Gold, the Dollar and Watergate

How a Political and Economic Meltdown was Narrowly Avoided

Onno de Beaufort Wijnholds

Gold, the Dollar and Watergate

This page intentionally left blank

Gold, the Dollar and Watergate

How a Political and Economic Meltdown was Narrowly Avoided

Onno de Beaufort Wijnholds

palgrave
macmillan

© Onno de Beaufort Wijnholds 2015

All rights reserved. No reproduction, copy or transmission of this publication may be made without written permission.

No portion of this publication may be reproduced, copied or transmitted save with written permission or in accordance with the provisions of the Copyright, Designs and Patents Act 1988, or under the terms of any licence permitting limited copying issued by the Copyright Licensing Agency, Saffron House, 6-10 Kirby Street, London EC1N 8TS.

Any person who does any unauthorized act in relation to this publication may be liable to criminal prosecution and civil claims for damages.

The author has asserted his right to be identified as the author of this work in accordance with the Copyright, Designs and Patents Act 1988.

First published 2015 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC,
175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries

ISBN: 978–1–137–47135–2

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

Contents

List of Figures vii

Preface ix

Acknowledgements xiii

Introduction **1**

Part I Gold **7**

1. A unique metal 7
2. The gold standard 12
3. Gold loses its luster 16
4. War chest, war loot 25
5. Yellow and green 31

Part II The Dollar **37**

1. The mighty greenback 37
2. From dollar famine to flood 41
3. Working toward a compromise 50
4. Change of the guard 62
5. Nixonomics 68
6. Showing his dark side 75
7. Texas hold ‘em 81
8. Floating Rudderless 88
9. Closing the window 96
10. Monetary diplomacy 107
11. Building an air castle 125
12. Nixon triumphant 134
13. Money masters 149

Part III Watergate **155**

1. Escalation 155
2. War and Oil 158
3. Recycling 164
4. No rest for the wicked 173
5. The scourge of stagflation 178

6. A Middle Eastern odyssey 187
7. Down to the wire 194
8. The recession bites 201
9. Nixon's last stand 206

Part IV: Ruin or Revival? 215
1. Searching for stability 215
2. Stimulate or deflate? 228
3. Talking down the dollar 237
4. The dragonslayer 253

Notes 261

Bibliography 275

Index 283

List of Figures

2.1 U.S. Gold and Official Dollar Claims, 1969–1973 70

3.1 Development of Oil Prices, 1972–1982 162

4.1 U.S. Misery Index, 1969–1984 216

4.2 German Marks per U.S. Dollar, 1969–1984 243

This page intentionally left blank

Preface

On June 17, 1972, I moved to Washington as a young economist released by the Netherlands central bank to be the personal assistant of Pieter Lieftinck, the Dutch executive director at the International Monetary Fund (IMF). The next morning, I woke early and skimmed the *Washington Post*, a copy of which had been placed in front of my hotel room door. Barely paying any notice to it, I glanced at an item describing a break-in at the headquarters of the Democratic National Committee, in the Watergate building. Soon I was immersed in my work at the IMF, which was experiencing the most challenging period in its almost 30 years' existence. Less than a year before, the link between gold and the dollar had been broken—the first dramatic act in the demise of the exchange rate system constructed at the Bretton Woods Conference in 1944. When I arrived at my new office, further fault lines were appearing in the patched-up monetary framework.

I was fascinated by what was happening in the arena of international finance and had studied the subject intensively both at the University of Amsterdam and at the Netherlands Bank. The IMF was at the center of the international monetary system, and there was no better place to work for someone with a deep interest in how the system worked in practice. I was fortunate in that my patron was the respected dean of the executive board and a former minister of finance who not only had a profound knowledge of how the IMF operated, but who was also greatly experienced in how the worlds of economics and politics interacted. Having a superb mentor was not the only benefit of being an assistant to a board member, but being allowed to sit in on discussions at the highest level was also a useful learning experience. In addition, my contacts with the outstanding fund staff and fellow assistants—later called advisors, reflecting title inflation—were both intellectually stimulating and socially enriching.

To me—an internationalist—the IMF was the most successful large international organization that had ever been established, and many of its executive directors had either been high officials in their home countries or were promising younger persons many of whom would go on to attain very senior positions in their later careers, as was also the case with a number of their assistants whom I befriended.

In my youthful enthusiasm at living in the power capital of the world, I began to follow American politics closely. Soon Watergate started featuring regularly in the media. I watched the hearings in the Senate and the House Judiciary Committee on television as often as I could. And when the White House tapes were discovered, I began to think, like so many others, that President Nixon would not survive as one revelation followed another. Being slated to return to Europe in October 1974, I often wondered whether I would still be in Washington for the final denouement of the Watergate imbroglio. I was, and I watched the president's resignation speech on my old black-and-white television. When I left the American capital—which I had come to like very much—with my young family, I felt that I had learned a lot both about the inner workings of the IMF and of American politics. What I took from Watergate was not so much amazement at the sordidness as an understanding of how the American system of checks and balances and a free press had made it possible to bring the nightmare to an end.

During the 2½ years I spent in Washington, three potentially very dangerous crises converged. First was the continuing unraveling of the international exchange rate system and the gambit into a system of general floating without rules; next was Watergate with its potentially disastrous final act; third was the oil shock of late 1973, which pushed the world economy into a steep recession while fueling inflation. What more could a macroeconomist and political junkie wish for? Of course, sitting in a nice office—mine had a view of the Lincoln and Jefferson Memorials—and enjoying job security, my personal discomfort was limited to the long gas lines after OPEC shocked the world. But to paraphrase Johannes Witteveen, who headed the IMF at the time, it is often best to approach crises with a certain detachment, like a medical doctor who simply cannot worry about his or her patients all the time.

This book is inspired by my precious first years in Washington during an especially turbulent time. It is written as a rolling narrative, spiced with anecdotes and descriptions of the personalities of the main political and money masters of that time. I hope it will to appeal not only to economists, political scientists, and historians but also to those readers who enjoy books of narrative nonfiction about subjects in which they are not experts. Although personal recollections form part of the book, it is based mainly on verifiable sources, such as memoirs, scholarly studies and articles, archives and interviews. Many of the sources I tapped are unknown or little known in the English speaking world, having been written in foreign languages, particularly Dutch, German, and French. Many quotes are taken from Dutch sources, not only because Dutch is my native language, but also, to quote Paul Volcker—one of the protagonists of this book—because of "the talent and dedication the Dutch have traditionally supplied to international organizations."[1] I hope readers will forgive this seemingly chauvinistic use of a quote that I want to place in perspective by mentioning that after serving on the executive board of the IMF from 1994 to 2003, I decided to stay permanently in Washington, D.C., which I now consider my hometown, together with Amsterdam.

This page intentionally left blank

Acknowledgements

This book has benefited greatly from interviews I was able to conduct with a number of senior officials who were intimately involved with the dramatic developments in the international monetary system in the 1970s. Foremost, I wish to thank Johannes Witteveen, managing director of the IMF during its first real crisis, who graciously invited me to his home to answer my questions. I was also fortunate to interview Andrew Crockett, Witteveen's personal assistant at the time, who has since passed away and is sorely missed. Sam Cross, Leo van Houtven and Andre Szasz, from whom I learned much about the politics of economics, all took time to the delve into the past at my request.

My knowledge of the history of the international system has also been enriched over the years through frequent discussions with Jacques Polak and Robert Solomon, both now deceased. Wim Duisenberg, Dolf Kessler, Alexandre Lamfalussy and Emile van Lennep, among others, shared important insights with me at various stages of my career.

Charles Lucas and Paul Shevchenko undertook the unenviable task of reading the manuscript and providing helpful comments. John Coleman and Ian Plenderleith, whom I befriended at the IMF in the early 1970s, kindly answered a few questions about that long-ago period.

I wish to thank Taiba Batool and Rachel Sangster of Palgrave Macmillan, as well as Dane Torbeck for their editorial input. Historical images were promptly provided by the photo archives of the IMF and the Netherlands Bank.

Besides badly needed technical assistance, I much appreciated the interest shown in my work by Aernout and Mariette de Beaufort and Alexandra and Blair Bowie.

Most of all, I am grateful to my wife Chris Nicholson, who not only read the manuscript and improved my grammar and style, but whose never failing support has been crucial for the completion of this project.

This page intentionally left blank

Introduction

When Richard Milhous Nixon was sworn in as the 37th president of the United States on January 20, 1969, Washington still had the feel of a southern city in a number of ways. People and business proceeded at a leisurely pace. Traffic jams were few and far between except on M Street, in fashionable Georgetown. Azaleas, dogwoods, and redbuds in profusion brought splotches of bright colors in spring, and the shadow of oak trees lining quiet streets provided welcome relief during the hot summers. Washingtonians dressed conservatively: Dark suits and white shirts were *de riguer* for men, and women wore dresses of subdued colors or buttoned-up blouses with skirts. Pant suits for ladies were yet to come. Courtesy in traffic and in the street was expected; loud voices were not appreciated. Cultural activities were limited, though the Kennedy Center for the Performing Arts, under construction, to be opened in September 1971, foreshadowed change. Tall structures were absent, the building code preventing national monuments from being dwarfed. New buildings were generally unimaginatively boxy and without frills, with the exception of the Watergate complex, completed in March 1967, which included luxury apartments, fancy shops, and a five-star hotel that introduced a daring curvy style with large balconies and shark-tooth adornments and that was destined to play a defining role in American history.

The White House was still truly the people's house, accessible on the east side to the public without a show of tickets. Although the south side was closed off to the public, a small gate close to the rear of the Executive Office Building was largely hidden from view by low hanging trees and surrounding shrubbery. White House staffers who wanted to stretch their legs during their lunch break could unobtrusively leave the grounds, avoiding gawking tourists assembled around the main entrance. And at a time when shooting at the president's residence from the street was still unknown, cars on Pennsylvania Avenue drove right by the most important building in the United States—arguably, in the world. On its left loomed the neoclassical U.S. Treasury Building, the most important financial institution in the world. Two blocks to the west, an unimpressive building was shared by the International Monetary Fund and the World Bank, the world's foremost international financial organizations, little known to the public. But their multinational staffs, along with the diplomatic community, added color to a city composed mainly of federal workers. A few blocks farther to the west stood the attractive marble façade of the building housing the board of governors of the Federal Reserve system, the most powerful central bank on earth. And Washington, though a little sleepy, was the political capital of the world, with deliberations on Capitol Hill not only determining the fate of Americans, but also greatly influencing the lives of billions abroad.

But east and north of Capitol Hill was a very different Washington, mostly inhabited by African Americans who mostly lived under unenviable conditions. Unemployment among blacks was high, and drug use and crime were rampant. Against this background, riots broke out after the assassination of Martin Luther King on April 4, 1968. Fires lit the sky, and a large section of buildings on 14th Street were reduced to charred remains. Racial strife was not the only serious problem undermining the earlier tranquility of the middle and professional class in Washington. The Vietnam War, still continuing, was dividing the country. Protests against the war often led to violent confrontations between demonstrators and the police or supporters of military intervention. Vocal opponents of the War, gathering in Lafayette Square across from the White House, were audible even in the Oval Office.

The newly inaugurated president, who had defeated Hubert Humphrey in the 1968 election after a bitter campaign, cherished the realization of his greatest ambition. Having narrowly lost the 1960 presidential election to John F. Kennedy, and having failed in his bid for the governorship of California 2 years later, Nixon had made a spectacular political comeback and was determined to maintain the trust of voters on the right, whom he referred to as the "silent majority." The continuing unrest in the country, which reached its peak at the Democratic Party's annual convention in Chicago in August 1968, had instilled anger and fear among many citizens, who were calling for restoration of law and order. The president was determined to quell the strife by two means. He declared that he would not tolerate further domestic disturbances, but also that he would bring the Vietnam War to an end in a year. But ending the war would take another 4 years after the Nixon administration, no longer seeking outright victory, pledged to achieve "peace with honor." Yet all of this was still far away in January 1969 as the president pledged to make the United States a calmer place, foster peace in the world, and strengthen America's position in the world, damaged by the conflict in Vietnam.

Although Nixon's first priority was ending the war without the United States' losing face in the eyes of the world, the economy and the international position of the dollar also required attention. The Vietnam War and President Johnson's Great Society project turned out to be much costlier than originally envisaged, and absent a tax increase, the government's finances would not be in good shape, contributing to a surge in inflation to 5%, the highest rate since 1951, when the Korean War had pushed up prices. And as U.S. trading partners posted lower rates of inflation, America was losing its competitive edge, causing the gap between its exports and imports to narrow rapidly. Sales of American cars abroad were falling even as Toyotas and Volkswagens were becoming more and more popular in the United States. The same was happening with other products that were less visible to the public, such as industrial machinery. In addition, the United States was exporting large sums of capital, most of it was earning healthy profits and dividends benefiting American companies and investors. But not all. Some of this outflow represented withdrawals of dollars by foreigners distrustful of the American currency. Thus the United States frequently ran deficits on its overall payments, and European countries and Japan were in surplus and were accumulating dollars. In sharp contrast to the years of dollar scarcity after World War II, Europeans no longer wanted to add to their dollar reserves. They worried that a dollar glut was developing, feeding inflation in their countries, and so had been converting part of their newly acquired dollars into American gold. But this process could not go on forever, as the United States' official gold was no longer sufficient—by a large margin—to exchange all dollars in the hands of foreign central banks into the sought after yellow metal. And politics was part of the equation. France, led by the nationalistic Charles de Gaulle, wanted to challenge what it regarded as the hegemony of the dollar.

