1969, yet the dénouement of Bretton Woods was clearly in sight.

On November 29, 1968, not long after the collapse of the London Gold Pool, *Time* reported that among the problems of the monetary system was that "the volume of world trade is rising far more quickly than the global supply of gold." Statements like this illustrate one of the great misunderstandings about the role of gold. It is misguided to say that there is not enough gold to support world trade, because

quantity is never the issue; rather, the issue is one of price. If there was inadequate gold at \$35 per ounce, the same amount of gold would easily support world trade at \$100 per ounce or higher. The problem *Time* was really alluding to was that the price of gold was artificially low at \$35 per ounce, a point on which the magazine was correct. If the price of gold was too low, the problem was not a shortage of gold but an excess of paper money in relation to gold. This excess money was reflected in rising inflation in the United States, the United Kingdom and France.

In 1969, the IMF took up the "gold shortage" cause and created a new form of international reserve asset called the special drawing right, or SDR. The SDR was manufactured out of thin air by the IMF without tangible backing and allocated among members in accordance with their IMF quotas. It was promptly dubbed "paper gold" because it represented an asset that could be used to offset balance of payments deficits in the same manner as gold or reserve currencies.

The creation of the SDR was a little-understood novelty at the time. There were several small issuances in 1970-1972 and another issuance in response to the oil price shock and global inflation in 1981. Thereafter, the issuance of SDRs came to a halt for almost thirty years. It was only in 2009, in the depths of a depression that had begun in 2007, that another, much larger amount of SDRs were printed and handed out to members. Still, the original issuance of SDRs in 1970 was a reflection of how badly unbalanced the supply of paper money had become in relation to gold and of the desperation with which the United States and others clung to the gold parity of \$35 per ounce long after that price had become infeasible.

The entire period of 1967 to 1971 is best characterized as one of confusion and uncertainty in international monetary affairs. The devaluation of sterling in 1967 had been somewhat of a shock even though the instability in sterling had been diagnosed by central bankers years before. But the following years were marked by a succession of devaluations, revaluations, inflation, SDRs, the collapse of the Gold Pool, currency swaps, IMF loans, a two-tiered gold price and other ad hoc solutions. At the same time, the leading economies

of the world were undergoing internal strains in the form of student riots, labor protests, antiwar protests, sexual revolution, the Prague Spring, the Cultural Revolution and the continuing rise of the counterculture. All of this was layered onto rapid technological change summed up in the ubiquity of computers, the fear of thermonuclear war and plain awe at landing a man on the moon. The whole world seemed at once to be on a wobbly foundation in a way not seen perhaps since 1938.

Yet through all of this, one thing seemed safe. The value of the U.S. dollar remained fixed at one thirty-fifth of an ounce of pure gold and the United States seemed prepared to defend this value despite the vast increase in the supply of dollars and the fact that convertibility was limited to a small number of foreign central banks bound to honor a gentleman's agreement not to press too hard for conversion. Then suddenly this last anchor snapped too.

On Sunday, August 15, 1971, President Richard Nixon preempted the most popular show in America, *Bonanza*, to present a live television announcement of what he called his New Economic Policy, consisting of immediate wage and price controls, a 10 percent surtax on imports and the closing of the gold window. Henceforth, the dollar would no longer be convertible into gold by foreign central banks; the conversion privilege for all other holders had been ended years before. Nixon wrapped his actions in the American flag, going so far as to say, "I am determined that the American dollar must never again be a hostage in the hands of international speculators." Of course, it was U.S. deficits and monetary ease, not speculators, that had brought the dollar to this pass, but, as with FDR, Nixon was not deterred by the facts. The last vestige of the 1944 Bretton Woods gold standard and the 1922 Genoa Conference gold exchange standard was now gone.

Nixon's New Economic Policy was immensely popular. Press coverage was overwhelmingly favorable, and on the first trading day after the speech the Dow Jones Industrial Average had its largest one-day point gain in its history up until then. The announcement has been referred to ever since as the Nixon Shock. The policy was conceived in secret and announced unilaterally without consultation

with the IMF or other major participants in Bretton Woods. The substance of the policy itself should not have been a shock to U.S. trading partners—*de facto* devaluation of the dollar against gold, which was what the New Economic Policy amounted to, was a long time coming, and the pressure on the dollar had accelerated in the weeks leading to the speech. Switzerland had redeemed dollar paper for over forty metric tons of gold as late as July 1971. French redemptions of dollars for gold had enabled France to become a gold power, ranking behind only the United States and Germany, and it remains so today.

