[Bonus] AFD Ep 407 Links and Notes - That 70s Woe: Nixon's Gold
Description: The August 1971 Nixon Shock and Understanding the Transition of the US Economy in the Crisis of the 70s - Foreign Exchange and Gold Convertibility Episode. (A Bill solo episode.)

[Music cue]

It's Arsenal For Democracy. I'm Bill Humphrey. This is episode 407, a bonus episode experimenting with a potential series called "That 70s Woe", recorded on January 12, 2022. Today's episode: "Nixon's Gold."

On August 15, 1971, US President Richard Nixon, more than halfway through his first term, addressed the nation by television for 18 minutes to announce a new economic policy for the country. Its objectives were to "create more and better jobs," to "stop the rise in the cost of living," and to "protect the dollar from the attacks of international money speculators" – or more simply: to tackle unemployment, inflation, and international speculation. Officially called the "Challenge of Peace" speech, it ended up coming to be known as "the Nixon Shock." The official explanation given for rising unemployment was a winding down of defense contracts and armed forces size. Various supply-side and demand-side stimulus measures were proposed to spur growth and thus job creation. Contradicting this effort was a proposal to match stimulus tax breaks with equal cuts to the federal budget. This was supposed to counter inflation, issue 2. Government workers under the plan would see pay freezes and a layoff of 5% of government workers. It is almost incredible to hear these back to back proposals for job creation and job cuts in the same speech aiming for "full employment." Partly this reflects Republican ideological preference for corporations and hostility toward government spending, as if some economic demand is the good kind and some is the bad kind when it comes to growth, but partly it simply reflects the incoherent and contradictory challenges and policy responses of the broader crisis of the 1970s we're here to discuss. It's also hard to write off the speech as pure market ideology when another major component was a 90-day emergency invocation of nationwide price controls, which will be dealt with in a separate episode. The final component of the August 15, 1971 speech – and the main focus of this episode – was the announcement of the end of convertibility between the US dollar and gold, with the explicit goals of halting currency speculation and of maintaining the position of the dollar as the leading global reserve currency, all of which I will explain and explore. This measure was also supposed to be temporary, but it was never reversed.

So, why am I talking about all of this? We've been dancing around it in recent episodes as background noise to all kinds of other topics, but it's time to talk in more depth about the crisis of the 1970s and specifically today about the currency crisis culminating in the Nixon Shock of August 1971. This event fell at roughly the midpoint of a two decade period of political instability in the United States where no president held office for a full two terms. The idea here is to make a case that the great personalities of this period, especially those presidents, actually had a lot less influence on the course of events than they are often credited with, because it is our view that the materialist structural factors created a tide of problems around them that they could not really hold back. Some people would suggest that – one by one – this economic tide, or perhaps the current pulling inexorably below the surface, would sweep five presidents out the door early, one way or another. Today, as I alluded to, we're really zeroing in on the August 1971 turning point in the US dollar's reserve currency role when the Bretton Woods system ended in the so-called "Nixon Shock." William Jennings Bryan might have called it the final coming down off the Cross of Gold for the United States. But just as he was mistaken in the 1890s about the underlying problems of the US economy, with the change in 1971, the situation for the United

States economy simply moved into a new phase, even as – or perhaps more accurately because – the currency retained its leading status anyway.

Let's begin with the basics. A reserve currency is any currency that is considered useful by a country's government to hold in substantial quantities as part of "foreign exchange reserves." Foreign reserves are basically the pool of cash on hand (or other easily transferred assets) that can be spent down to make payments abroad. Conversely, it grows as inbound foreign payments arrive. Sometimes they're literally moving reserves back and forth across borders, but often they're just re-labeling whose pile belongs to whom and everyone is keeping track at home, so that it all balances out on the ledgers. This is not unlike a Medici banker in the 1400s sending a message to another branch to supply someone with cash there, without always needing to physically move coins across Europe's bad and dangerous medieval roads.