Unforeseen by Nixon or anyone else at the time, the American president would also have to deal with a unique problem that would ultimately prove his undoing during his second term. As more evidence of the "third-rate burglary" in the summer of 1972 at the offices of the National Democratic Headquarters in the Watergate complex came to light, Nixon lost the confidence of the American public, and foreign investors and politicians also started to take notice. No sane person, except perhaps Communist leaders, wished to see a serious political crisis developing in the strongest country in the world: The Watergate crisis added to the dollar's weakness. And as the American leader became increasingly distracted and erratic with the unfolding of the Watergate drama, the possibility of a cornered and angry Nixon taking extreme action to divert attention away from the ongoing investigation could not be ruled out. Alexander Haig, White House chief of staff at the time, wrote in his memoirs that "[the] stakes were higher and the circumstances stranger than the world imagines" toward the end of the Nixon presidency in August 1974.[2]

Also not foreseen when Richard Nixon took the oath of office was that a fourfold increase of oil prices in 1973 would place the world economy in grave danger. Dealing with the oil crisis was unusually hard as the soaring prices of kerosene, heating oil, gasoline, and a variety of industrial products simultaneously depressed economic growth and added to already high inflation. This new phenomenon—soon to be known as stagflation—represented uncharted waters for economists and policymakers. No economics textbooks dealt with this vexing problem. But if not addressed, the consequences could be very serious and even lead to a meltdown of the world economy. The huge jump in oil prices and accompanying Arab oil boycott of the United States also harbored disturbing political risks. Israel had been attacked in October 1973 by Egypt and Syria and was only able to turn the war in its favor after receiving American military materiel. The conflict in the Middle East also created serious tensions between the United States and the Soviet Union, which championed the Arab countries. After Nixon had stared down the Soviet leader, Leonid Brezhnev, and the American secretary of state, Henry Kissinger, succeeded in brokering an end to the hostilities between Israel and its enemies, the boycott was lifted. But oil prices remained elevated, plunging oil-importing countries into a deep recession while fueling already high inflation. And many countries were unable to pay their much higher oil bills.

The presidency of Richard Nixon—from January 1969 to August 1974—was the most dramatic period in the post–World War II era. Nixon was an intelligent man with a masterful grasp of foreign affairs but with a dark side that included hate, suspicion, paranoia, ruthlessness, lying, and even criminal behavior. "It was easy to draw out Nixon's dark side," according to his aggressive special counsel, Charles Colson.[3] The president's complex personality made him highly controversial and a figure of fascination, morbid or otherwise. During his 5½ years as president and the most powerful man in the world, he was not blessed with an easy ride. Although the Watergate imbroglio was of his own doing, the gold–dollar crisis and the oil shock had their roots outside the White House. What makes the early 1970s unique is the convergence of these three crises, each carrying its own dangerous load and in combination posing a unique political and economic threat to global stability.

This book is set mostly in the period of the Nixon presidency but also explains its context, from the evolution to the demise of the gold standard. The final part relates how the stubborn problem of inflation—the remaining major risk factor to the world economy—took until 1982 to be overcome. This book focuses on economics but also highlights the role of politics where it influenced or determined monetary and fiscal policy—which was often. The main actors dealing with these dramatic developments are also illuminated, personalities being important in shaping future developments. International negotiations on the role of gold and the dollar as well as on dealing with the oil shock—the main monetary and economic and financial problems encountered on Nixon's watch—were markedly influenced by strong personalities. The main actors on the international financial stage were Americans and western Europeans, and Frenchmen played a special role. Several of these men were up-and-coming politicians and technocrats who would later reach the highest levels of government. President Nixon, who instead was, in his second term, on a downward trajectory, did not focus much on economic and monetary issues—it has been reported that they made his eyes glaze over—being much more interested in foreign political affairs. By contrast, presidents De Gaulle and Pompidou of France displayed a stronger focus on monetary and financial matters but, like Nixon, were only involved at the end of negotiations.

Those who did the really hard work operated at the level of ministers of finance and central bank governors and their technocratic deputies. The U.S. secretaries of the treasury, the equivalent of finance ministers elsewhere, stood out not only because they represented the most powerful country, but also because of their strong personalities or their expertise. Among these the swaggering Texan, John Connally, sometimes appreciated but mostly reviled by his European counterparts, stood out even among equals. His successor, the soft-spoken and diplomatic George Shultz, was influential and respected but became better known after being named secretary of state. And although he was of lower rank, Paul Volcker, then undersecretary for monetary affairs at the U.S. Treasury was the American point man on monetary negotiations during the early 1970s. Direct and sometimes domineering, Volcker nevertheless earned the respect of his foreign interlocutors with his deep knowledge of the issues. Showing early promise, Volcker later became perhaps the most admired chairman of the board of governors of the Federal Reserve system. On the other side of the Atlantic, the French minister of finance, Valéry Giscard d'Estaing—destined to become president of his country—emerged as the most influential European negotiator. French views often clashed with those of the United States, and Giscard skillfully presented his country's case. Helmut Schmidt, who became the German minister of finance in July 1972, soon made his mark at international meetings. Fewer than 2 years later, he was chosen to succeed Willy Brandt as chancellor of West Germany. Not as well known, but effective in his quiet, diplomatic way, Johannes Witteveen took the helm at the International Monetary Fund in September 1973. Also a former minister of finance, the ascetic Dutchman was faced with the oil crisis soon after he became the IMF's managing director. His plan to recycle money from oil exporters to oil importers proved to be a success in dealing with the dangerous effects of the jump in energy prices.

After a number of harrowing years, the risk of a political and economic meltdown was contained. But after this narrow escape, still not all was well: An inflationary aftershock stemming from the oil crises of 1973 and 1979 called for strong measures. Preventing out-of-control price increases required a brutally tight monetary policy engineered by Paul Volcker, who had become head of the Federal Reserve. Resolving the daunting challenges of the 1970s and early 1980s came at a high cost yet ultimately was worth it: The 25 years following 1982 turning out to be a period of growing economies, low unemployment and inflation, and political stability. How it all came about is narrated in what follows.

Part I
Gold

1. A unique metal

> Truly it is hard to imagine . . . any standard other than gold—yes, gold whose nature does not alter, which may be formed equally well into ingots, bars, or coins, which has no nationality, and which has, eternally and universally, been regarded as the unalterable currency par excellence.[4]

Stirring words spoken by French president Charles de Gaulle on February 4, 1965, based on a centuries-old and widely held conviction. Capturing the spirit of the preference for gold, the Irish playwright George Bernard Shaw declared:

> You have to choose between trusting in the natural stability of gold and natural stability of the honesty and intelligence of the members of the government. And, with due respect to the gentlemen, I advise you, as long as the capitalist system lasts, to vote for gold.[5]

But the famous British economist John Maynard Keynes held a very different opinion, stating in 1923 that while "gold still enjoys the prestige of its smell and colour," it "is already a barbarous relic."[6]

Throughout at least 6,000 years of history, gold has had a magic ring to it. Possessing the hugely prized yellow metal led to riches for miners, kings, and potentates, provided nation-states with the means for waging war, fostered criminal activity, and in modern times, aided by deep drilling techniques, formed the core of economic activity in countries such as South Africa. Gold proved to be very suitable for making exquisite jewelry by what we now consider primitive societies and much later for use in sophisticated industrial products. But, most important, it played a dominant role in the world's currency arrangements for centuries and has served as a war chest from early to modern times.

Gold has particular characteristics that make it a metal unlike any other. Apart from its attractiveness as a soft and shiny yellow metal, its density (19 times the weight of water), malleability (it can be completely flattened), and immunity to rust and most acids make it a unique element in nature. And as greedy as much of mankind has always been, gold's high monetary value has encouraged constant attempts at swindling prospective buyers from ancient times on by representing painted lead or certain alloys as gold. As buyers caught on to these practices, they responded by applying a number of ways to verify the presence of gold in an item, the most effective being the "acid test." Because gold, unlike other metals, is not dissolved by nitric acid, the lack of a chemical reaction when exposed to the acid proves that a metal object is truly gold. Another old practice is the "bite test," whereby a prospective buyer is satisfied if his teeth leave a mark in the soft gold.

The main uses of gold today in industry (about 10% of new production), as jewelry (about 40%), and in investment (50%). Purchases of newly mined gold by central banks—once representing a huge chunk of world production—have become a trickle. By contrast, gold's industrial use has increased steadily. It is now used for electrical wiring for high-energy applications, as a thin layer coating for electrical conductors, for other parts for certain computers, in communications equipment, in spacecraft and jet aircraft engines, as a protective coating on satellites and astronaut's helmets, in electronic warfare planes, and, of course, in dentistry. Gold jewelry, together with diamonds, is the most popular adornment across the globe, often doubling as an investment.

Investment can take the form of simple hoarding "under the mattress," for which French peasants have been famous, or as a means of protection against wars, inflation, and bank failures. Asians have traditionally been the world's largest hoarders of gold. This is particularly so in India, where gold jewelry is regarded as both an adornment and a store of value readily transportable in troubled times. In Western countries, investors have long bought gold as a means of diversifying their investment portfolios or merely for speculation. Because gold does not earn interest, investors depend on higher gold prices to attain a satisfactory yield. Gold holders of this type seldom keep their gold in physical form at home—except perhaps coins—preferring safety and often anonymity. Vaults in Swiss banks and other secretive financial centers contain large amounts of gold held for private customers. Usually these individuals never see their gold and thus never see the beautiful yellow metal, even though they may have Midas's touch when it comes to investing.

Monetary gold

By far the largest stocks of gold are held by central banks or national treasuries, known as monetary gold—nowadays to the tune of 35,000 metric tons, worth almost $18 trillion at present market prices: 11% more than the United States' gross domestic product.[7] Monetary gold, which in the past increased steadily in volume because central banks bought the bulk of newly produced gold, has played a crucial role in world history since the early 19th century. Gold was long generally accepted as a means of payment for domestic transactions, as well as across international borders, and it became the pivot of the monetary system known as the gold standard.

Nations also considered their gold reserves a war chest for use during times of conflict. In ancient times, gold was seen as the *nervus belli*, or sinews of war. Later on, gold was also used as collateral against borrowing from foreign bankers. And if collateral was not required, gold nevertheless provided comfort to potential lenders. At one extreme, powerful countries conquered smaller and weaker ones chiefly to obtain their gold. In the early 16th century, Spain's *conquistadores*, such as Hernan Cortez, overpowered Indian tribes in Latin America in a quest for gold. But when *El Dorado* was not found, the *conquistadores* had to settle mainly for silver brought back to Spain. In the late 19th century, British troops conquered the small republics in South Africa that had been established by the Boers (mainly descendants of Dutch settlers who called themselves Afrikaners). The main push for British occupation came from the fierce imperialist Cecil John Rhodes, who combined a dream of British dominance from the Cape to Cairo with a desire for the diamonds (he founded the De Beers company) and gold that had been discovered in Transvaal in the late 19th century. Over the years, South Africa became the world's largest gold producer.

The golden fleece

No written history of the first use of gold exists—only informed guesses. Gold artifacts found in the Balkans and the Levant dating from 4,000 BC are often cited as the beginning of the yellow metal's ascendancy. Early gold was probably mined in present-day Transylvania (a part of Romania) and Thrace (in the south eastern corner of the Balkans). Gold production followed in the Middle East around 3,000 BC, by the Sumerians, in present-day south Iraq, whose gold jewelry showed imaginative design. In Pharaonic Egypt, hieroglyphs from 2,600 BC onward mention gold, most of it mined in Nubia, in present-day Sudan. An evolutionary jump occurred around 1,500 BC as gold assumed the role of the standard medium of exchange for conducting international trade. Subsequently new and more sophisticated techniques for mining and designing jewels were introduced, mostly in the Middle East. And on the shores of the Black Sea, gold dust from river sands was extracted by using unshorn sheepskin, which after drying out released the gold flecks when shaken. The legend of the quest for the "golden fleece" by Jason and the Argonauts is probably derived from this practice. In a further step, the Scythians, a people who inhabited parts of present-day Ukraine from 200 BC to 800 AD, achieved remarkable results in gold jewelry design, today sought after for museum display.

Although in China little squares of gold were legalized as a form of money in 1,091 BC, the first gold coins were minted in Lydia, in present-day Turkey, around 610 BC. The use of coins meant that gold and silver lumps or ingots no longer had to be weighed. Determining the weight and fineness of these metals was a cumbersome process and slowed down commercial transactions. Issuing pieces of gold and silver in a standardized way was one thing, but for coins to receive general acceptance, they also had to be stamped with an authoritative testament to their weight and fineness. Soon the right of coinage was reserved to the state or crown (states were generally kingdoms in pre-modern times), the "stamp" usually consisting of the king's image or his coat of arms.

The next significant step in the evolution of gold was the introduction by the Romans of hydraulic mining methods, mainly in Spain and Dacia (an ancient name for Romania, used as a penal colony by Rome). As gold was extracted in increasing quantities in different regions, it became important war booty. The armies of Alexander the Great, Julius Caesar, and Charles the Great were all successful plunderers of gold. Because gold was seen as the way to riches by so many, attempts to produce gold by chemical processes started as early as 300 BC. The first alchemists were the Greek and Jewish residents of ancient Alexandria. Lead was often used as the base for their experiments in the hopes that it would interact with a mythical substance known as the philosopher's stone. Despite their lack of success, alchemists persevered for an amazing two millennia, a testament to the human obsession with gold.[8]

Throughout history, coins have often been made of silver instead of gold. Thus in 1066, the year of the Norman conquest of England, the British pound, made of a poundweight of sterling silver, was introduced. Some 200 years later, England, having introduced the florin as its first major gold coin, adopted a monetary system of gold and silver. And the rich republic of Venice introduced the famous gold ducat in 1284, a coin that was used around the world for five centuries. The thirst for gold, seldom uplifting, became especially ugly when King Ferdinand of Spain, who had earlier succeeded in driving the Moors and the Jews from his country, exhorted explorers to "[g]et gold—humanely, if you can—but at all hazards, get gold."[9] The consequence was the brutal subjugation of indigenous inhabitants of what is now Latin America. In 1700, the Portuguese colonizers discovered gold in Brazil—which in a mere 20 years became the world's largest gold producer. A weakened Spain could only watch as its Iberian neighbor raked in the profits.

A brief bout of bimetallism

Around the same time, much of the world was moving to bimetallism, with gold and silver circulating side by side in a fixed ratio. In England in 1700, when Isaac Newton was master of the mint, the price of gold was established at just below 85 shillings per troy ounce, where it remained until 1914. The ratio of gold to silver was fixed at 16:1. The United Sates adopted a bimetallic standard in 1792, with a 15:1 ratio. Bimetallism proved to be an unstable system and was later abandoned, first by Great Britain in 1816 and then by the United States in 1873, over the strong objections of American supporters of silver. In 1896, William Jennings Bryan, a presidential candidate and impressive orator, drew directly on America's Christian heritage when he proclaimed, "[Y]ou shall not press down upon the brow of labor this crown of thorns. You shall not crucify mankind upon a cross of gold."[10] Soon afterward, he was defeated by William McKinley, who staunchly supported the gold standard. Bryan, an anti-Darwinian, became even more famous not only by losing three presidential elections, but by also being on the losing side in the famous Scopes monkey trial.