What most shocked Europeans and the Japanese about the New Economic Policy was not the devaluation of the dollar, but the 10 percent surtax on all goods imported into the United States. Abandoning the gold standard, by itself, did not immediately change the relative values of currencies—sterling, the franc, and the yen all had their established parities with the dollar, and the German mark and Canadian dollar had already been floated by the time of Nixon's speech. But what Nixon really wanted was for the dollar to devalue immediately against all the major currencies and, better yet, to float down thereafter so that the dollar could indulge in continual devaluation in the foreign exchange markets. However, that would take time and negotiations to formalize, and Nixon did not want to wait. His 10 percent surtax had the same immediate economic impact as a 10 percent devaluation. The surtax was like a gun to the head of U.S. trading partners. Nixon would rescind the surtax once he got the devaluations he sought, and the task of negotiating those devaluations was delegated to his flamboyant Treasury secretary, John Connally of Texas.

International response to the 1971 Nixon gambit was not long in arriving. By late August, Japan had announced that it would allow the yen to float freely against the dollar. To no one's surprise, the yen immediately rose 7 percent against the dollar. Combined with the 10 percent surtax, this amounted to a 17 percent increase in the U.S. dollar price of Japanese imports to the United States, which was welcome news to U.S. car and steel producers. Switzerland created "negative interest rates," in the form of fees charged on Swiss franc

bank deposits, to discourage capital inflows and help prop up the dollar.

In late September, the council of the General Agreement on Tariffs and Trade (GATT) met to consider whether the U.S. import surtax was a violation of free trade rules. There was no justification for the surtax and U.S. deputy undersecretary of state Nathaniel Samuels made almost no effort to defend it, other than to suggest that the surtax would be lifted when the U.S. balance of payments improved. Under the GATT rules, retaliation would likely have been justified. However, the U.S. trading partners had no stomach for a trade war. Memories of the 1930s were still too fresh and the role of the United States as a superpower balance to the Soviet Union and military protector of Japan and Western Europe was too important to risk a major confrontation over trade. Japan and Western Europe would simply have to suffer a weaker dollar; the question was to what extent and on whose terms.

An international conference in London was organized under the auspices of the so-called Group of Ten, or G10, in late September. These were the wealthiest nations in the world at the time, which importantly included Switzerland, even though it was not then an IMF member. Connally put on a performance worthy of his Texas pedigree. He told the delegates that the United States demanded an immediate \$13 billion swing in its trade balance, from a \$5 billion deficit to an \$8 billion surplus, and that this demand was nonnegotiable. He then refused to engage in discussions about how this might be achieved; he told the delegates it was up to them to formulate a plan, and upon his review he would let them know whether they had been successful. The nine other members of the G10 were left to mutter among themselves about Connally's arrogance and to think about what kind of swing in the U.S. trade balance they might be willing to orchestrate.

Two weeks later, in early October, the key players met again in Washington at the annual meeting of the IMF. Little progress had been made since the London conference, but the implications of Nixon's 10 percent surtax were beginning to sink in. The Canadian trade minister, Jean-Luc Pépin, estimated that the surtax would de-

stroy ninety thousand Canadian jobs in its first year. Some dollar devaluation had already taken place on the foreign exchange markets, where more countries had begun to float their currencies against the dollar and where immediate gains of 3 percent to 9 percent had occurred in various currencies. But Nixon and Connally were seeking total devaluation more in the 12 percent to 15 percent range, along with some assurance that those levels would stick and not be reversed by the markets. The IMF, not surprisingly given its research-dominated staff, began vetting a number of technical solutions. These included wider trading "bands" within which currencies could fluctuate before requesting formal devaluation, and possibly the expanded use of SDRs and the creation of a world central bank. These debates were irrelevant to Connally. He wanted an immediate response to the immediate problem and would use the blunt instrument of the surtax to force the issue for as long as it took. However, he did soften his views slightly at the IMF meeting by indicating that the surtax might be lifted if the U.S. trade balance moved in the right direction even if its ultimate goals had not yet been achieved.

There was one other issue on which the United States seemed willing to show some flexibility and on which the Europeans were quite focused. While the United States had announced it would no longer redeem dollars for gold, it had not officially changed the dollar-gold parity; it still regarded the dollar as worth one thirty-fifth of an ounce of gold, even in its nonconvertible state. An increase in the price of gold would be just as much of a devaluation of the dollar as an upward revaluation of the other currencies. This was symbolically important to the Europeans and would be seen by them as a defeat for the United States in the currency war despite U.S. indifference. The Germans and French would also benefit because they held large gold hoards and an increase in the dollar price of gold would mean an increase in the dollar value of their gold reserves.