Historically, various currencies have served as common reserve currencies because countries they traded with were willing to accept that cash for their goods. For example, for many years, Venetian gold ducats were widely accepted in the European, Middle Eastern, and North African trading cities. And later on, Spanish silver dollars from the Americas could purchase things or pay off debts in both China and Europe. After the first and second industrial revolutions, Britain became such a massive exporter of manufactured goods and services that it could command payment in silver Pound Sterling. But, even then, the Pound remained in competition with gold currency transactions by the other major powers, like the French Franc and Imperial German Mark.

The US dollar is currently (and since World War II) the most convenient and widely used reserve currency around the world because virtually everyone is willing to make exchanges internationally in US dollars, and therefore stockpiling dollars is a relatively safe move for building reserves. In the years between the World Wars, before the dollar's supremacy was established, countries would manipulate the value of their own currency. This manipulation would necessarily affect both domestic purchasing power and the exchange rate with other foreign currencies. Devaluation of the currency (among various effects) makes imports more expensive, which discourages sending money abroad and helps domestic producers compete against foreign competition.

By moving to a system of foreign exchanges and payments through a mutually agreed upon currency like the US dollar, in theory there would be less currency manipulation, but the shift still wouldn't really solve the problem of insufficient volumes of cash available to actually hold in reserves around the world for balancing payments between nations on the ledgers. This reality quickly forced the United States to adopt a policy of cash grants like the Marshall Plan and post-decolonization development aid or to find various political pretexts or economic import ideas – effectively simply to give out some walking around money to other countries. This status as the world's reserve currency provider unfortunately had some fairly dire internal consequences for the United States, as we will gradually get to, even while it put the US on top of the global economy abroad. This is referred to as the Triffin Dilemma, where a country acting as the supplier of a reserve currency must continue spending it abroad even as doing so damages the domestic economy; but, on the other hand, attempting to reverse the flow of dollars out would create a liquidity crisis worldwide, which also hurts the domestic economy, too.

Besides a literal currency held in reserve, another thing mid-century governments liked to hold in their reserves was bars of gold, because that was another thing that could sit around holding value until such time as it needed to be exchanged abroad, and it would be relatively widely accepted. The reliance on gold was sort of a holdover from an earlier era when gold and silver were the only widely accepted unit of foreign exchange, and they kept it around as a feature of the postwar setup. Shortly after World War II, when the Bretton Woods financial system was being instituted among the non-Soviet Allied powers, due to a decade or two of policies and choices by various governments for various reasons, most of the world's gold happened to be physically sitting in the reserves of the United States. And in fact that reality is the real reason that the dollar became the choice for the reserve currency under the postwar system, as opposed to the other way around.

By agreement, if a country holding US dollars in reserve wanted to switch to US gold and do something with that instead, they were welcome to purchase some of that gold at a fixed price, which would be shipped to them in return for dollars being transferred home to the US. As you can imagine, because the gold reserves in the US were not limitless (and in fact they had never actually held a 1:1 ratio of gold dollar-equivalent units to real printed dollars because most of the time ordinary people just circulate the dollars without cashing them in), this international dollar-to-gold conversion rule would pose a problem if for some reason there was an increasing demand outside the US to either get a bunch more gold or to unload a bunch of dollars or both. And this outflow of gold was especially going to pose a problem if the private world market price of gold drifted too far out of sync with the agreed upon fixed exchange price for conversion of dollar reserves into gold reserves, which is exactly what ended up happening.

There's an interesting parallel between the Silver Purchase requirements in the late 19th century (discussed in our 2021 miniseries on American money in the 19th century) and the Bretton Woods System's gold convertibility rule from the 1940s through the 1960s. Under Bretton Woods, US dollar reserves overseas could be exchanged by other governments for gold reserves at a fixed rate of exchange. But by contrast the private global gold market itself was unrestricted, so governments would simply cash in their dollars for US government gold at the fixed rate and then sell the gold on the open market at a higher rate of exchange, either in their own currency or to get even more dollars. Basically, this is like the 19th century situation we talked about in our miniseries where Americans were acquiring gold cheaply at a legally fixed ratio of silver cash and then using the gold to buy more expensive things than the nominal exchange rate would imply.

The official exchange rate, by the way, was US paper 35 dollars to buy one ounce of US government gold. That exchange rate had remained unchanged since 1934, when domestic dollar to gold conversion was ended as a measure to combat the Depression. By the start of the 1960s, the market exchange rate was far enough off that a foreign government could buy reserve gold for $35 from the Americans and then sell it on the market for $40/ounce and hypothetically make a profit of $5/ounce. (At the start of 2022, for reference, gold trades at around $1,800/ounce.)