Another fanatic "silverist," Senator Key Pittman from silver-producing Nevada, would cause considerable irritation and delay at the World Economic and Monetary Conference, held in London in 1933, during the Great Depression.[11] The conference had been called to discuss what could be done to improve the dire state of the world economy. Because all members of the League of Nations, along with the United States, were present, expectations of an economic breakthrough were high.

But the 7-week conference, now largely forgotten, was a failure. A number of participating countries were strongly in favor of restoring the gold standard—abandoned in 1931 by Great Britain and, not long before the conference, by the United States, a response to the financial crisis. The American delegation carried in their pockets a draft resolution advocating a return to gold. To their great surprise, President Franklin Roosevelt stated while the American delegation was still crossing the Atlantic that he had come to realize that gold was “an absolute fetish of so-called international bankers.”[12]

The American draft resolution, suddenly obsolete, had also contained some language on restoring the monetary role of silver, an idea that had not been seriously discussed since Bryan’s impassioned oration, and little attention had been paid to it before the conference. But unexpectedly, much of the discussions in London on monetary matters were devoted to the silver issue. Senator Key Pittman, from Nevada, who chaired the subcommittee on silver, insisted that his favorite metal’s role in the monetary system be restored—which would require that the price of silver be raised. Pittman, widely considered an eccentric, made quite a name for himself while the conference dragged on, appearing shabbily dressed at a reception and greeting the British monarch with the words, “King, I’m glad to meet you. And you too, Queen.”[13] He was described as going on “monumental drunks during which he shot out street lights.”[14] But he diligently chaired his subcommittee, actually achieving—after 7 weeks of excruciatingly boring meetings—the only concrete result of the whole conference. He steered an “international agreement on silver” to adoption that ultimately meant little but that made the state of Nevada happy for some time to come. Among those who forbore in the subcommittee was J. Willem Beyen, who would lead the Dutch delegation at the Bretton Woods conference 11 years later. He noted in his memoirs that although he was firmly against returning silver to any monetary role, he had “helped” Pittman by drafting the resolution on silver while at the same time almost neutering it. Beyen recalled that when the resolution was approved, Senator Pittman told him, “Young man, in the beginning I thought you were the Antichrist, but you turned out to be almost a saint.”[15]

2. The gold standard

Before Great Britain officially adopted the *gold coin standard* in 1816, gold already played an important role in international trade. Most countries sought to accumulate as much of the precious metal as they could. This mercantilist mindset represented the economic side of state-building and was mostly intended to accumulate as big a war chest as possible. But the emphasis on gold hoarding made way for more sophisticated insights. At the end of the 17th century, an influential British merchant, Joshua Child, even argued that gold and silver were commodities just like "wine, oil, tobacco and stuff,"[16] and that their exportation could be just as advantageous to the national interest. And the famous Scottish philosopher and economist David Hume provided the foundation for the theory of the gold standard, explaining that there was an "automatic mechanism" at work in international trade conducted in gold. This "price specie-flow mechanism" was a continuous process by which specie (gold) would flow from a country with a trade deficit to another with a surplus. The result would be an increase in the supply of money in the receiving country, which would push up its price level, in turn leading to lower exports with the reverse happening in the country losing reserves. This presumed mechanism of automatic adjustment of trade balances foreshadowed the working of the international *gold standard*. Over time this monetary standard acquired a mystique and "developed all the trappings of a full-fledged religion with shared beliefs, high priests, strict codes of behavior, creed, and faith."[17]

Britain leads the way

Great Britain, the richest country in the world of that day, officially introduced the gold standard in 1816 by tying the pound to a specific quantity of gold. Paper money, first issued by the Bank of England as early as 1694, and which had gradually become more popular with the public, could be converted into gold at the fixed price. This system lasted almost a century when the outbreak of World War I in August 1914 led to its suspension. The value of the gold coins in circulation in Britain is estimated to have been around 30 million pounds in 1796 and to have fallen to around 20 million by 1825 before rising steadily to 100 million pounds in 1875. By 1914 the number was 124 million pounds. By contrast, notes issued by the Bank of England between 1810 and 1913 grew only from 20 to 28 million pounds.

Clearly the public still preferred shiny coins over pieces of paper, which they eyed with some suspicion. But despite the modest circulation of paper money, the value of the Bank of England's gold stock for a long time covered only a fraction of the bank notes issued. And when the deposits of commercial banks held at the Bank of England, which could be drawn upon at any time, were added, the cover ratio of gold against all potential claims on the British central bank at times fell to as little as 2%. These dangerously low levels of official gold on several occasions led to a lack of confidence in bank notes, and suspension of convertibility was only narrowly avoided. Walter Bagehot—a leading thinker on financial issues and author of the famous book *Lombard Street* (1873)—did not focus on the ratio of gold to banknotes, but emphasized that there was an absolute minimum in gold reserves, which he called the "apprehension level,"[18] below which loss of confidence would lead to a rush to demand gold from the central bank. And there was another reason for the British central bank to hold a large stock of gold. Because London was by far the world's major financial center up to 1914, British gold also served as a reserve for practically the whole world.

The golden age

The real breakthrough of the gold standard as a global monetary system came in 1873, when silver was eliminated as a standard of value in the United States and the world's fastest-rising economic power unofficially went on a gold standard. The yellow metal's status became official with the passing of the Gold Standard Act in 1900. As a result the exchange rate of the dollar was fixed against other currencies on the gold standard, the rate being $20.67 per troy ounce. With currencies firmly pegged to gold in most Western countries, dollars were as welcome in Paris as francs, pounds in London, and marks in Berlin. "Currencies were just names for particular weights of gold."[19]

With the gold standard squarely in place, the world economy enjoyed a period of unparalleled prosperity up to 1914. International transactions were largely free and grew rapidly, while discoveries of the precious metal in several parts of the world ensured that there was enough gold to keep the engines of international trade humming. Although gold was first discovered in the United States as early as 1799 in North Carolina, it was master carpenter John Marshall's discovery of gold flakes near

Underground mining at Klondike, 1998.

Sacramento, California, 50 years later that triggered the Gold Rush and dramatically increased gold production. Soon afterward gold was found in Australia and South Africa, where gold veins were particularly rich, and in Klondike, Alaska, ensuring that the gold standard would not be constrained by a lack of gold. On the contrary, the huge influx of gold produced worldwide inflation.

The gold bullion standard

Converting notes into gold coins was cumbersome for central banks, as the public almost always demanded them in small amounts. Banks also felt that the ability to demand gold was preventing the use of more efficient paper money. Economizing on gold stocks was yet another reason to move to a system whereby conversion would in practice be restricted to businesses, which would allow for fewer transactions and for much larger amounts. The solution was the *gold bullion standard*—a British invention—which allowed central banks to provide gold only for large foreign transactions and in the form of bullion (bars) that could be easily shipped. Central bankers could now sleep better, secured from runs on their banks by the public in bad times. Another important but ultimately pernicious innovation was the *gold exchange standard*, a system that made it possible to earn interest on part of central banks' reserves. This was done by buying foreign currency convertible in gold—in those days mainly pounds sterling—which were invested in interest-bearing deposits. The first country to adopt this practice was Russia, in 1894. Continental European countries held an estimated 15% of their reserves in foreign currencies in 1913, but the formal gold exchange standard only began to play a major role in the 1920s.[20]

National legislation often obliged central banks to hold gold in a certain percentage against their paper money with the aim of removing doubts about keeping the gold window open. When the Federal Reserve System was established in the United States in 1913, it was required to maintain a minimum ratio of gold to banknotes of 40%. Other countries on the gold standard put in place similar requirements, to which many of them adhered to for decades, even after they no longer made sense under the monetary system adopted after World War II. Already in 1913, John Maynard Keynes, the famous British economist, who had rationally calculated the size of gold reserves that India should hold based on its trade balance, was scathing in his criticism of the practices employed by many central banks, stating that "the management of gold reserves is not yet a science in most countries."[21]

3. Gold loses its luster

On a warm day in August 1914, an avoidable war broke out between western Europe, Serbia, and, initially, Russia on one side and central and eastern Europe (Germany, Austria-Hungary, and Turkey) on the other. Also heavily involved were countries from the British Empire and, toward the war's end, the United States, whose army under General Pershing swung the balance in favor of the Allies. World War I did not turn out to be the fresh and merry war that the German Kaiser Wilhelm and his military leaders had expected. On the contrary, Germany suffered a humiliating defeat after 4 years of slaughter and was economically devastated to boot. On top of that, Germany's former enemies demanded huge reparation payments, including in gold, leading to strong resentment that ultimately contributed to the rise of Hitler. At the outbreak of the war, most of the belligerent countries were enjoying healthy economic growth, but realizing that the war effort would be costly—even if of short duration, as the German leadership anticipated—almost all countries on the gold standard suspended it.

When an armistice was declared on November 11, 1918, the world was a different place. The *ancien régime* largely gone, Germany became a republic and the Kaiser went into exile in the Netherlands. Gone was the lavish lifestyle of many of Europe's landed gentry. Socialism and communism were in ascendency, and politics was more chaotic than before. Germany's Weimar Republic was highly unstable and wracked by bouts of hyperinflation. Russia had been transformed into the communist Soviet Union and had turned severely anti-Western. The Habsburg Austrian-Hungarian monarchy was no more, and a large swath of Balkan countries united in the new state of Yugoslavia after the Versailles peace conference. The Ottoman empire was collapsing, adding to post-war misery and uncertainty. At the same time, the United States became the major political and economic force in the world, and its dollar started its ascent to becoming the world's major currency at the expense of the pound sterling. In Europe, countries dealt not only with the ravages of war, but also with inflation fueled by an enormous surge of money in circulation—a classic case of too much money chasing too few goods.

Back to normal?

The pre-war gold standard had worked well—as described by the great Austrian economist Ludwig von Mises[22]—and prevailing opinion had it that returning to gold would help solve most of the problems ailing the world economy. This sentiment was backward-looking and did not take into account the drastic changes that had taken place in the global arena. Much of the support of going back to gold reflected nostalgia for the past. In the end, the wish to return to "normalcy" was so strong that bringing back gold as the center of the monetary system was seen as the only way of achieving stability. And at a League of Nations–sponsored international monetary conference held in the Italian city of Genoa in 1922, a consensus in favor of a return to gold emerged, although no longer as a gold coin standard. But two prominent economists were highly skeptical of a return to gold. Gustav Cassel, a prominent Swedish economist, had already warned at an inconclusive international conference in Brussels in 1920 that reinstating the gold standard risked serious deflation that could only be avoided by choosing a new gold parity for currencies "considerably lower than it was before the War."[23] In essence, he advocated devaluation, though without mentioning the dreaded word. And Keynes, in his outspoken way, stated: "I feel no confidence that an old-fashioned gold standard will give us even a modicum of stability that it used to give"; he therefore rejected, he said, "the policy of restoring the gold standard on pre-war lines."[24]

But although the majority of decision makers were not ready to abandon gold, they did support adopting a gold exchange standard, which would require less gold and earn interest for central banks accumulating pounds sterling and dollars. No thought was apparently given to the possibility that such investments could be risky and eventually lead to capital losses for the creditors. For the British, such a system held great advantages, as London would attract gold against mere bookkeeping entries in return. Moreover, it would be a profitable enterprise, as there would be an attractive margin between interest rate paid on deposits held with the British banks and the rate at which these funds could be lent. Montagu Norman, the governor of the Bank of England, understood this perfectly well, as did the British commercial bankers, such as the Barings and Rothschilds.

Although the United States preferred to stick to a gold coin standard, it was alone in this preference. The other major financial power, Great Britain, whose stock of gold had shrunk dramatically, wanted to formally adopt a gold bullion standard but only after it felt confident that it could safely take the step. Besides political considerations—several continental European countries had returned to the gold standard—the British decision makers were also interested in the advice that Professor Edwin Kemmerer of Princeton University, known as the "money doctor" would give to the Union of South Africa about a return to gold.[25] Also invited by the South Africans was Gerard Vissering, respected president of the Dutch central bank and a known supporter of the gold standard.

The duo, accompanied by a small staff, sailed for Cape Town in November 1924. After a prolonged visit, as was usual in those days, they recommended that the South African government adopt the gold *exchange* standard. This was not surprising; South Africa, a member of the British Commonwealth, conducted most of its foreign trade in British pounds. Kemmerer and Vissering had been convincing, and South Africa took the advice, soon followed by the Netherlands. Ironically, Vissering was to become a victim of the gold exchange standard 7 years later.

The gold exchange standard

On April 28, 1925, not long after the Kemmerer mission, the British chancellor of the exchequer (as Great Britain's minister of finance is known to this day), Winston Churchill, after a heated internal debate, announced that Britain was returning to gold. But it adopted the gold bullion standard and repealed the gold coin standard. The Bank of England would only pay out gold on demand at a fixed price, in the form of gold bars weighing some 400 troy ounces. This practically ruled out conversion of pounds into gold by the general public. The rate (parity) of the pound to gold was maintained at the pre-war level reflecting the wish to return to "normalcy" as well as an attempt to demonstrate the strength and integrity of sterling. But the return to the old rate would turn out to be a major mistake, as Great Britain could not compete in the world market with the pound fixed at 4.86 to the dollar. John Kenneth Galbraith painted the episode as a "superb manifestation"[26] of Liebling's law, which held "that if a man of adequately complex mind proceeds in a sufficiently perverse way, he can succeed in kicking himself in his own ass out the door into the street." Still, it would take a while before the overly high rate of the pound would become blatantly clear, as unemployment in Britain kept rising.

