Nixon and the Dollar

By Hobart Rowen 6/10/73

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PARIS — At a time when the U.S. economy is enjoying one of the biggest booms in history, the dollar is being battered in world markets, stock prices are collapsing and the economic seers are worrying about a recession.

If this paradox seems bewildering to the average citizen, it is no less perplexing to the so-called experts, many of whom were here last week for a meeting of international bankers. One thing, however, is painfully clear: Whatever the underlying realities of the U.S. economy, the overriding factor of the past several weeks has been a lack of confidence in the American government brought on by the Watergate scandal.

The rapid-fire series of revelations bringing President Nixon himself ever closer to the actual management or cover-up of the sordid Watergate affair has been accompanied, almost in exact rhythm, by a deterioration of the dollar's value in foreign exchange markets, and an even more sensational rise in the price of gold.

Why should the value of the dollar drop as a response to Watergate? Because uncertainty is the disease feared most by Wall Street and the foreign exchange markets alike, and Watergate breeds uncertainty.

Will President Nixon ultimately be forced to resign or be impeached? If so, would Vice President Agnew succeed him in normal course? What will the effect be on relations with Congress, notably on the trade legislation considered to be so urgently needed? Without answers to these questions, a sense of panic set in, and the result was as much as a 7 per cent deterioration in the foreign exchange value of the dollar since its last devaluation on Feb. 12. "This was not a speculation against the system," says Norwegian central banker Knut Wold. "There was no economic reason for it."

Hamburgers and Gold

FRENCH President Georges Pompidou, greeting bankers at a reception at the Elysee Palace, said bluntly that "we are witnessing the third devaluation of the dollar." In a de facto sense, there is an element of truth to that glib description, although a recovery in the dollar by the end of the week reduced the average depreciation to less than 6 per cent. Moreover, the general expectation in Europe is that the dollar will gain additional strength in the weeks ahead.

But as one digs deeper into the crisis of the past few months, the outlines of a more rational response appear. In fact, there seem to be four major reasons, all related, all sensitive to the emotions of Watergate, which can explain the seeming paradox.

First, there is the great wave of inflation that has sent prices soaring. "The American people," Nixon adviser Herbert Stein observed the other day, "are more concerned with the price of hamburger than the price of gold."

Second, there was the second devaluation of the dollar—by 10 per cent—on Feb. 12. "Coming on the heels of the first one, just 14 months earlier," says New York banker Robert Roosa, "it created shell-shock all over the world. They wonder if it can happen again."

Third, there has been the serious deterioration in U.S. export trade, culminating in a deficit of nearly $7 billion in 1972; as recently as 1961, the United States enjoyed a trade surplus of that amount. Americans may have become inured to the deficit in the overall balance of payments, but the minus numbers in the trade accounts alone suggest that American producers somehow may have lost their competitive edge for good.

Fourth, as the above worries fed upon each other, the energy crisis burst on the American scene.

The scattered reports of gasoline shortages, or occasional sales at 90 cents a gallon, were said to be the harbinger of a serious domestic shortage that would force greater oil imports; this, in turn, would mean a worsened trade deficit and thus a further strain on the dollar.

The Benefit of Floating

THE RECENT fluctuations of the dollar in foreign exchange markets, although greeted with big headlines here and in the United States, were actually modest in view of the anxiety over the Watergate situation. Because the dollar has been "floating" (allowed to seek its own level) in world markets since March, the "crisis" has been of much smaller dimensions than otherwise would have been the case.

Under the old system of fixed rates, the kind of gold speculation that has developed in the past few weeks would have resulted, first, in the purchase of billions of dollars by foreign central banks to support the price of the dollar, then a closing of the exchange markets as the support burden became too heavy—and, finally, a formal new devaluation of the dollar.

Thus, what has happened has provided the first real test of the "floating" system, and by almost universal consent it has been successful. Speculators, German central banker Otmar Emminger said here last week, "will find they have overdone it, and then the dollar will come back to a much less devalued range."