The Kennedy Administration's circuitous proposed fix to the gap between official exchange and market exchange (a plan not implemented until shortly after his death) was not to change the official exchange rate but instead to enact a massive overhaul of the federal tax system. (That reform is when rich people's marginal rates and corporate taxes came way down, if you were wondering.) The tax reform was meant to encourage so much investment in export production that the market gold rate would subside back toward $35/ounce.

[LBJ AUDIO CLIP]

For one thing, there is clearly a total lack of imagination in how to solve the gold problem or the reserve currency problem and also seemingly a poor understanding of what was likely to happen with this newly untaxed money swirling around in the US or global economy. The blowback problem of this tax reform decision, therefore, was that when the US government almost immediately turned around and began pouring money into the US defense industry for the Vietnam War (and to a lesser extent the Space Race), there were now lower taxes on the domestic winners of this wartime spending spree, which fueled inflation. (Usually LBJ's Great Society programs like Medicare, Medicaid, food stamps, and welfare get lumped in with all that as inflation factors, but I'm struggling to imagine that those bottom-up dollars from the poor were a bigger inflation driver than the amount of money raining down on the defense companies and their executives and employees. Johnson's proposed FY68 budget for example would have spent $73.1 billion on defense vs $18.3 billion on Great Society programs.)

Despite this inflation supposedly linked to a flurry of government spending, in reality, as early as 1968, the year before Nixon took office and began threatening budget cuts, and fully three years before the Nixon Shock measures of 1971, the US economy actually began slowing down and from December 1969 through 1970 it was in a mild recession, just barely negative economic growth nationally, with unemployment peaking in December 1970:
https://en.wikipedia.org/wiki/Recession_of_1969%E2%80%931970

Even so, the focus of decision-makers at this point remained on inflation, not stagnation, and it would continue to do so moving into the crisis of the 1970s. To quote a 2016 article from the Richmond Fed: *"high inflation, so closely associated today with the 1970s, was already ticking upward in the 1960s. While it averaged only 1.5 percent a year from 1952 to 1965, it rose to an annual average of 4.5 percent starting in 1966. In 1969, it hit an 18-year high of 5.75 percent. In retrospect, many scholars now believe that the roots of the 1970s inflationary spiral can be found in the 1960s."*

The same article also acknowledges that even as early as 1965, there was some sense that easy credit, more than rising wages, was boosting price inflation. And I promise we are coming back to talk in a different episode about the domestic price inflation leading up to August 1971 and the question of price controls.

But today we shouldn't get too far afield talking about domestic budgets and domestic inflation when we're really here to talk about the currency crisis or foreign exchange crisis and the end of Bretton Woods. As Shakespeare said, "all the world's a stage." It turns out that the domestic indicators were "merely players" on that global stage.

After 1968 as these various difficulties began adding up, Nixon seemed befuddled by all the economics (not to mention the politics of the economics) surrounding the Bretton Woods System falling apart and his eventual termination of the international gold convertibility in August 1971, when the market price of gold was back up to $40/ounce vs the official exchange rate and other countries were trying to obtain more and more of it at the favorable exchange rate to turn a quick profit. Apparently the White House secret tapes have confirmed Nixon's personal confusion about the whole thing. In the speech itself, the clearest explanation or rationalization he offers for ending Bretton Woods is that it was a system (along with Marshall Plan aid) designed to promote the recovery of the foreign economies destroyed by World War II and that it was time to phase it out now that recovery had been achieved in those countries.

By contrast with Nixon, at the time of the reform efforts between 1964 and 1968, LBJ had completely understood the problem: A) There wasn't enough physical gold out of the ground worldwide to support full convertibility to/from paper dollars relative to the actual need for paper dollars in circulation globally to keep things from grinding to a halt. B) The main reason the US was struggling economically at home from the effects of that was *because* the US was the leading global economy and the reserve currency for global transactions and business (as well as the leading evangelist for free trade and capitalism) … any attempt to correct the results domestically, to avoid hurting Americans, would collapse the pole position of the US economy and the dollar and lead to the return of the protectionism and devaluation battles that created so many problems before WW2 and Bretton Woods.