But in 1925 the British decision was welcomed by other countries, as all the major powers had re-adopted the gold standard and talk of the "triumph of gold"—the title of a book by Charles Rist, appointed deputy governor of the Banque de France in 1926—resurfaced.[27] During this, the Western world's foremost central bankers engaged in unprecedented cooperation.[28] Contacts between the Americans, particularly the savvy Benjamin Strong, president of the Federal Reserve Bank of New York; the British, led by Montagu Norman, governor of the Bank of England, a traditional English gentleman; Hjalmar Schacht, the German Reichsbank's capable and idiosyncratic head; and France, represented by Emile Moreau. Also playing a role on the international stage were Gerard

Vissering of the Netherlands and Ivar Rooth, head of the Swedish Bank; Ernest Harvey, deputy governor of the Bank of England, substituted for Norman when Norman was abroad on one of his many voyages.

But as contacts between these individuals was mostly of a bilateral nature and urgent matters such as German reparations could only be fruitfully discussed in a wider circle, it was decided in 1930—not long before the gold standard would be imperiled—to establish the Bank for International Settlements (BIS) in Basel, Switzerland. Central bankers met regularly—maintaining strict confidentiality—at the BIS, located in a former hotel near the train station.

Although Basel was by no means an international financial center, its advantage was that it was situated in a neutral country in the middle of Europe and at an important railroad crossing. According to oral history, a few central bankers, when inspecting the future BIS building for suitability, stumbled upon a sign in German reading "Achtung Schacht" (Attention: Shaft).[29] And Schacht being the name of the skilful and idiosyncratic president of the German Reichsbank, it was quickly decided that the former hotel would do. After Hitler took power, Schacht had a difficult and stormy relationship with the dictator—but survived. On one occasion when the central banker was able to patch up things after a row with the unpredictable Hitler, he daringly joked, when asked by

Central Bank governors meeting informally: Montagu Norman (Bank of England), Gerard Vissering (Netherlands Bank), Hjalmar Schacht (German Reichsbank), and Benjamin Strong (Federal Reserve Bank of New York), Bloemendaal, the Netherlands, August 1926. (Courtesy Netherlands Bank.)

waiting journalists whether he could tell them what happened, "Everything is fine; the Führer stays."[30]

Breaking out of the golden cage

Great Britain had mistakenly returned to the gold standard at the pre-war parity of the pound against gold. Churchill's refusal to devalue the pound turned out to be a major mistake, sowing the seeds for the future collapse of the system. Because Britain had suffered from high inflation during the Great War, it had difficulty competing with other countries, soon leading to outflows of gold. And according to the informal "rules of the game" of the gold standard, the Bank of England had to raise its discount rate (the rate it charged banks who borrowed from it) to stop the loss of gold. Higher interest rates coupled with an overly strong currency led to economic stagnation and high unemployment, fueling strong criticism of government policies. And the countries receiving gold, which according to those same rules had to lower their interest rates, were often slow to do so. In this way France and other European countries accumulated large amounts of gold in their coffers. Under these circumstances, central bank cooperation deteriorated. According to Clarke "[for] the period up to June 1928, the record has considerable merit. On the other hand, the record of central bank cooperation after mid-1928 must be judged a failure." And again: "The breakdown of the American economy immensely complicated the problems of central bank cooperation."[31]

After 1925, hot money—speculative movements of capital—placed enormous strains on currencies, and central banks struggled to maintain the gold standard. The problem was not so much a shortage of monetary gold in the world as a skewed distribution of the metal: "If you want to play with marbles, each player must have a certain minimum of them, otherwise the game cannot be played."[32] With the economic depression becoming deeper by the day after 1929, the British government, led by Ramsey MacDonald, decided in absolute secrecy to abandon the gold standard on September 20, 1931. In an attempt to soften the blow, the government included in its statement the assurance that "there is no doubt that the present exchange difficulties will prove only temporary."[33] The diary entry of Montagu Norman, governor of the Bank of England, for September 21 simply reads "at sea";[34] he was returning from Canada to Liverpool. But he was also "at sea" regarding the momentous decision, not understanding a cryptic telegram he received from his deputy: "Sorry we have to go off tomorrow and cannot wait to see you before doing so."[35]

The pound's exchange rate plunged by 30% after Great Britain abandoned the gold standard, and as a result central banks that owned large sterling balances suffered huge losses. The Banque de France lost 60 million pounds, the Belgian National Bank 12.6 million, and the Netherlands Bank, which held a third of its reserves in pounds at the time, 10.7 million. Other central banks incurred smaller losses, but the Swiss National Bank, which cannily had converted its pounds earlier that year, escaped unscathed.

A rude shock

For the central banks whose losses were big, the consequences were serious. The Netherlands Bank's capital was wiped out and its international reserves largely depleted. Its president, Gerard Vissering, was deeply shocked. Less than a month earlier, he had visited the Bank of England to inquire whether the Dutch sterling investments were safe; there had been strong speculative pressure on the pound. On that occasion, he had been received by the Bank of England's deputy governor, Sir Ernest Harvey—the governor, Montagu Norman, being on a month-long holiday in Canada—who assured Vissering that he had nothing to fear after the forthright Dutchman asked for a guarantee that the Netherlands Bank would continue to be able to exchange its pounds for gold at the prevailing fixed rate. During a long monologue, Harvey told Vissering that the British government was about to receive large foreign loans that would ensure that it could maintain the value of the pound in gold. He added that if the Netherlands Bank wished to convert all of its pounds into gold, she would receive every penny from the Bank of England. But when asked for a written guarantee, Harvey demurred; Vissering did not insist, apparently feeling sufficiently reassured. The same assurances are believed to have been given to other central banks that were on the gold exchange standard. And in the final weeks before the devaluation, no requests were made by the Dutch central bank for conversion of pounds into gold. Either the Belgian and the Dutch central banks had been too trustworthy—Vissering has been described as a hardworking and very decent, but naive, man—or were imbued with a sense of solidarity to maintain the gold exchange standard. The French, sitting on a large pile of gold, seemed less perturbed by the matter and observed that their holdings of pounds were too large to get rid of at the end.[36]

Richard Sayers, author of the history of the Bank of England from 1891 to 1944, described the Dutch–British drama as follows: "The Dutch especially sought reassurance, and eventually Vissering . . . visited Harvey on 26 August [1931] and asked for earmarking some of the bank's gold to cover its own Bank. Harvey refused to give such a guarantee, but it seems (from the strength of the Dutch feelings afterward) that he went a long way in attempting in general terms to allay Vissering's anxiety. Three days later, on finalization of the final Paris and New York credits, Harvey cabled the news to Vissering (and to other central bankers) adding, "I trust this announcement will serve to abolish all doubts as to the safety of foreign funds in London."[37] Whether the central banks were sufficiently reassured to leave all their London funds untouched is not known, but certainly there was no drawing down of their normal deposits at the Bank of England. After the event, complaints were bitter, and the Netherlands Bank represented very strongly that its balance at the Bank of England should be adjusted to compensate for the depreciation against gold. The Bank of England resisted and continued to resist such claims. There was in London some feeling that the UK had been driven off gold by the misbehavior of others, and this helped to ease consciences. . . . Inevitably there was resentment among those continental central bankers whose specific requests for guarantees had been—as they felt—brushed aside."

Reverse gold rush

Chastened by their bad experience with the Old Lady of Threadneedle Street, as the Bank of England is popularly known, continental central banks hastened to exchange dollars for gold, led by the Belgian National Bank, which dumped $106 million in one shot almost immediately after the pound had "gone off," followed in the next days by the French—for about $350 million—and the Dutch and Swiss, for smaller amounts. The French central bank was not yet done cashing its dollars for gold and shipping the precious metal to Paris, but—fearing an American devaluation—the French prime minister, Pierre Laval, sailed to the United States in October 1932 "to hammer out conditions for maintaining dollar deposits . . . even temporarily."[38] But the aggressive Frenchman returned emptyhanded.

The fate of the short-lived gold exchange standard was now sealed. Vissering, miserable and shell-shocked, resigned soon after the British said farewell to the gold standard. Nevertheless the Netherlands remained on the gold standard, and together with other monetary conservatives—Belgium, Italy, Poland, and Switzerland—formed the *gold block* in 1933, which was maintained until 1936. Clinging to gold was in line with the recommendations of the Gold Delegation of the League of Nations in 1932 that countries that had gone off gold return to the fold. The Swedish economist Gustav Cassel was the only person within the delegation who disagreed, stating that trying to set up another gold standard in order to escape from the depression would be "the height of folly."[39]

And this was the position of other European countries who abandoned the gold standard sooner or later and whose economies started to recover after their currencies started floating.

Setting the gold price

In the United States, whose claims in sterling were small, and where support for the gold standard was still strong, a banking panic forced President Franklin Roosevelt to prohibit private holdings of gold coins, gold bars, and gold certificates in 1933. He wanted to set up a federal agency to execute a gold-buying program in the belief that he could raise farm prices by pushing up the gold price, in fact devaluing the dollar as more dollars would be needed to buy an ounce of gold. The plan was challenged as illegal by the young Dean Acheson, acting secretary of the treasury (later to become secretary of state under President Truman), but after a while Attorney General Cummings ruled it acceptable for the U.S. Treasury to buy gold on the open market. Roosevelt biographer Ted Morgan relates how the price of gold was determined: "Each morning in the president's bedroom . . . there took place a strange rite called 'setting the price of gold.' As FDR breakfasted on soft-boiled eggs in his solid mahogany bed, he and [Henry] Morgenthau [Secretary of the Treasury] and Jesse Jones, the chairman of the Reconstruction Finance Corporation, would set the price of gold slightly higher than the London and Paris prices. One day they decided on a rise of twenty-one cents and FDR said, 'It's a lucky number because it's three times seven. . . .'"[40] FDR kept raising the price of gold through 1933, but it did not produce the hoped-for rise in farm prices. Keynes, the theorist of countercyclical spending, described this currency management as "a gold standard on the booze,"[41] and the British ambassador to Washington, Sir Ronald Lindsay, sent his gruff appraisal to Winston Churchill, who had in 1929 resigned as chancellor of the exchequer: "For two months Roosevelt has been giving us pure hocus pocus and a continent has watched him agape. . . ."[42] Keynes, who met FDR in 1934, shared this dim view of the American president, having "supposed the President was more literate, economically speaking."[43] In his turn, FDR saw Keynes as some kind of "a mathematician rather than a political economist."

Dollar devaluation

In April 1934, the United States moved to a modified gold bullion standard that allowed only foreign central banks to convert their dollars into gold. All monetary gold was now owned by the government. And by act of Congress, the dollar price of gold was increased from $20.67 per ounce to $35 per ounce, a devaluation of the dollar to 60%. Now that the two major world currencies had devalued, a race to the bottom known as competitive devaluation was set in motion, which, together with the spread of trade restrictions, only deepened the world depression. The countries still clinging to gold were doing themselves no favor and saw their economies shrink, whereas those with floating rates were in recovery. In the largest member of the gold bloc, and the most resistant to change, France, vicious political clashes broke out between the pro-gold right and the left, which pressed for devaluation.[44] But right-wing Prime Minister Pierre Laval (executed for treason after the World War II for collaborating with the enemy) stubbornly issued more than 500 deflationary decrees. After Laval was ousted in January 1936, the Popular Front of the left under the socialist Leon Blum gave up defending the franc's gold parity, accepting severe losses on France's reserves—and with that, the last vestiges of the gold standard in Europe disappeared forever.

Hot money flows intensified, and because all currencies could not float downward together, severe tensions developed and restrictions on international payments proliferated. A widespread—if not fully justified—belief that a shortage of gold existed caused central banks to hoard the precious metal, aggravating the crisis atmosphere. The production outlook for gold was judged to be poor, and the requirement that paper money and deposits with central banks be backed by gold—40% in the Unites States—"locked up" a large part of monetary gold. Out of $10.8 billion gold held by central banks in 1930, only $3 billion could be used to settle payment deficits. As the world depression continued, many central banks were wisely allowed by their governments to reduce their cover ratios, moderating the scramble for gold. By 1936, "free" reserves had risen to $7 billion, or 54% of total gold reserves. In addition, unexpectedly large increases in gold production were the result of currency devaluations that made gold mining more lucrative. Moreover, existing gold stocks had become worth much more in dollars, pounds, and the like, abating worry about a shortage of gold.

But currencies no longer fixed to the price of gold fluctuated wildly, harming international trade through greater uncertainty about future prices. Moreover, as the BIS noted, there was a "retreat from the direction of internationalism toward a self-reliant, self-contained but ominous nationalism."[45] A final attempt to bring about greater stability resulted in the Tripartite Agreement of September 1936 between Great Britain, the United States, and France each of which pledged to keep its currency stable against the others so long as doing so did not interfere with internal prosperity. But the agreement did not fundamentally change the system of floating rates that had evolved—participants could withdraw with a mere 24 hours' notice. And on the eve of World War II, gold had lost much of its luster, the gold standard having been fully abandoned in practice.

4. War chest, war loot

The inter-war period had started with severe austerity and frantic reconstruction, followed by a burst of prosperity and hyperinflation in central Europe and, after the Wall Street crash of 1929, the Great Depression. The German population was thoroughly disillusioned: "The war had decimated its youth, destroyed its political system and the subsequent inflation led to the collapse of its social structure. [The Germans] could not understand, nor accept that their army had been beaten. The army was the symbol of their unity and military might the basis for their self esteem. Its defeat could not be true."[46]

Hitler adroitly made use of the German humiliation and malaise and after coming to power in 1933 started to build up his war machine, contributing to a drastic reduction of unemployment. At the same time, the Nazi regime strived for economic autarky, stopped paying war reparations, and imposed rigid controls on foreign exchange transactions. When war broke out in September 1939, practically the whole world imposed foreign exchange controls, and foreign trade was conducted to a large extent by barter. Currencies were pegged to the dollar or sterling, putting an abrupt end to floating exchange rates.

Building a war chest

The monetary role of gold had been greatly diminished in Europe during the 1930s. But that did not mean that gold's role became limited to industrial use and private hoarding. What Keynes had famously called a "barbarous relic" fully regained its ancient status as a war chest against chaotic times during which gold would be the only acceptable medium of payment among countries. And even if the yellow metal was hardly used in settling accounts after one and then another country "went off" gold, central banks in the runup to "Hitler's War" were feverishly adding to their gold reserves. As the BIS put it in typically understated fashion, countries did not care any longer about cover for their banknotes—which were expanding hugely as too much money was chasing too little goods—on account of the "dominating importance of other considerations."[47] The increasing fear of war with Germany and the need to be able to pay for much-needed raw materials, commodities, and food to feed the population were a major consideration for building up the "national treasure."