But this will depend on the Nixon administration's ability to convince the rest of the world that—in Treasury Secretary George Shultz's phrase—"government goes on," and that in the process of "going on" the United States will succeed in controlling inflation, as Mr. Nixon promised on Friday, and will convert the trade deficit into a surplus.

Inflation, to be sure, is not uniquely an American problem. In Europe, according to a report by the Organization for Economic Cooperation and Development, consumer prices rose 8 per cent in the 12 months to April, 1973, despite a wage-price freeze in Britain and some special efforts elsewhere. (A two-day rental of a tuxedo in Paris costs $60, shirt and tie not included.)

The U.S. record in the 12 months to April (a 5.1 per cent increase in consumer prices) actually is the best of any of 20 major countries. In Germany, the price rise over this period

was 7.5 per cent, and in Japan it was 9.4 per cent.

"Very Explosive"

THE SALIENT POINT, however, is that after excellent results under Phase II last year, U.S. inflation has been galloping ahead. Wholesale prices last month, for example, climbed at a 24 per cent annual rate. In the preceding month of April, consumer prices were up at a 7.2 per cent annual rate, a bit less than in February and March but at a clearly unsustainable rate. At an OECD session, Shultz frankly termed the first quarter "very explosive and unsatisfactory."

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The inflation surge in February, March, April and May coincided, of course, with the introduction by the Nixon administration of Phase III of the wage-price control system.

By no small coincidence, the stock market touched its high for the year on Jan. 10 and plunged into a steep decline as analysts concluded that weaker price controls, in the face of strong business and consumer demand, would mean renewed inflation.

This could only mean a boom and bust, the way stock analysts saw it, because without strong controls, the main defense against runaway inflation would have to be higher interest rates—and, indeed, the Federal Reserve Board fulfilled the analysts' expectations Friday by boosting the interest rate it charges to member banks by 0.5 percentage point, to 6.5 per cent—a pattern which historically produces a crunch, an eventual slowdown, higher unemployment—in a word, recession.

Arthur F. Burns, the wise old head of the Federal Reserve, was privately distressed by the administration's decision to abandon Phase II so quickly. "I would like to see stronger measures," Burns said here the other day. "I think that monetary policy is carrying too much of the burden."

But Burns says a definite "no" to the forecast of recession, although like most other experts he anticipates—indeed hopes—to see a decline in the boom-level real growth rate of 8 per cent in the first quarter. In the first quarter, overall growth was about $43 billion at an annual rate, a spectacular jump by any standard. But this level of the Gross National Product involved a 6.6 per cent increase in prices, more than twice the 1972 inflation rate.

"Temporary Phenomena"

SO FAR, the Nixon administration has not been able to fully explain the great price zoom. It relies largely on the assertion that "temporary forces" were at work, and promises that there is no reason to expect that things will continue to be as bad.

The "temporary phenomena" repeatedly cited by Treasury Secretary Shultz and economic council chairman Herbert Stein are skyrocketing food prices, extraordinary consumer demand for goods of all kind, a worldwide boom that raised the prices of American imports, the devaluation of the dollar, and worries about a new freeze that triggered some deliberate price increases.

Private analysts don't necessarily disagree that these factors played a role. But they are less convinced than Messrs. Shultz and Stein that food prices or any other prices will soon come down, whether or not the economic boom in the United States and elsewhere tapers off.

As Burns has pointed out, wages and prices in the last several years have moved persistently higher, even during periods of recession. This reversal of the more traditional pattern is traceable to modern social pressures: No government can expect to stay in office if it tries, as in years gone by, to cure inflation by austerity measures that throw people out of work. This development, Burns says, "has led me to conclude that governmental power to restrain directly the advance of prices and money incomes constitutes a necessary addition to our arsenal of economic stabilization weapons."