(There was an attempt in 1968 to prohibit gold convertibility with any governments that traded gold on the open market, but I don't think that really went anywhere long-term.)

So, in August 1971 after months of deliberation and following the little recession that had ended the previous year, Nixon abruptly announced (among other measures, including peacetime domestic price controls to be discussed in a separate episode) that foreign dollars could no longer be redeemed for US gold, echoing FDR's decision to end domestic dollar purchases of US gold. Once again, for the US to live, gold had to die. But that itself wasn't going to end global reserve currency status for the dollar, because of the other intangible factors encouraging people worldwide to keep it there. After all, who else wants to take that albatross if the US will keep it a while longer?

[Nixon AUDIO CLIP]

Shipments of gold out of US vaults, such as the one at Fort Knox, suddenly ended. In fact, a few years later, when a right-wing conspiracy theory took root in the American media and among conservative Congressman willing to entertain their constituents' flights of fancy, the US government felt forced to hold an incredibly rare public tour in 1974 – about a month and a half after Nixon's resignation – for members of Congress and the press to see inside Fort Knox and confirm that the gold was still there and hadn't secretly been removed. You can read a journalist's recollection of the bizarre expedition at the online archives of Numismatic News, published in 2009. That conspiracy theory was arguably more nonsensical than the plot of the 1964 Bond film "Goldfinger," from a decade earlier, wherein the villain planned to irradiate the reserves in order to effectively remove them from the global supply of gold to make his own gold assets more valuable on the market.

But let's get back to the post-gold albatross problem. As we discussed earlier with reference to the Marshall Plan, the other underlying structural problem with being the global reserve currency is that you have to figure out how to get your own currency out of the country so other countries can use it to buy things. If the US isn't pumping dollars out into the rest of the world, on balance, then there will not be enough cash in circulation and again things will grind to a halt. After WW2, for a brief period the US was the only major producer of finished goods. This export bonanza was great if you wanted to bring dollars into the country. But even then you would still somehow need the other countries to have dollars first, in order to send them back. Organically, there simply wasn't much reason to send dollars out, even though that's what was needed to buy things from the US producers. So, as noted earlier they had to do Marshall Plan grants and such – or just give away money to anti-communist dictators to get it circulating. Eventually foreign production (especially in Europe and Japan) rebounded in quantity and then quality so there would be some reason to spend (and thus send) dollars out of the US naturally. But that almost by definition meant hurting domestic American competitors in those industries.

The other huge solution, of course, is sending dollars abroad to purchase raw materials for production of finished goods or transportation fuel. This came most prominently in the form of the growing postwar expenditure of US dollars on Arab oil instead of US oil. Domestically produced oil in the US actually reached a pre-shale exploitation peak in production in 1970. There was plenty of oil left to produce in the US, but it was no longer unknowably infinite and therefore no longer as cheap. Without capital controls, tariffs, or other restrictions on imports, investment dollars and wholesale purchase dollars would tend to flow to larger and therefore cheaper oil sources, with an expectation of a higher profit margin when selling the oil back home in the United States. And this suited the US government just fine, not only to keep consumer prices lower for longer, but also crucially for getting reserve currency shoveled out the door to keep the global financial system humming.

This growing outbound American spending on foreign oil from the 1940s through the 1960s is where the concept of [Petrodollar Recycling] comes into play. The role of high resource but low population Arab states in the international financial system after WW2 was literally just to take US dollars for cheap oil and then go hog-wild spending it in Europe so that Europe has enough dollars to make its economies function and to buy things from the US. The US and Europe were also buying raw materials from the former colonial regions of Africa and Latin America, too, although those countries ideally tended to be attempting to reinvest more of those dollars at home to build out industry and infrastructure to support their bigger populations, rather than recycling surplus royalties to the Global North. Obviously a lot of it mysteriously left those countries for Swiss bank accounts in a less ostentatious version of Gulf monarch petrodollar recycling, but with similar financial benefits to Europe and the United States.