For Western democracies, adding to their gold reserves required them to either buy newly mined gold or run a trade surplus to be settled in gold. For dictatorial regimes, there were also other ways to obtain gold: They could steal it. The Soviet Union seems to have adopted this practice early in its existence. During World War I, the central bank of Romania's gold was sent to Russia for safekeeping. It is strongly suspected that the gold was "afterward appropriated by the Bolsheviks."[48] The next victim was Spain. At the time of the Spanish Civil War (1936–1939), the leftist Republican government, fearing that the large stock of gold held by the Bank of Spain—the fourth largest in the world—would be captured by the Nationalists under Francisco Franco, decided to send most of central bank's gold to Moscow for safekeeping and to pay for Soviet weaponry. Transport was arranged in October 1936 for 510 tons of gold, at that time worth about $500 million ($25 billion at mid-2013 market prices). The first leg was to dispatch the 10,000 crates of gold coins to the southern port of Cartagena, where they were loaded onto Soviet vessels. Next the gold was transported to the Soviet port of Odessa, whence it traveled in a huge convoy of trucks to Moscow.[49] A "deposit" was created for the Spanish gold, now safe from Franco's Falange but not from the wily dictator Stalin, who remarked to his inner circle that the Spaniards would never see their gold again, "just as they can't see their own ears."[50] Although Madrid was not able to recover its gold, what happened to the stash has remained murky. The Soviets later insisted that the Spanish Republicans had spent all the gold on military equipment. Records exist of large payments made by the Spaniards, who—according to strong evidence—were vastly overcharged for their purchases, but it is hard to believe that the Republicans used up all the yellow metal, which the Soviets conveniently smelted into bars.

After World War II was under way, adding in legitimate ways to gold reserves that—reflecting increased economic and political apprehension—had grown from $10 to $26 billion between 1928 and the beginning of the war—became virtually impossible. Great Britain, still at risk of invasion, was rapidly depleting its gold and dollar stocks to pay the United States for essential supplies. President Roosevelt, greatly concerned, informed his secretary of the treasury, Henry Morgenthau, in December 1940 that after thinking hard what to do for England, he would tell the British that the United States would "give you the guns and ships that you need, provided that when the war is over you will return to us in kind the guns and ships we have loaned you."[51] While

FDR's proposal was debated within the United States, Lord Lothian, the British ambassador in Washington, bluntly told the American press: "Well, boys, we are broke. It's your money we want."[52] And in March 1941 the United States came to Britain's rescue with its Lend–Lease Program, allowing London to spend up to the then-huge sum of $7 billion. More was to come as the program was expanded, by end of the war totaling a staggering $27 billion in aid.

War loot

It was one thing to build up a country's gold reserves as a wartime buffer, but another to protect the national treasure from being looted. And before the outbreak of hostilities in September 1939, central banks—a risk-averse group—concluded that keeping their gold in their own vaults would not prove protection enough if their countries were occupied. It was also recalled that during World War I, German forces had raided Belgium's stock of gold. As a precautionary measure, several years before Germany launched its *blitzkrieg*, France, the Netherlands, and Belgium started shipping their gold abroad. At a later stage, Great Britain started doing the same, even though general opinion held that Albion could repel a German landing. In fact, much of the Dutch and Belgian gold shipments were destined for the vaults of the Bank of England. Although more expensive, shipments of gold to New York, Ottawa, and even South Africa also took place.

Nazi Germany aggressively complained about American and British (Jewish) monetary "manipulations" using language such as "currency hyenas." As Berlin was strapped for gold and usable foreign currencies, its exports having shrunk, it was forced to regularly resort to cumbersome and inefficient barter trade. And by paying large sums of gold in reparations demanded after World War I, the Reichsbank's reserves had fallen to very low levels in the late 1930s. Nazi Germany's strategy of economic autarky could not fix the problem; building up its war machine required it to import certain indispensable goods not produced domestically, such as tungsten, which it was forced to buy from Spain and Portugal. As these countries wisely demanded to payment in gold, Germany was desperately looking for precious metal to loot. First it "procured" assets from Austria after the *Anschluss*, then followed that up by stealing gold from Czechoslovakia and Danzig. This boosted Germany's reserves by $70 million—not much, but a promising beginning. During the war, Germany stole a much larger amount of gold, mostly from Belgium and the Netherlands, to the tune of $550 million. The German army also appropriated gold from companies and wealthy individuals, but naturally no records were kept of these crimes.

Gold raids

Germany's first act of military aggression was occupying parts of Czechoslovakia in September 1938. By March 1939, Germany had occupied all of the country, declaring the "liberation" of the "mistreated" ethnic German community. Prague had prudently deposited part of its gold at the Bank of England via the Bank of International Settlements. One of the services provided by the BIS was to earmark gold it held at the Bank of England for its shareholders. This was a supposedly anonymous arrangement, and the British central bank knew only the number of the account, but not the owner—although insiders "were fairly sure"[53] which names belonged to which numbers. A mere 5 days after the Czechs had surrendered, the Czech central bank ordered the BIS to transfer its gold to the German Reichsbank's anonymous gold depot with the Bank of England. The affair became highly politicized after a leak from Prague to the press in London and Paris. After much handwringing, and after the BIS's legal advisor had concluded that there were no legal grounds to refuse the order, which had not been made under duress, the BIS executed the transaction.[54]

The British and French governments were heavily criticized for not having intervened, but maintained that they had nothing to do with the matter, claming that the central banks were to blame; the banks in turn blamed the BIS, on whose board the same central banks were represented. The BIS's young president, J. W. Beyen, he of the Silver Committee at the World Economic and Monetary Conference in 1933, was made the final scapegoat, and in his memoirs he expressed resentment at this passing of the buck to him. Only 76 years later was it revealed that the role of the Bank of England and of its governor in the affair was questionable. Soon after transferring the Czech gold to the Reichsbank's account, the central bank sold the Nazi gold. When on May 27, 1939, the chancellor of the exchequer inquired whether the Bank had sold the Czech gold, "[the] Governor in his reply . . . did not answer the question,"[55] knowing that the government was not in favor of aiding the Nazi cause in this way. The behavior of Montagu Norman, who headed the Bank of England at the time, has been ascribed to his support for "appeasement" as well as his German sympathies, which lasted until the German invasion of Poland and the British and French declarations of war. As the precise role of the Bank of England was not known at the time, the blame fell squarely on the BIS, contributing to the American proposal after World War II of liquidating the central bankers' club (though lack of support scuppered the plan).

The Dutch experience

As early as 1929, the Netherlands Bank started depositing a modest share of its gold reserves abroad. This was part of a general security policy; there was no fear of Germany at that time. After the Netherlands finally went off gold in 1936, it repatriated most of its gold kept abroad, arguing that it no longer needed to hold gold outside the country as the guilder was floating and there was no reason to make payments in gold. But soon afterward the central bankers in Amsterdam, concerned about the political climate, reversed their policy and began shipping a large share of Dutch gold to London and New York. This turned out to be far from easy; the Bank of England was also sending part of its gold to New York, making it more and more difficult to find ships that could transport the valuable cargo. Still, the Netherlands Bank's efforts to get its gold out of the country were largely successful, and at the time of the German invasion of the Netherlands on May 10, 1940, only 20% of the central bank's gold remained in its vaults in Amsterdam and Rotterdam.

The very last shipment from Amsterdam took place on the day of the invasion, with the same British vessel that transported the Dutch crown princess Juliana and her family to England. When after the Dutch capitulation the German occupiers demanded that the vaults of the Netherlands Bank's headquarters be opened, they were disappointed to find only a very modest amount of gold. The situation was different at the Bank's Rotterdam office, where the bulk of the Dutch gold that had not been shipped out in time had remained. Evacuating this gold proved almost impossible; heavy fighting was taking place in the center of Rotterdam. But Dutch marines succeeded in transporting some 10% of the Rotterdam gold to a pilot boat that was to be escorted by a British anti-torpedo boat to England. The daring operation did not succeed when the pilot boat was sunk by a mine near Hook of Holland. Most of the gold was recovered and transported to Germany. A total of $193 million in Dutch gold was carted off to Berlin.[56]

The theft of the National Bank of Belgium's gold is "one of the most notorious cases" of Nazi plunder.[57] Like in the Netherlands, the Belgian central bank, anticipating a German occupation, had deposited a substantial amount of gold outside the country, in this case with the Banque de France. The French in turn had shipped some of its gold, plus that of Belgium to Dakar, the capital of the French African colony of Senegal. But, worried that even Dakar was not safe enough, the gold was moved farther inland. After the capture of Paris, the pro-Nazi government of non-occupied France, situated in Vichy, was ordered by Germany to ship the gold held in Senegal to Marseille. This entailed an extraordinary journey of the precious metal across the Sahara to the port of Algiers and on to France. After a while it reached Berlin, where it was added to existing reserves of stolen gold. And after German forces took over Italy, they carted off its gold as well.

The bulk of the stolen gold ended up in neutral Switzerland, where it was used to pay for Swiss-made military equipment and strategic raw materials produced by other neutral countries. It has been discovered that $440 million in gold was transferred by Germany to the Swiss National Bank during World War II, of which $316 million had been looted. The Eizenstat Report—prepared under the supervision of Stuart Eizenstat, the United States Undersecretary of State for Economic, Business, and Agricultural Affairs—released in June 1998, states that: "The Swiss National Bank must have known that some portion of the gold it was receiving from the Reichsbank was looted from occupied countries, due to public knowledge of the low level of the Reichbank's gold reserves and repeated warnings from the Allies."[58] In 1946 the United States, Britain, and France concluded an agreement with Switzerland without involving the smaller countries, according to which the government in Bern paid $58 million in return for the Allies giving up all claims on Swiss held gold. The smaller countries were unhappy with this deal; when some of them later tried to obtain more money from the Swiss, they were referred to the 1946 agreement and on top of that subjected to Swiss arguments of action in good faith. But a government commission in 1998 admitted that the Swiss National Bank already knew in 1941 that gold from the Netherlands and other countries were held in the vaults of the German Reichsbank.

Toward the end of World War II, Nazi gold that had not been held in Switzerland but that had been kept in Berlin came adrift.[59] A first German caravan of gold, jewelry, and foreign currency started out for the salt mines in Thuringen in February 1945 but fell into the hands of the advancing American army, which deposited the loot in Frankfurt. In April, new caravans journeyed from Berlin to Bavaria, where gold was hidden in the woods at Mittelwald. After the German surrender, American gold rush teams scoured the American sector, discovering small amounts of gold at various locations and bringing them to Frankfurt. These assets later became part of an Allied gold pool. Gold was returned from this pool to countries from which it had been looted. But these amounts were much smaller than the actual volume stolen, and the question of the division of the yellow metal among the 18 countries involved was not laid to rest until a conference on Nazi gold held in London in December 1997.

5. Yellow and green

Reform without a crisis is exceptional in democratic societies. This was well understood on both sides of the Atlantic, and no time was wasted in Great Britain and the United States to work on a drastic overhaul of the international monetary system for the post-war world. With remarkable foresight, American and British officials, supported by prominent academic economists—in particular John Maynard Keynes—already started planning for a post-war international monetary system in the early days of World War II. There was a strong desire to avoid repeating the experience of monetary chaos that followed the previous global war, which itself contributed to nationalism and military aggression. In addition, the period of floating currency rates of the 1930s had metastasized into self-defeating competitive depreciations of currencies and severe exchange controls. And a return to a full-fledged gold standard, with its rigidity and reliance on a yellow metal whose production was uncontrolled, was ruled out by the future victors of the war. But there were also broader political motives. The United States, expecting to be the indisputable world leader on all fronts after the war, wanted a system that would make the dollar the sun of the new monetary universe. Britain, severely weakened, sought to maintain its position as a leading financial center and to promote the sterling, which it thought could bring considerable benefits to Britain.

The odd couple

Keynes, who had often expressed a low opinion of the Her Majesty's Treasury, was at an enlightened moment made a special advisor to that very institution to work on post-war monetary plans. Lord Catto, who would become governor of the Bank of England in 1944, was brought in as financial advisor at the same time. The two money masters, who did not always get along well, and were referred to as "Doggo and Catto."[60] But Doggo got the upper hand. Starting his project in the summer of 1941, Keynes produced several drafts of a plan for a new international monetary system. Across the Atlantic, Harry Dexter White, assistant secretary of the U.S. Treasury, was also working on a design for a new global system around the same time.

Keynes and White were very different personalities. Keynes, a British patrician through and through, was sophisticated, a patron of the arts, humorous and charming (when he wanted to be), and a world-famous economist. White, the brilliant son of Lithuanian immigrants, was not in the least sophisticated and was the opposite of charming.

Keynes acknowledged the American's intelligence and influence at the U.S. Treasury but had a low opinion of his social skills: "[H]e is overbearing, a bad colleague, always trying to bounce you, with harsh rasping voice, aesthetically oppressive in mind and manner; he has not the faintest conception of how to behave or observe the rules of civilized intercourse."[61] White, who worked mainly in the shadows at the U.S. Treasury building, was also seen as anti-British. Despite these differences, the two got along well enough and exchanged drafts during the war. By the time the United Nations Monetary and Financial Conference opened on July 1, 1944, in Bretton Woods, New Hampshire, the Keynes and White plans had been thoroughly merged.