Nixon and Connally did not really seem to care; having closed the gold window, the price of gold seemed somewhat irrelevant, and devaluation by whatever method was all just a means to an end. By the end of the IMF meeting, it seemed that some combination of

continued upward revaluation of most currencies against the dollar on foreign exchange markets, some flexibility on timing of trade deficit reduction by the United States and a U.S. willingness to explicitly raise the dollar price of gold might form the basis of a lasting currency realignment consistent with Nixon's goals.

By early December, the endgame had begun with another G10 meeting, convened at the ornate Palazzo Corsini in Rome. This time, Connally was ready to deal. He proposed an average revaluation of foreign currencies of 11 percent and a devaluation of the dollar against gold of 10 percent. The combination of the two meant an effective increase of over 20 percent in the dollar price of foreign exports into the United States. In exchange, the United States would drop the 10 percent surtax.

The Europeans and Japanese were in shock: a total swing of perhaps 12 percent to 15 percent might have been acceptable, but 20 percent was too much to bear all at once. Moreover, the members of G10 began to position themselves against one another. A 20 percent swing against the dollar would be one thing if all countries did it at once, but if, for example, the UK revalued only 15 percent while Germany did the full 20 percent, then Germany would be disadvantaged against the UK and the United States. France wanted to limit the size of the dollar devaluation against gold so that more of the adjustment would be pushed onto a German revaluation in which France would not fully participate. And so it went.

By now the negotiations were almost nonstop. A few days after the Rome meeting, President Nixon met one-on-one with President Georges Pompidou of France in the Azores, where Pompidou pressed the case for an increase in the dollar price of gold as part of a package deal. Nixon conducted the negotiations in a sleep-deprived state because he had stayed up most of the night to follow a Washington Redskins football game in local time. In the end, Nixon agreed to the French demands and Pompidou returned to France a hero for having humbled the Americans in the delicate matter of the dollar and gold. Still, Nixon did not leave empty-handed, because Pompidou agreed to push for significant reduc-

tions in the stiff tariffs on U.S. imports imposed by the European Common Market.

The tentative agreements reached at Palazzo Corsini and in the Azores were ratified two weeks later by the G10 in a meeting held in the historic red castle of the Smithsonian Institution, adjacent to the National Mall in Washington, D.C. The venue gave its name to the resulting Smithsonian Agreement. The dollar was devalued about 9 percent against gold, and the major currencies were revalued upward between 3 percent and 8 percent against the dollar—a total adjustment of between 11 percent and 17 percent, depending on the currency. Important exceptions were England and France, which did not revalue but still went up about 9 percent relative to the dollar because of the devaluation against gold. The Japanese suffered the largest total adjustment, 17 percent—even more than the Germans—but they drew the least sympathy from Connally since their economy was growing at over 5 percent per year. The signatories agreed to maintain these new parities in a trading band of 2.25 percent up or down—a 4.5 percent band in total—and the United States agreed to remove the despised 10 percent import surtax; it had served its purpose. No provision for a return to the convertible gold standard was made, although technically gold had not yet been abandoned. As one writer observed, "Instead of refusing to sell gold for \$35 an ounce, the Treasury will simply refuse to sell . . . for \$38 an ounce."

The Smithsonian Agreement, like the Nixon Shock four months earlier, was extremely popular in the United States and led to a significant rally in stocks as investors contemplated higher dollar profits in steel, autos, aircraft, movies and other sectors that would benefit from either increased exports or fewer imports, or both. Presidential aide Peter G. Peterson estimated that the dollar devaluation would create at least five hundred thousand new jobs over the next two years.

Unfortunately, these euphoric expectations were soon crushed. Less than two years later, the United States found itself in its worst recession since World War II, with collapsing GDP, skyrocketing unemployment, an oil crisis, a crashing stock market and runaway

inflation. The lesson that a nation cannot devalue its way to prosperity eluded Nixon, Connally, Peterson and the stock market in late 1971 as it had their predecessors during the Great Depression. It seemed a hard lesson to learn.

As with the grand international monetary conferences of the 1920s and 1930s, the benefits of the Smithsonian Agreement, such as they were, proved short-lived. Sterling devalued again on June 23, 1972, this time in the form of a float instead of adherence to the Smithsonian parities. The pound immediately fell 6 percent and was down 10 percent by the end of 1972. There was also great concern about the contagion effect of the sterling devaluation on the Italian lira. Nixon's chief of staff briefed him on this new European monetary crisis. Nixon's immortal response, captured on tape, was: "I don't care. Nothing we can do about it. . . . I don't give a shit about the lira."