Fluctuations in the prices of these raw material imports – whether by the actual market prices going up or by a fall in the foreign purchasing power of the US dollar after the 1971 Nixon shock – could trigger or at least contribute to domestic price inflation spirals in the wider economy. We know a couple years later of course that the 1973 Arab Oil Crisis was a big driver of mid-1970s "stagflation," but it's important to underscore that in reality the wholesale price of foreign oil had started going up back in 1969, and especially after early 1971. The domestic retail price of gasoline and other refined oil products need not have gone up automatically, of course, but unsurprisingly private capitalist oil companies opted to raise sale prices in order to avoid taking a reduction in profits. This anticipated decline in the rate of profit, unless prices were raised, was a result of the partner countries with the oilfields finally flexing their political muscle to demand higher royalty fees and/or greater ownership stakes. This came first under Gaddafi who took power in Libya in 1969 and then in a series of other countries, culminating in a sweeping new profit-sharing agreement between 6 of the oil countries and 22 major oil companies in Tehran in February 1971. https://www.geoexpro.com/articles/2015/06/the-first-oil-shock (It is also discussed at length on the September 2020 Trillbillies podcast episode I recommend, entitled "Year Zero 2: Black Gold," with guest Timothy Mitchell, author of the 2011 book 'Carbon Democracy: Political Power in the Age of Oil':
https://soundcloud.com/user-972848621-463073718/year-zero-2-black-gold-fever-w-special-guest-timothy-mitchell)

The August 1971 Nixon Shock's changes to gold convertibility and emergency price controls followed about six months after the Tehran Agreement. But the countries that had just negotiated a new fee arrangement realized that dollars, which is what they were paid in for their oil, were now going to decline in value globally, hurting their expected spending power from the same nominal revenues. They therefore renegotiated the recent agreement, beginning a cycle of inflationary pressure. In a sense, the so-called "Arab Oil embargo" of 1973 tied to the Yom Kippur War was a sideshow to the main event. It was merely the thing that ordinary Americans could see clearly within a pre-existing trend that was harder to spot. The 1973 embargo also proved to be that excellent cover story for the oil companies to jack up their prices suddenly to avoid or mitigate the expected profit hit to owners and shareholders from the higher fee splits with the oil countries they were operating in.

This oil crisis domestically is a case study in the contradiction of petrodollar recycling. After all, greater profit-sharing to the Arab oil countries meant more dollars in circulation, mostly coming back to Europe and the US to buy luxuries, weapons, and investment assets. But Americans at home experienced it as prices going up suddenly. (That being said, however, we're not going to get further into the 1973-74 oil crisis here, because it played out pretty weirdly with a lot of interacting factors that don't all directly relate to actual supply and demand; plus we are focusing on 1971-72 right now.)

Less recognizable, but still crucial in how everything was unfolding as the 1960s turned into the 1970s, was the role of steel imports. Quality steel is necessary to make a lot of other things, but it's not a raw material, since it is produced from iron and metallurgical coal and various additives, as I think we discussed on our Coal and Steel Strikes of 1919 episode in November 2020. Steel occupies a middle space in the chain of production of finished goods and therefore it was also easy for newly industrialized countries to produce good steel, even if they weren't yet up to the level of producing competitive finished goods. As early as 1959, the US was actually a net importer of steel. Demand was high enough for a while that the US economy could support both domestic steel producers and foreign steel producers even as that need was increasingly met by imports. But over the course of the 1960s, American-made steel was less and less able to compete on price with foreign steel. Plus American firms weren't keeping up with technological improvements in productivity (a reality vaguely hinted at in the Nixon Shock speech by calling for federal incentives for American capital machinery upgrades). Unfortunately, protectionist trade measures begun in 1969 simply had knock-on effects of job losses in US sectors buying the steel for use in production of other things. By 1974, the industry was in the full-blown crisis we now recognize as the start of the transition from the Steel Belt to the Rust Belt. https://en.wikipedia.org/wiki/Steel_crisis (Here's a modern map showing flows of iron ore, metallurgical coal, and steel production, by the way: https://www.woodmac.com/wallmaps/metals-steel-iron-ore-and-metallurgical-coal-wallmap-44866610)

Conclusion

It's important to emphasize with all of this that Nixon did not use the New Economic Policy of 1971 to try to free the domestic economy from the problems of reserve currency status. Indeed the speech specifically cited the policy objective of maintaining that leading position in the global economy and financial system, as "a pillar of monetary stability." The policy shift only specifically addressed the one narrow problem of being shackled to gold in an especially vulnerable way. But the end of gold convertibility and the Bretton Woods system meant that the United States was going to have to double down even more on some of the most internally damaging policies in order to secure its worldwide primacy.