The Bretton Woods conference was a unique undertaking aimed at establishing a new world monetary order. Delegates from 44 countries were housed at the grand old wooden Mt. Washington Hotel outside the village of Bretton Woods. The lovely setting against the backdrop of the White Mountains of New Hampshire was a tonic for the delegates, especially those who came from Europe as representatives of governments in exile. Among these enticing surroundings, the delegations worked continuously for 3 exhausting weeks, mostly in good spirits, signing the formal documents in the hotel's gold room (now a little museum) of what came to be known as the Bretton Woods agreement. Despite its size, the conference was a huge success by "[weaving] consensus, harmony, and agreement, as if under a magician's spell."[62] The excellent results owed much to the strong political will to come to agreement among wartime allies and to avoid the mistakes of the previous decades. But besides the abundance of good will and the readiness to reach compromises, the often obscure legal language, drafted by skillful American lawyers,

John Maynard Keynes and Harry Dexter White preparing for the Bretton Woods Conference, Atlantic City, New Jersey, June 1944. (IMF photo archives.)

made it easier to reach agreement. The statutes establishing the International Monetary Fund (IMF)—the major result of the conference—were "a body of international law pregnant with interpretative ambiguity."[63] These intricate texts laid the groundwork for what came to be informally known as "Fundese," a writing style of the IMF staff that can often only be understood by those who have learned to read between the lines.

A remarkable achievement

The new international monetary system agreed on at Bretton Woods represented the first time that a totally new framework had been created through international agreement and included the setting up of a global financial institution, the IMF. The gold standard, both the bullion and the gold exchange variety, had evolved without any formal rules, let alone codification. And the episode of floating exchange rates, coupled with highly disruptive flows of hot money that followed, had been the unwanted result of the collapse of the gold standard. The new system presented a return to fixed exchange rates but allowed for devaluation when a currency had clearly become overvalued or, as the drafters of the statutes of the IMF formulated it in typically obscure fashion, was in "fundamental disequilibrium." Devaluations of more than 10% had to be approved by the IMF's executive board. The dollar, which had remained fixed to gold at $35 per ounce throughout the war years, was to become the pivot of the new system, to which other currencies would be aligned. Instead of expressing the value of their currencies in gold, the exchange rates of members of the IMF were from then on expressed in dollars. The dollar was now king in what had become a gold–dollar standard with trade deficits settled mainly in dollars, which could only be converted in gold when offered to the American Federal Reserve System.

The structure of the IMF made it look more like a bank than a fund. It was given the power to provide credits to countries that had difficulty making ends meet. Those running large balance of payments deficits (their imports exceeding their exports) were entitled to receive the dollars needed to settle their bills. But this was not free money. In addition to paying a modest interest rate, the borrowing country would have to follow sound economic policies, such as closing budget gaps and keeping inflation in check. To avoid repeating the 1930s experience of frequent speculative attacks on currencies, IMF members were allowed to place controls on outflows of capital. But they were not allowed to limit imports of goods through a rationing of dollars or other foreign currencies, although they were given some temporary respite. There were many other rules the member states were to follow, including providing extensive economic information, which later played a role in the withdrawal from the IMF of satellites of the Soviet Union. But in July 1944, the sentiment was generally one of having created a new monetary order that was to last for a very long time.

The final result of unremitting hard work was deeply satisfactory for the United States and a personal victory for Harry Dexter White, who in 1943 had already envisaged the dollar at the center of the postwar structure of stable currencies. "The United States was not only the first among equals: it was clearly dominant."[64] And the United States made full use of its economic and military superiority by putting pressure on "recalcitrant" nations to bring them into line. Harry White, although not of the same intellectual brilliance of Keynes, was a master strategist who with a combination of craftiness, bilateral deals, and rudeness outsmarted a tired, unhealthy, and maladroit Keynes.[65] The British, seeing which way the wind was blowing, did not put up much of a fight, keeping in mind that they needed continued American financial support.

Sharing the pie

The toughest negotiations at Bretton Woods concerned the shares of voting rights and financial contributions of IMF members. Keynes and White had prepared the ground for the discussion and agreed on a dollar number for the overall size of the fund, close to the final compromise of $8.8 billion. That had been the easy part, but the going was tougher when it came to determining the share of each country in the pie (known as quotas). Several countries lobbied for quotas that were higher than justified by economic indicators. Fred Vinson, number two in the American delegation and a future chief justice, chaired the quota committee and applied his considerable political and oratorical skills to achieve consensus. In a glowing off-the-cuff speech, he "lauded the deep friendship of the American people with China, France, and several other countries that had protested the proposed quotas. Most of the delegations concerned felt that this expression of friendship could not be answered other than by withdrawing their protests."[66] But future French prime minister Pierre Mendes-France, who led the French delegation, responded to Vinson's flattery with an equally strong declaration of love—but maintained his objection. The most challenging issue turned out to be agreeing on a quota share for the Soviet Union. The Soviet delegation, led by the inscrutable M. S. Stepanov, argued that economic indicators alone were insufficient for establishing quotas and should also reflect military strength. The United States, with an agreed quota of $2,750 million—almost a third of the total—was most willing to accommodate Moscow's wishes. The Soviet Union, after all, was a war-time ally and was envisaged by some—Harry White in particular—as working closely with the United States in the postwar international arena. Moreover, it was not possible to get the Soviet delegation to deviate from the instructions coming from Moscow.

J. W. Beyen, who led the Dutch delegation, relates that an American central banker whose family had fled Russia in 1917 (identified by later sources as Emanuel Goldenweiser) told him: "Don't forget that my former countrymen are in the predicament of finding themselves between the difficulties of the English language on the one hand and the firing squad on the other."[67] After intense deliberations, the proposed quota for the Soviet Union was raised from $800 million to $1,200 million, making it the third largest shareholder, only slightly smaller than the quota of the United Kingdom. China, not yet communist, was given the fourth largest share at the insistence of the United States. This came at the expense of France, whose delegation saw the move as a "deliberate insult."[68]

The education of a POW[69]

The German population had other things on its mind as the country began losing the war in the summer of 1944, yet the Bretton Woods conference had not remained entirely unnoticed in Nazi-occupied Europe. In September 1944, Pieter Lieftinck, a former economics professor at the University of Rotterdam, an inmate of a POW camp in Poland, hastened to pick up a newspaper that a camp guard had unintentionally dropped. The German-language paper contained a short item describing a conference in the United States where the allies had decided to establish an international monetary fund and an international bank for reconstruction and development. Lieftinck was intrigued and sent a letter to the International Red Cross in Geneva asking for material on the conference. Two months later, he received a package that to the disappointment of his fellow prisoners did not contain food, but only documents. The former professor could now study the Keynes and White proposals and the statutes of the IMF. Soon after the end of the war, Lieftinck joined the Dutch government as minister of finance and in that capacity was involved in international monetary matters in which he had an edge over other ministers from formerly occupied Europe. Ten years later, Lieftinck became an executive director of the IMF, representing the Netherlands and a few other countries for 22 years.

Stalin pulls back

Life for the IMF officially started on March 8, 1946, with an inaugural meeting held in the General Oglethorpe Hotel in Savannah, Georgia. The atmosphere was not wholly festive. There were some personal tensions and some surprises. The Soviet Union unexpectedly did not participate, stating that Moscow needed more time to study the documents. At first the Soviet foreign minister, Vyacheslav Molotov—whose name became associated with a cocktail—had leaned toward participation, but he soon changed his tack, likely after having talked to Joseph Stalin. "Stalin's brutally realistic mind could never see any purpose in an institution whose function lay in fostering international cooperation."[70] The Soviet Union's rejection of IMF membership coincided with the beginning of a strong anti-communist sentiment in the United States, as well as the early signs of a future iron curtain dividing Europe into East and West. Another surprise concerned news about the future of Harry White, who was to be anointed the first head (managing director) of the IMF. White's candidacy was withdrawn after accusations that he had been spying for the Soviets and handing them sensitive material. The Savannah conference was also marred by the suspicious nature of Fred Vinson, who had succeeded Henry Morgenthau as the U.S. secretary of the treasury and who chaired the meetings. Vinson, a lawyer by training, felt uncomfortable in the presence of the brilliant economist Keynes and "suspected that the English lord was poking fun at him."[71]

Only 6 weeks after the Savannah gathering, Keynes died of heart failure. The same fate awaited White, who passed away in August 1948 just a few days after testifying that he was not a communist before the House Un-American Activities Committee. His accuser was Whittaker Chambers, a former member of the American Communist Party, who later testified in the Alger Hiss spy case during which Richard Nixon—then a young Congressman—made a name for himself as a fervent anti-communist. It has never been fully established whether White, who clearly saw the Soviet Union as a force for the good, was a genuine spy or a naive man who believed he was not really doing anything wrong by providing an allied nation with valuable information. White obviously has been given the benefit of the doubt by the IMF: His bronze bust adorns the executive board room alongside that of Keynes.[72]

Part II
The Dollar

1. The mighty greenback

The Harry White affair cast a pall over the early days of the IMF, and the new institution was hardly involved in the major issues of the time. Dealing with the aftermath of World War II in Europe was initially largely left to the World Bank, which timidly provided modest loans for reconstruction. This support turned out to be insufficient for a devastated continent full of uncertainty following a short period of euphoria. For many, "[s]urviving the war was one thing, surviving the peace another."[73] The war effort had depleted the gold and foreign exchange reserves of the European Allies, who urgently needed to be able to purchase goods from the United States and formerly neutral countries such as Sweden. Dollars were the only means with which countries that desperately needed American foodstuffs, raw materials, and machinery could pay. And the only way to obtain dollars was to run a trade surplus and take up large dollar loans. This turned out be an enormous challenge, as most European countries, with Great Britain the first to face economic collapse, were running large trade deficits and were also not creditworthy. In a visionary act, the United States announced the European Recovery Program in 1947, popularly known as the Marshall Plan, having been conceived by the American secretary of state George Marshall. European countries were to be provided with massive dollar loans, but with certain strings attached to avoid poor use of the money. And in a remarkable gesture, and contrary to earlier American intentions, Germany was invited to make use of the funds as well. The generous Marshall aid, amounting to $12.7 billion in a 3-year period, or about 1.3% of the United States' national income, was a resounding success and helped close the dollar gap.

The IMF was waiting on the sidelines as the United States, calling the shots in the Washington-based institution, insisted that countries receiving dollars through the European Recovery Program could not borrow from the fund.[74] This was fair enough, as dollars supplied by the IMF would be provided to it by the United States. But it was a disappointing start for the newly established international organization. Many Europeans also saw a hidden agenda, suspecting that the United States did not favor a strong IMF. And when the succession of the first managing director of the fund, the Belgian Camille Gutt, was discussed in 1951, a Bank of England source explained that "[t]he Americans and we are at this time not looking for somebody with ideas and initiatives."[75]

Europe devalues

While the Marshall Plan brought relief, the problem of dollar scarcity remained as European countries were still struggling to bring down their trade deficits with the United States. This lead to a joint American and IMF push for large devaluations of European currencies against the dollar to make them more competitive and increase European exports. But many Europeans leaders were not convinced that they should give up their existing exchange rate parities, and heated discussions took place in European capitals. In Great Britain, the most pressed to devalue as it was the weakest link in the chain, the Labour chancellor of the exchequer, Sir Stafford Cripps, vehemently opposed lowering the value of the pound for fear of higher import prices, but was bypassed by other cabinet members. As the economic situation in Britain became direr by the day, the pound was devalued by 30% in September 1949, followed by the French franc by 22%, the German mark by 20% and the currencies of smaller countries by similar percentages. Britain was also granted a large IMF credit.

The good news was that the adjustment in currency values was helpful, and European trade balances were improving quickly, but at the same time it became clear that it would take quite a few more years until dollar scarcity was a thing of the past. The large group devaluation of 1949 was also welcome as it showed that the Bretton Woods system was not a disguised gold standard and allowed adjustments of currency values when there was a convincing case to do so. Great Britain, the sick man of Europe until the middle of the 1970s, had to devalue its currency again in November 1967, this time by 14.3% after big losses of reserves. Once again the IMF had to overcome strong British resistance, in part due to pride and fear of political fallout of the ruling Labour Party under Harold Wilson. And the policy mandarins in London would continue to be plagued by pressure on sterling. Not only did management of the British economy leave much to be desired, but central banks that still held pounds—known as sterling balances—were keen to sell them for dollars.

The IMF takes off

The International Monetary Fund, not having much of an impact during the first 10 years of its existence, started to make its mark in the middle of the 1950s, extending sizable credits to France and Great Britain. It helped that the fund had come under strong leadership when Per Jacobsson took the helm in December 1956. Jacobsson arrived at a time when the Bretton Woods system was becoming well established. The world economy was booming, the United States continuing to show enormous economic strength, and Europe and Japan were in the process of very rapid recovery from the deep trough of World War II. Latin America, Australia, and South Africa, large producers of metals (including gold), foodstuffs, and raw materials, had economically benefited from the war and were supplying the industrial world with their goods. World trade was growing rapidly, and capital movements were generally benign in contrast to the prewar speculative flows.

The IMF—written off by many as an ineffective organization during its first 10 years—started to make its presence felt not only by lending money to countries in trouble, but also by producing economic analyses that became the state of the art. The staff of the IMF, initially dominated by American and British economists, became more diverse without sacrificing quality. Jacobsson and Edward Bernstein—Harry Dexter White's understudy at Bretton Woods—as well as Jacques (Jack) Polak, who succeeded Bernstein in 1958 as the IMF's chief economist, greatly contributed to giving the IMF a higher profile.

Jacobsson takes over

Per Jacobsson, a physically imposing Swede wearing heavily rimmed glasses, was already 62 years old when he became the head of the IMF. An intellectual powerhouse who in his spare time wrote detective stories, Jacobsson had joined the Bank for International Settlements at its inception in 1931 as the head of its prestigious research department. He was very much hands-on when dealing with borrowing countries but also did not shy away from taking firm positions with the United States and other major countries. In 1957 he personally negotiated a "stand-by credit" for France and later discussed economic reforms with Charles de Gaulle, who became president of France in May 1958, "in the only language De Gaulle really understood: that of power politics."[76] Possessing a strong personality, Jacobsson was able to influence meetings by his assertiveness as well as his arguments. He used this trait to his advantage in his dealings with a now prosperous Germany—having achieved its "economic miracle"—running large trade surpluses as well as receiving a flood of foreign capital, in the process amassing a prodigious dollar stash.[77] At the same time, Germany was facing rising inflation for which the remedy at that point was not to tighten monetary policy, as higher interest rates would only lead to even more capital entering Germany. The best solution was to make the German mark more expensive or, in policy jargon, to revalue it. But the German policymakers did not want to go along with an increase in the value of their currency of more than 5% in March 1961. Jacobsson, relying on estimates by his chief economist Polak that a 15% revaluation was needed, told the German financial leaders that 5% would not be enough, as turned out to be the case a few years later. By taking strong positions, the head of the IMF helped greatly to put his institution on the map as an effective international organization, in contrast to bodies such as the United Nations. While the big Swede displayed enormous drive, he was not liked by everyone: Some staffers described him as a megalomaniac. But nobody denied his central role in bringing about a quantum jump in international monetary cooperation and in the stature of the IMF. He died suddenly in 1963, after having served 6½ years as managing director.