On June 29, 1972, Germany imposed capital controls in an attempt to halt the panic buying of the mark. By July 3, both the Swiss franc and the Canadian dollar had joined the float. What had started as a sterling devaluation had turned into a rout of the dollar as investors sought the relative safety of German marks and Swiss francs. In June 1972, John Connally resigned as Treasury secretary, so the new secretary, George P. Shultz, was thrown into this developing dollar crisis almost immediately upon taking office. With the help of Paul Volcker, also at Treasury, and Fed chairman Arthur Burns, Shultz was able to activate swap lines, which are basically short-term currency lending facilities, between the Fed and the European central banks, and started intervening in markets to tame the dollar panic. By now, all of the "bands," "dirty floats," "crawling pegs" and other devices invented to maintain some semblance of the Bretton Woods system had failed. There was nothing left for it but to move all of the major currencies to a floating rate system. Finally, in 1973, the IMF declared the Bretton Woods system dead, officially ended the role of gold in international finance and left currency values to fluctuate against one another at whatever level governments or the markets desired. One currency era had ended and another had now begun, but the currency war was far from over.

The age of floating exchange rates, beginning in 1973, combined with the demise of the dollar link to gold put a temporary end to the devaluation dramas that had occupied international monetary affairs since the 1920s. No longer would central bankers and finance ministries anguish over breaking a parity or abandoning gold. Now markets moved currencies up or down on a daily basis as they saw fit. Governments did intervene in markets from time to time to offset what they saw as excesses or disorderly conditions, but this was usually of limited and temporary effect.

■ The Return of King Dollar

In reaction to the gradual demise of Bretton Woods, the major Western European nations embarked on a thirty-year odyssey of currency convergence, culminating with the European Union and the euro, which was finally launched in 1999. As Europe moved fitfully toward currency stability, the former twin anchors of the world monetary system, the dollar and gold, were far from stable. Despite the expectations of growth and higher employment coming from the dollar devaluations, the United States suffered three recessions from 1973 to 1981. In all, there was a 50 percent decline in the purchasing power of the dollar from 1977 to 1981. Oil prices quadrupled during the 1973-1975 recession and doubled again from that new, higher level in 1979. The average annual price of gold went from \$40.80 per ounce in 1971 to \$612.56 per ounce in 1980, including a short-term superspike to \$850 per ounce in January 1980.

In the eyes of many, it was a world gone mad. A new term, "stagflation," was used to describe the unprecedented combination of high inflation and stagnant growth happening in the United States. The economic nightmare of 1973 to 1981 was the exact opposite of the export-led growth that dollar devaluation was meant to achieve. The proponents of devaluation could not have been more wrong.

With faith in the dollar near the breaking point, new leadership and new policies were desperately needed. The United States found

both with the appointment of Paul Volcker as chairman of the Federal Reserve Board by President Jimmy Carter in August 1979 and the election of Ronald Reagan as president of the United States in November 1980.

Volcker had been undersecretary of the Treasury from 1969 to 1974 and had been intimately involved in the decisions to break with gold and float the dollar in 1971-1973. He was now living with the consequences of those decisions, but his experience left him extremely well prepared to use the levers of interest rates, open market operations and swap lines to reverse the dollar crisis just as he and Arthur Burns had done during the sterling crisis of 1972.

As for inflation, Volcker applied a tourniquet and twisted it hard. He raised the federal funds rate to a peak of 20 percent in June 1981, and the shock therapy worked. Partly because of Volcker, annual inflation collapsed from 12.5 percent in 1980 to 1.1 percent in 1986. Gold followed suit, falling from an average price of \$612.56 in 1980 to \$317.26 by 1985. Inflation had been defeated and gold had been subdued. King Dollar was back.

Although Volcker's efforts were heroic, he was not the sole cause of declining inflation and a stronger dollar. Equal credit was due to the low-tax and deregulatory policies of Ronald Reagan. The new president entered office in January 1981 at a time when American economic confidence had been shattered by the recessions, inflation and oil shocks of the Nixon-Carter years. Although the Fed was independent of the White House, Reagan and Volcker together constructed a strong dollar, implemented a low-tax policy that proved to be a tonic for the U.S. economy and launched the United States on one of its strongest periods of growth in history. Volcker's hard-money policies combined with Reagan's tax cuts helped gross domestic product achieve cumulative real growth of 16.6 percent in the three-year span from 1983 to 1985. The U.S. economy has not seen such levels of growth in any three-year period since.