The speech itself called for policies that would make imports more expensive by exchange rate changes and more expensive through temporary direct tariffs, and it proposed to cut foreign aid by 10%. But as we know, a system built on the global reserve currency status of the US dollar, required dollars to circulate outside of the United States and to flow out of the United States to support that. Therefore, we know that in the long run, if this status was to continue, as the speech insisted it would, then the US government would in fact eventually resume with an even greater enthusiasm any policies that would divert the flow of cash out of the United States, whether by direct aid or by imports of raw materials and finished goods.

Arguably, after the Nixon shock and the end of gold convertibility, it became incumbent upon the US government to incentivize the offshoring of production for import (instead of trying to incentivize production exports, as it had traditionally done), because offshoring is another way to get dollars out of the US and into circulation to prop up global liquidity. Any talk of a New Economic Policy to restore competitiveness to the American worker and American factories was simply incompatible with a continued economic policy of dollar hegemony.

Offshoring, of course, was not the only coming horseman of the slowly-unfurling economic apocalypse within the domestic US economy that would leave behind a Rust Belt, shuttered mines, retreating government services, and stagflation that even sometimes reached into the affluent suburbs while settling on the rest of the country permanently like a thick blanket of smog. No, offshoring policy was joined by other horsemen too, like the shareholder revolution and the closely associated cyclical waves of corporate mergers geared toward asset-stripping and labor squeezes instead of real growth in plants and productivity. There would be a newly enthroned all-encompassing ideology of market-based price signals and privatization. Basic costs of life, from housing and healthcare to education, would eat away at people's resources even as an all-consuming government war on inflation purported to fight for people's costs to remain stable.

And finally, joining together all of these forces that deserve their own episodes, was the further explosion of personal consumer finance options to purchase cheap foreign goods on less money than ever, as a means of managing public dissatisfaction and papering over the reduction in circulating dollars here at home due to all these problems. But as we know from the emphasis on maintaining access to dollars abroad, eventually people need money in their hands to spend or else everything stops.

Which might make you wonder: All this Fed-backed speculative venture capital with no expectation of return in the past 13 years is just the equivalent of petrodollar recycling within the US, isn't it? In order for us plebs to have dollars to spend, they need to circulate it to us somehow – and (since we don't have oil to sell or communist insurgents to resist) the chosen method of circulating money to us is insane cokehead schemes. This is our domestic Marshall Plan, now that all the heavy industry has been destroyed within the US and everyone is permanently underemployed. This scheme is instead of some kind of UBI or strong welfare system untethered from work. Our domestic petrodollar recycling 50 years after the Nixon Shock is just some guy pitching investors like "what if we were the Uber for Netflix in a metaverse hyper tunnel" and those investors spot us the consumer spending power and we the people get some free or discounted but unprofitable stuff like MoviePass or food deliveries for a while…

Thanks for listening to this experimental episode and consider subscribing at Patreon.com/ArsenalForDemocracy for $3/month to support the show and hopefully more special episodes like this. This episode's special theme song is "Cold War Echo" by Kai Engel from the 2017 album "Sustains," although I curated and added the political speech clips myself.

If you want to look up some more of the basics of what I've been talking about in this episode, see here.
https://en.wikipedia.org/wiki/Bretton_Woods_system#Readjustment
https://en.wikipedia.org/wiki/Nixon_shock (Better off watching the full speech linked above tho)
https://en.wikisource.org/wiki/Executive_Order_11615

https://en.wikipedia.org/wiki/Foreign_exchange_reserves
https://en.wikipedia.org/wiki/Balance_of_payments#1945%E2%80%931971:_Bretton_Woods
https://en.wikipedia.org/wiki/Executive_Order_6102

[Music cue out.]