Cutting-edge research[78]

Jacques Polak, born in the Netherlands in 1914, left his country at the tender age of 23 to join a small team of outstanding economists at the League of Nations in Geneva (the forerunner of the United Nations). There he worked with such luminaries as Jan Tinbergen—who won the Nobel Prize in economics in 1969—on pioneering models of the world economy. Polak was offered an associate professorship at the University of Rotterdam in April 1940—1 month before the sudden German occupation of the Netherlands. He wisely declined that offer—the vast majority of Dutch Jews would be exterminated during World War II. Together with the disbanded League of Nations staff, he reached the United States via occupied France and Portugal in 1943. The following year, he served as a junior member of the Dutch delegation at the Bretton Woods conference.

After joining the IMF in 1946, Polak rapidly climbed the ranks and was appointed its economic counselor (chief economist) in 1958, soon enjoying a reputation for his brilliant analyses and innovative thinking. The elevated research profile of the IMF attracted rising stars to Polak's staff, including future Nobel Prize winner in economics Robert Mundell. Among Polak's major achievements was developing the monetary approach to the balance of payments, which holds that an overlarge money supply in a country can spill over into trade deficits and outflows of capital. The remedy is to reign in the excessive growth of money in circulation. In most economic programs agreed to between the IMF and deficit countries in need of financial support, the borrower pledges to control the volume of money and credit in its economy so as to turn around the balance of payments, in line with Polak's theory. Later in his career, the fund's top researcher also became the intellectual father of the special drawing rights in the IMF (also known as "paper gold"), introduced in 1969 as a solution for the then existing lack of monetary gold. Polak was not only respected, but also feared among the staff—and even by some executive directors of the IMF—as he was not averse to lecturing individuals he considered lightweights. On one occasion when addressing the executive board together with the head of another department, he reacted to an underprofound remark by his colleague by turning to the chairman and asking: "Do we have to teach economics to schoolchildren?"[79] But by the time Polak retired in 1980, he had mellowed. At the end of his career, he served as the Dutch executive director of the fund for 6 years and continued to display a strong interest in all things monetary right up to his death in 2009.

2. From dollar famine to flood

Toward the end of the 1950s, Europe's lack of dollars was turning into a surfeit, to the surprise of many. Western Europe and Japan were enjoying rapid economic growth, fueled by exploding exports. And foreign investment, much of it from the United States, flowed richly to the formerly wartorn countries as profit opportunities grew. As a result, countries such as Germany and Japan started to accumulate large dollar reserves. Most European countries also succeeded in making their currencies freely exchangeable into each other's monies and into dollars. Known as convertibility, this free exchange gave world trade a big boost but slowly and steadily complicated the way the international monetary system was working. While the Bretton Woods system was still regarded as superior to other exchange rate regimes, the first fault lines were appearing.

At first American balance of payments deficits were welcomed as they provided the formerly wartorn countries with much needed dollars. The United States had become the banker to the world, much as Great Britain had been before 1931. But too much of a good thing can turn into excess, and gradually as the American deficits continued, Europeans, who were receiving what was becoming a flood of dollars, became somewhat sated. Reluctantly at first, but more assertively over time, they started to convert some of their dollars into gold. The United States' pile of gold had peaked in 1949 at 700 million ounces valued at $24.5 billion, equal to 70% of the world's monetary gold. But the French, German, and Italian visits to the Fed's gold window were gradually causing unrest in the United States. And in the late 1950s, a perceptive and influential economist named Robert Triffin warned against future strains on the dollar that could eventually call into question the gold–dollar exchange standard established at Bretton Woods.

An Atlantic citizen[80]

Triffin was a French-speaking Belgian economist, born in 1911, who after his graduate studies in the United States opted to remain there and adopt American citizenship. Still in his 30s, he became a "money doctor" in the vein of Edwin Kemmerer in the 1920s. Working first at the Federal Reserve Board in the 1940s and at the IMF from 1947 on, he trekked to many Latin American countries and also Iran, advising them on all kind of money matters. Later in his career he would also act as an advisor to Eastern European countries. While a member of the United States delegation to the Organization of European Economic Cooperation (OECD) in Paris in early 1963, he was at the same time getting actively involved with the cause of European economic integration. Attending the IMF annual meeting in September 1963 as part of the European Commission representation, Triffin sometimes defended positions that were not those of his adopted country. This naturally led to some tension, but when American then–Secretary of the Treasury Douglas Dillon drew his president's attention to the economist's dual role, he was surprised by John Fitzgerald Kennedy's response: "Drop it, Doug, he is one of our first Atlantic citizens, and we need many more of them."[81] In the meantime, Triffin had joined the Yale University faculty, where he remained until 1977, educating future "Triffin boys" and developing strong and highly influential views on the international monetary system.

Triffin held strong views not only on monetary matters, but also in the political domain, being at heart a pacifist and internationalist. Coming from a small country, he displayed, like a quite a large number of economists from like-sized countries, a very outward-looking mentality. This attitude was only enhanced by his stints in international organizations. And as was common in the postwar years—and long after—like other outstanding foreign scholars and practitioners, he was attracted to the possibilities that the United States offered to academics. His American sojourn was part of a huge brain drain of European economists from 1945 onward.

The Triffin dilemma

By pointing out in 1960 that the Bretton Woods system was flawed and would eventually break down if not reformed, Triffin harvested acclaim, mainly in continental Europe, and strong criticism from the United States. He argued that the international monetary system was suffering from a lack of reserves, gold production's falling short of the need of countries to increase their reserves in a growing world economy. He was also uncomfortable knowing that most of the gold was mined in politically unstable South Africa and the anti-western Soviet Union. In addition, Triffin criticized the legal requirement that at least 25% of the United States' monetary gold serve as cover for dollars in circulation. Since private holders of dollars could not convert their dollars into gold, and had not been able to since 1934, this requirement no longer had any practical purpose. And as the United States was financing its balance of payments deficits with dollars that ended up with foreign central banks that could demand gold at any time, it would make sense to lift the cover requirement.

The other part of the problem, which became known as the *Triffin dilemma*, was that increases in countries' reserves mainly consisted of dollars. And the creation of greenbacks was dependent on the state of the American economy and the resulting trade deficits and capital outflows. If the United Sates were to run surpluses, the resulting lack of reserves would lead to trade restrictions and exchange controls and possibly also to deflation, whereas if American deficits continued to be large foreign central banks would come to doubt the strength of the dollar. And as a devaluation of the dollar could have grave consequences for the world economy something had to be done. Triffin suggested that by developing an alternative to the dollar, to be managed by international agreement, the dangers he foresaw could be averted. His was a perceptive vision, much of which came to pass around 1970.

The dollar under attack

In late 1960, the year when Triffin's influential book *Gold and the Dollar Crisis* appeared, currency markets were becoming restless. The dollar—the key currency of the Bretton Woods system—came under pressure as many money traders considered the price of gold to be too low or, amounting to the same thing, the dollar exchange rate to be too high. Not only did markets feel uncomfortable because of Triffin's warnings, which were widely embraced in Europe, but rising inflation in the United States was also seen as a red flag. Uncertainty about the outcome of the election in November 1960 (Kennedy versus Nixon) and the policies that a new administration would adopt contributed to further unrest. On top of that, the French government complained about the dominant position of the dollar, which it considered unfair. A few years later, General de Gaulle would express serious discontent about what he called the "monumentally excessive privilege"[82] enjoyed by the United States as the only country that could finance its balance of payments deficits with its own currency. The Gaullist position went beyond economics and to be very much an extension of French foreign policy.[83] In De Gaulle's words, "Politics and economics are linked to each other like action and life."[84] And since the French president judged the United States to be vulnerable in monetary matters, his insistence on a primary role for gold—and by implication a secondary role for the dollar—was his way of challenging America's dominant position in world affairs. He backed up this policy by converting large amounts of dollars into gold.

The gold pool[85]

The official price of gold had remained at $35 per ounce since 1934, but on the private gold market, concentrated in London, demand started outstripping supply, driving up the gold price to $40. The market "had tasted blood," and alarmed governments concluded that something had to be done. The Bank of England, the obvious institution to intervene in the market, started to sell gold, but the pressure persisted. Politicians also took notice, and U.S. presidential candidate John F. Kennedy—a few days before the election—pledged that as president he would not devalue the dollar. Soon after he was sworn in, the new American leader declared that fighting inflation would be his main priority. And in dramatic fashion, he repeated his personal pledge to maintain the official gold price. This helped for a while, but full calm was restored only after the central banks that held the largest gold reserves agreed among themselves to sell and buy gold in the London market to control the price of the yellow metal. Total commitments to the so-called *gold pool* amounted to $270 million, half of that pledged by the United States.

The operations of the pool were very successful for a number of years. After initially acting as a seller, the pool ended up buying the precious metal, as market conditions and expectations had changed. But as the architect of the gold pool, Charles Coombs, a senior official at the Federal Reserve Bank of New York, put it: "[T]he handful of central bankers who were familiar with the Pool's accounts knew all too well that we could not rely on such good fortune. The London gold market still represented a time bomb resting at the very foundation of the Bretton Woods system. . . ."[86] By 1967, after several years of escalating tension, France saw no benefit in continuing the gold pool and withdrew; all other participants quit the following year. The Soviet leader, Leonid Brezhnev, interpreted the event as "the beginning of the devaluation of the United States dollar" and "the possibility of a profound crisis of the capitalist system."[87]

Palliatives

There were other initiatives to try to strengthen the system. As a means to counter short-term pressures on the currency markets, the Federal Reserve decided in 1962 to build a network of short-term credit lines with other central banks, making it possible for the New York Fed to borrow German marks for 3 or 6 months and sell them in support of the dollar. As these transactions, known as foreign currency swaps between central banks, had to be reversed at their due dates, they were intended only for tiding over temporary weaknesses of the dollar. Eventually a huge network of swap lines between the Federal Reserve and central banks in Europe, Japan, and Mexico—who was a borrower rather than a lender of dollars—was put in place. At its peak the network amounted to $20 billion, but actual use remained far below the maximum. Swap network operations were moderately successful in defusing short-term speculative attacks on the dollar but remained largely unknown outside the confines of monetary officials or were eyed with suspicion such as by one British journalist who considered central bank swaps to be "monetary incest." And in the many international monetary plans devised by academics in the early 1960s, swaps as a first line of defense were hardly acknowledged or were described as only a "stop-gap solution."

A second line of defense of the dollar was to issue German mark Treasury bonds by the United States. Buying these so-called Roosa bonds—named after Robert Roosa, the American monetary point man at the time—with maturities of several years was an attractive way for Germany to protect itself against losses caused by a devaluation of the dollar. And the marks obtained by the U.S. Treasury provided it with longer-lasting ammunition to prop up the dollar. Although currency swaps and Roosa bonds were useful, they were essentially nothing more than holding operations. But there was one more arrow in the American quiver to protect its gold stock from further erosion, and that was knocking on the door of the IMF. President Kennedy had explicitly mentioned this as possibility in 1961, although such a step was considered unlikely: It would carry a stigma of weakness. Reasoning that in case the United States (or in combination with another big country such as Britain) was nonetheless forced to borrow such a large sum from the IMF that it would run out of funds, it would be prudent to jointly establish a large credit line to the monetary organization. In a spirit of cooperation, $6 billion was made available to the IMF. These General Arrangements to Borrow (GAB) proved to be the embryo of the *Group of Ten* (G-10), which became a focal point of negotiations on the international monetary system. The Ten, as the richest and financially most interconnected countries in the world, felt a special responsibility for keeping the Bretton Woods system intact. The United States' share was one-third of the total, but it could of course not be used if it needed to borrow from the IMF. The other participants were Great Britain and six Continental European countries, as well as Japan and Canada. Switzerland later joined the GAB, even though it was not a member of the IMF or of most other international bodies on account of its policy of strict neutrality.[88]

A rich man's club

Not everybody was enthusiastic about the GAB. Countries outside the G-10, including such emerging economies as Australia, Brazil, India, and Spain, feared that the Ten were likely to decide all important monetary matters among themselves, presenting the outsiders with a *fait accompli*. They saw it as an exclusive rich man's club that could from time to time reach decisions that would not take their views into account. This remained a sore point for decades, including when the smaller G-10 countries were excluded from the inner circle after the Group of Seven was launched in 1975. The secret monthly meetings of the central banks of the richest countries at the Bank for International Settlements in Basel were also a source of some resentment. These meetings were often quite effective in coordinating positions on issues such as the gold pool, the Federal Reserve swap network, and the foreign exchange markets. They brought together most of the world's top central bankers. These included William McChesney Martin, chairman of the Federal Reserve System from 1951 to 1970, and the president of the Federal Reserve Bank of New York, the gentlemanly Alfred Hayes, who with the arrival of the Nixon administration in 1969 was pushed into early retirement. The Bank of England was represented by its governors, Lord Cromer (1961 to 1966), followed by Leslie O'Brien (until 1973), who had rapidly climbed the career ladder after starting at a modest level; the Deutsche

Bundesbank by the outspoken Karl Blessing; and the Banca d'Italia by Guido Carli, who enjoyed an unusual degree of independence from his government. Also influential at the Basel meetings was Marius Holtrop, who headed the Netherlands Bank from 1946 to 1967, and who often terrified his staff at home but controlled his temper at international meetings. His successor, Jelle Zijlstra, a former finance and prime minister, presided over BIS meetings for many years before retiring in 1981. The amiable Bernard Clappier of the Banque de France carried less weight, as his bank enjoyed virtually no independence from the French government.