As inflation has mounted in recent weeks, the Nixon administration, beset at the same time by the Watergate mess, has been importuned by Burns and others to return to a more forceful set of wage and price controls. Shultz has resisted the pressure, banking on the analysis that the first quarter will prove to have been an aberration, and that prices for the year as a whole will be no worse than 4 per cent higher. This would not match the brilliant 3 per cent record compiled in 1972, but it clearly would be an improvement over recent weeks.

There are some signs that under the combined pressure from home and abroad, the administration, which has already taken steps to make Phase III more effective, may attempt to take out more anti-inflation insurance.

Shultz was under so much pressure to say something reassuring about the ability of the U.S. government to function efficiently, despite Watergate, that he put aside a prepared speech on energy at one of the International Monetary Conference luncheons here last week and said, "We are determined to get all the mileage we can out of controls," even if it means getting more "flamboyant" to get attention.

"The Doubters"

OBVIOUSLY, the future course of the economy depends largely on the accuracy of the administration's assessment that the first quarter binge was due to temporary factors, which could allow an easy letdown from that over-excited stage to a more sustainable growth rate of 4 to 4.5 per cent in real terms. If the administration view is correct, we should witness a decided cooling in the economy very quickly, followed by a stretch of high-level activity for most of 1973 and 1974.

But there are respectable forecasters who think that the economy, given the stimulus of an extraordinary plant and equipment boom, will remain overheated for most of this year and then collapse into a recession next year. Those who accept this view would act more decisievly now to clamp on

"I understand he was quite influential before he fell into bad company!"

tighter price controls and somehow slow down the business boom, perhaps by withdrawing or modifying the 7 per cent investment credit.

One of the most distinguished U.S. economic technicians, Geoffrey H. Moore, the former commissioner of labor statistics (fired last January by Nixon) who now heads the business-cycle activities of the National Bureau of Economic Research, thinks a recession is likely.

It is important here to define "recession." Most economists and government officials conclude that an economy has undergone a recession if there are two successive quarters when the "real" Gross National Product declines. That is different from a situation in which the economy continues to grow, but at a lesser rate.

The last actual recession, in 1969-70, was relatively mild, and while it was going on there was a great debate as to whether it was or was not a recession. The Nixon administration, of course, denied that one was taking place, but official data later showed it was a fact.

Moore bases his conclusions on an examination of a group of "leading" economic indicators, which tend to give an early signal of what lies ahead. But Moore is among the first to agree that these indicators can be obscure, and at best indicate direction rather than magnitude.

Thus, Moore makes clear that he the dip could be what many economists euphemistically call a "growth recession"—that is, a sharp reduction from the 8 per cent real growth rate to something in the 3 to 5 per cent range.

The Effect on Jobs

WHILE MANY economists and bankers would consider such a "growth recession" desirable at this stage, because it would imply a considerable reduction in inflation, the question for political leaders is what that would do to jobs. There is no doubt that it would push unemployment above the present 5 per cent level—and that's one reason why the Nixon administration, with a falling dollar, rising gold prices and Watergate, hasn't been eager to come forward with a tightened-up controls program or other deflationary measures.

So far, the administration has relied mostly on the traditional tools of fiscal and monetary policy to slow down inflation. The fiscal 1974 budget will be near balance. The big home-building boom appears to have reached a crest and will likely slow down further as the cost of money is pushed up by the Federal Reserve.

But in the face of these deflationary elements, consumer buying is still on a rampage, supported by an extraordinary amount of installment credit. The business investment boom shows no sign of letdown, and the probability is that businessmen, who so far have been cautious about building up their inventories, will begin to add to their stocks.

As one official puts it, there is a race going on between the major negative influences in the economy—tighter money, the dip in housing, consumer overbuying—and the boom-supporting or expansive influences inherent in the capital goods and inventory situations.

The best way out of the dilemma would be for the sustaining forces to expand gradually while the housing-consumer sector eases off. But things never work that smoothly, and in a Watergate-saturated world, the prospects for neat results would appear to be even dimmer.