The strong dollar, far from hurting growth, seemed to encourage it when combined with other progrowth policies. However, unemployment remained high for years after the last of the three recessions ended in 1982. The trade deficits with Germany and Japan

were growing as the stronger dollar sent Americans shopping for German cars and Japanese electronics, among other goods.

By early 1985, the combination of U.S. industries seeking protection from imports and Americans looking for jobs led to the usual cries from unions and industrial-state politicians for devaluation of the dollar to promote exports and discourage imports. The fact that this policy had failed spectacularly in 1973 did not deter the weak-dollar crowd. The allure of a quick fix for industries in decline and those with structural inadequacies is politically irresistible. So, under the guidance of another Treasury secretary from Texas, James A. Baker, a worthy successor to John Connally, the United States made another demand on the world for a cheap dollar.

This time the method of devaluation was different. There were no longer any fixed exchange rates or gold conversion ratios to break. Currencies traded freely against one another and exchange rates were set by the foreign exchange market, consisting mostly of large international banks and their corporate customers. Part of the dollar's strength in the early 1980s stemmed from the fact that foreign investors wanted dollars to invest in the United States because of its strong economic growth. The strong dollar was a vote of confidence in the United States, not a problem to be solved. However, domestic politics dictated another fate for the dollar, a recurring theme in the currency wars. Because the market was pushing the dollar higher, it would require government intervention in the exchange markets on a massive scale if the dollar was to be devalued. This kind of massive intervention required agreement and coordination by the major governments involved.

Western Europe and Japan had no appetite for dollar devaluation; however, memories of the Nixon Shock were still fresh and no one could be sure that Baker would not resort to import surtaxes just as Connally had in 1971. Moreover, Western Europe and Japan were just as dependent on the United States for their defense and national security against the communist bloc as they had been in the 1970s. On the whole, it seemed better to negotiate with the United States on a dollar devaluation than be taken by surprise again.

The Plaza Accord of September 1985 was the culmination of this

multilateral effort to drive the dollar down. Finance ministers from West Germany, Japan, France and the United Kingdom met with the U.S. Treasury secretary at the Plaza Hotel in New York City to work out a plan of dollar devaluation, principally against the yen and the mark. Central banks committed over \$10 billion to the exercise, which worked as planned over several years. From 1985 to 1988, the dollar declined over 40 percent against the French franc, 50 percent against the Japanese yen and 20 percent against the German mark.

The Plaza Accord was a success if measured solely as an exercise in devaluation, but the economic results were disappointing. U.S. unemployment remained high, at 7.0 percent in 1986, while growth slowed considerably to only 3.2 percent in 1987. Once again, the quick fix had proved chimerical and, once again, there was a high price to pay in the form of inflation, which took off with a lag after the Plaza Accord, shooting back up to 6.1 percent in 1990. Devaluation and currency wars never produce either the growth or the jobs that are promised, but they reliably produce inflation.

The Plaza Accord was deemed too successful by the parties and occasioned one last adjustment to put the brakes on the dollar's rapid decline from the heights of 1985. The G7, consisting of the Plaza Accord parties plus Canada and Italy, met at the Louvre in Paris in early 1987 to sign the Louvre Accord, meant to stabilize the dollar at the new, lower level. With the Louvre Accord, Currency War II ended, as the G7 finance ministers decided that, after twenty years of turmoil, enough was enough.

By 1987, gold was gone from international finance, the dollar had been devalued, the yen and mark were ascendant, sterling had faltered, the euro was in prospect and China had not yet taken its own place on the stage. For now, there was relative peace in international monetary matters, yet this peace rested on nothing more substantial than faith in the dollar as a store of value based on a growing U.S. economy and stable monetary policy by the Fed. These conditions largely prevailed through the 1990s and into the early twenty-first century, notwithstanding two mild recessions along the way. The currency crises that did arise were nondollar crises, such as the sterling crisis of 1992, the Mexican peso crisis of 1994 and the Asia-

Russia financial crisis of 1997-1998. None of these crises threatened the dollar—in fact, the dollar was typically a safe haven when they arose. It seemed as though it would take either a collapse in growth or the rise of a competing economic power—or both—to threaten the supremacy of the dollar. When these factors finally did converge, in 2010, the result would be the international monetary equivalent of a tsunami.