Although some of these capable men and their deputies displayed certain idiosyncrasies, it was Rupert Raw, a senior official of the Bank of England, who became the unofficial holder of the title "most eccentric." Charles Coombs of the Federal Reserve Bank of New York and a regular visitor to Basel related how Raw could not resist swimming from one bank to the other side of the fast flowing Rhine River, which bisects Basel. "As Raw surreptitiously slid into the river in his underwear, a friend carried his London banking attire . . . to a roughly targeted arrival point on the other side. But the velocity of the current had been grossly underestimated. Raw reached the shore nearly a half-mile downstream, where he was promptly arrested for indecent exposure. . . ."[89]

Emptying Fort Knox

Even though swap and bond defenses were in place and the United States took various measures to stem the outflow of capital, its gold stock kept declining. It had already fallen by several billion dollars in the late 1950s but at that time did not cause any friction. This harmonious situation changed as new demands from European central banks for gold started to worry the U.S. Treasury around 1960, a time described by Robert Solomon, a former high official at the Federal Reserve Board, as "the transition year."[90] At that point the American gold stock still stood at $16 billion but was following a steep downward path, dropping to $12.5 billion in 1965. This was about $2 billion less than the total sum of dollars owned by foreign central banks. Acutely aware of this mismatch, market participants were regularly testing the resolve of the American decision-makers to maintain the gold parity of the dollar.

All European countries running payments surpluses were at the time asking Washington for gold against dollars, including France, Germany, Great Britain, and Italy, as well as smaller countries such as the Netherlands, Belgium, and Switzerland. Japan refrained from going to the gold window, wanting to avoid antagonizing its close postwar ally. The Europeans, experiencing rapid economic growth but also stronger inflation, complained that the United States was exporting inflation to them as American deficits ended up increasing the money supply in their countries. And as they felt that the Americans were not doing enough to stem the outflow of dollars they wanted to force greater discipline on their Atlantic partner. Buying American gold with their "excess" dollars was seen as the only way to improve the international adjustment process, in other words to even out deficits and surpluses in international trade and capital.

The U.S. government countered that their country was incurring large expenses in providing military security to Europe, including the deployment of American troops. Washington also felt that Europeans acted ungratefully in view of the aid they had been provided in the past. France was not impressed by this argument as it did not have an American military presence and had all but left the North Atlantic Treaty Organization (NATO). But Paris's main reason for trying to "discipline" the United States was that it considered the Bretton Woods system unbalanced, the United States being the only country that could finance its deficits by issuing its own currency. And it felt that this amounted to an unfair advantage to the world's largest and richest economy, or, as Valéry Giscard d'Estaing, De Gaulle's young minister of finance put it, amounted to an "exorbitant privilege."[91] The only way that the international monetary system could be made balanced and robust was—in the French view—to return to the pure gold standard in lieu of the gold–dollar standard.

The president speaks

Although he apparently never openly advocated an increase in the price of gold like his dogmatic economic advisor Jacques Rueff did, President De Gaulle, in his famous press conference at the opulent Elysee Palace in Paris on February 4, 1965, eloquently made the case for a return to gold. But to anyone who could do simple arithmetic, it was clear that such a step would require a big increase in the official price of gold, as there would otherwise be too few marbles to play with. Moreover, countries with large gold holdings, such as France, would greatly benefit from this "reform." De Gaulle's moderate minister of finance, followed up with a similar though less provocative speech a week later, remarking that gold alone was not enough to improve the way the international monetary system works. Such heresy did not sit well with the nationalists, and Giscard was ousted, with Michel Debré, an orthodox Gaullist, taking over as minister of finance. Debré, often "affecting a theatrical tone in long-winded speeches at international meetings,"[92] proved ineffectual; brilliant and internationally respected, Giscard would make a comeback.

A few weeks after the French president's "grand performance," monetary guru Robert Triffin sent a letter to De Gaulle praising him for his criticism of the existing system but also arguing that an internationally issued reserve asset was needed for the international monetary system to work properly. He emphasized that it was a bad idea to double the price of gold (to $70 per ounce), as suggested by Rueff, since it was too risky to rely on the production from a country threatened by civil war—an obvious allusion to South Africa. In addition it was unwise to rely on the sales of Russian gold that had supplied between half and two-thirds of the accumulated gold of Western central banks and treasuries. And these sales depended on Russia's domestic production of the yellow metal, which was as unpredictable as the Kremlin's political strategies. Triffin also argued that private purchases of gold for artistic, industrial, and, above all, speculative purposes could fluctuate sharply.[93] De Gaulle answered politely that he found Triffin's ideas very interesting; it seems a little naive that the Yale Professor concluded from such a brief, polite reaction that the French president agreed with his views.

From Frost to Fowler

The relationship between France and the United States, often testy, became quite frosty at the highest political level during the presidency of Lyndon Johnson. The American president, on being briefed on the French president's famous speech in 1965, "rushed to the microphone" to denounce De Gaulle's attack on the dollar and his "attempt to revive the gold standard which had failed in 1931."[94] The other European countries stayed on the sidelines, although some of them harbored some sympathy for the French position. But real support came only from major gold-producing countries South Africa and Australia, with Russia refraining from strong comments. And the Maoist Peoples Republic of China, although completely outside the international monetary system, for purely political reasons welcomed De Gaulle's criticism of the special position of the United States, a commentator writing triumphantly in the *Peking Review* that "President Charles de Gaulle's recent call for an end to U.S. dollar dominance . . . and a return to the gold standard has met with an immediate spate of abuse from Washington. The alarmed U.S. rulers are apprehensive of losing their financial hegemony over the capitalist world."[95]

Around the same time, Henry "Joe" Fowler, President Johnson's amiable but sometimes brusque secretary of the treasury, had become partially convinced by Triffin's warnings. He supported reforming the international monetary system, remarking that "providing reserves and exchanges for the whole world is too much for one country and one currency to bear."[96] It was best to repair the roof while the sun was shining, Fowler added. But this constructive American negotiating stance on developing a new kind of international reserve asset—and "demonetizing" gold—started to crumble as European central banks continued demanding American gold. These redemptions reached new heights in 1966, another $2 billion worth of gold flowing into the coffers of the Europeans, with France leading the way. After Fowler's departure in 1968 and the elevation of Nixon to the White House, the monetary debate between America and Europe, mostly taking place during the many meetings of the Group of Ten in Paris, Washington, London, and other capitals, became more confrontational. The United States, more and more alarmed by the erosion of its gold stock, started to actively discourage European central banks from knocking on the Federal Reserve gold window. As a result Karl Blessing, president of the German Bundesbank, in early 1967 wrote a letter to William McChesney Martin, the Chairman of the Federal Reserve, pledging to refrain from any future purchases of American gold. The "Blessing letter"[97] caused something of a stir but did not inspire other European countries to follow suit.

3. Working toward a compromise

In the wake of Triffin's frequent writings on the shortcomings of the Bretton Woods system, a spate of academic plans for reform were launched. Fritz Machlup, who had left Europe around the time of Einstein's departure for the United States and like him became a respected professor at Princeton University, observed in 1964 that "[n]ew plans . . . for reform of the international monetary system are being spawned at an extraordinary rate. . . ."[98] In 1960, Machlup himself proposed to lower, instead of increase, the official price of gold gradually so as to discourage speculation of future increases.[99] Not surprisingly his ivory tower proposal gained no traction. More attention was paid to his "Mrs. Machlup's Wardrobe Theory of Monetary Reserves," which drew an analogy between his wife's "need" for dresses and the "need" central banks feel for accumulating reserves. He concluded that "Central Bankers look not at their clothes closets but at their balance sheets" and "start fussing when the reserve ratio declines."[100] In other words, central bankers look only at whether their reserves—and by extension world reserves—show some increase and do not care very much about whether the stock of their reserves is adequate. But since the money masters, together with their government counterparts, were in the mid-1960s actively discussing how to make sure that reserves would be large enough in the future, the Wardrobe Theory was not taken very seriously, either.

This is not to say that academics, besides Triffin, had little or no input in the reform debate. A group of 32 academic economists from 11 countries, known as the Bellagio group after the attractive venue on Lake Como in Italy where they held some of their deliberations, produced a level-headed report on reform of the international monetary system.[101] It was chaired by Fritz Machlup, who had in the meantime returned to more mainstream thinking. Also a member of the Bellagio group was Peter Kenen, a brilliant young professor from Princeton University and at some stage an advisor to the U.S. Treasury. In an influential paper, he explained how the carrot of more international reserves and the stick of adjustment of domestic policies should go hand in hand.[102] And German economists such as Otmar Issing, who became an executive director of the European central bank at the end of his career, generally did not believe that there was a shortage of global reserves and emphasized the need for economic adjustment, having in mind the United States deficits but also Great Britain's weak balance of payments.[103]

Floating as a fix

Most proposals for monetary reform were based on some form of fixed exchange rates. But a radically different view was taken by a growing group of economists who favored allowing currency rates to move freely. The advantage of such floating rates was that they provided much more freedom to countries to conduct their monetary policies. For the United States, a floating dollar would allow it to stimulate the economy and bring down unemployment without having to worry about its balance of payments, as it would—supposedly—no longer show deficits. It was assumed that as exchange rates moved up and down, balances of payments would automatically be evened out.

As for Germany, floating the mark would make it easier to fight inflation imported from the United States, because German monetary policy would no longer be dominated by the need to keep its exchange rate stable. This line of thinking had been inspired by Milton Friedman of the University of Chicago, a future recipient of the Nobel Prize in economics, who had argued that if all currencies would float freely, countries could follow independent monetary policies and—a comforting thought—would no longer need to hold reserves.[104] And in one fell swoop the problems of the international monetary system would be solved. But this assumed that no country would ever want to support its currency when it was under pressure by dipping into its reserves. The fallacy of Friedman's "no reserves" stance would be demonstrated after floating rates had been adopted on a wide scale in the 1970s. And it transpired that countries were not prepared to let their currency experience a free-fall float.

Much to his credit Friedman's central idea of focusing on domestic monetary developments and not on the exchange rate eventually did prove very influential, leading to the "monetary counterrevolution"—a foil against the expansionist policies favored by the followers of Keynes. But in Friedman's world, which held a strong appeal for conservatives cum nationalists, the international monetary system was an afterthought at most.

A matter of prestige

In the mid-1960s, a number of other well-known American economists, sometimes labeled nationalists, defended the *status quo*. The most famous of these, Charles Kindleberger, a professor at the prestigious Massachusetts Institute of Technology and author of widely used economics textbooks, argued that the various proposal for reform that were being debated in the Group of Ten were all "contrived, artificial and less efficient than the dollar standard."[105] He rejected the notion that his ideas were chauvinistic. The problem lay with the Europeans who did not understand and appreciate the role the United States as the world's banker was performing by continuing to convert dollars into gold. Turning to politics, Kindleberger stated that "[a]t the bottom of much of the European case against the dollar standard is prestige."[106] He also saw "some irrationality in the way that central banks hold gold and forego earnings on assets denominated in foreign exchange based on an implicit decision rule that the central bank gets none of the benefits from foreign earnings [these are usually paid out to the treasury] and all the blame in the event that the foreign currency is devalued."[107] He went on to say that "much of the French case against the dollar-exchange standard is based on prestige, and much of the French case rubs off on other Europeans."[108] But Kindleberger also reckoned that "[c]onsiderations of prestige partly govern U.S. policies with regard to international monetary reform."[109]

While this view contained more than a kernel of truth, especially where it concerned French foreign policy, the United States' reluctance to give up its status as the only key currency was equally based on economics. To be able to finance its balance of payments deficits with its own currency and enjoying the benefit to be able to borrow cheaply in dollars (central banks investing their dollars only earned modest short term interest on them) and invest the proceeds elsewhere at a higher rate of return was an attractive state of affairs. On top of that, the Federal Reserve earned foreign *seigniorage* (issuing banknotes is pure money creation, which allows a central bank to obtain something for mere pieces of paper, with the profits usually mostly flowing to the government) on the billions of dollar banknotes circulating abroad.

Getting serious

While academics had contributed some interesting ideas—although there was much chaff among the wheat, reflecting ivory tower thinking—the real work of designing a new reserve asset that was to become the centerpiece of the international monetary system was the domain of governments and central banks and the IMF. The aim was to construct—in addition to the dollar—a reserve asset within a system of fixed exchange rates to add to world reserves. The need for more reserves was based on the premise that when the balance of payments of the United States was to start showing surpluses—and for brief while, this looked possible—the supply of dollars to the rest of the world would dry up. And a shortage of reserves could lead countries to protect their trade balances by imposing quotas and higher tariffs on imports, posing the danger of triggering trade wars or, worse, forcing countries to deflate their economies. For the Europeans, favoring a less dominant role of the dollar, a new globally used asset was an attractive option.

Under the guidance of chief economist Jacques Polak, IMF staffers were directed to work out various plans put forward by France, the United States and Britain and ideas added by Germany, the Netherlands, and others. But while the fund's executive board discussed the analytical and technical work at various stages and reported to their ministers and central bank governors, those outside the G-10 were largely sidelined, to the chagrin of countries like prosperous Australia, which during the entirety of the existence of the "rich man's club" was never invited to join. After a raft of meetings among the Ten—sometimes boring, at other times productive—they agreed that there was a need for some kind of deliberately created reserve asset which could be issued whenever there was a shortage of international liquidity (reserves and official credit lines). Such an asset would bear interest and would be held by central banks alongside dollars and gold. The new reserve asset's value would be linked to gold and not to the too-unstable dollar. But there were many complications and political sensitivities to overcome, and negotiations dragged on for a number of years.

The debates were dominated by the United States and France. The Americans were represented by the eminent treasury secretaries Douglas Dillon (under President Kennedy) and Henry Fowler (during President Johnson's tenure). Their able negotiators at the deputy level were the highly skilled Robert Roosa and former central banker Fred Deming. The long-serving William McChesney Martin and his deputy Dewey Daane represented the Fed most of the time, assisted by top international expert Robert Solomon. On the French side, a young, brilliant minister of finance by the name of Valéry Giscard d'Estaing made his mark from the start. Germany was represented by Finance Minister Franz Josef Strauss, a corpulent, moody, and tough Bavarian, as well as by its economics minister, publicity-seeking Karl Schiller. As they hailed from different political parties, the relationship between the German colleagues was troubled from the beginning. Otmar Emminger, the skillful deputy governor (later governor) of the German central bank, chaired the G-10 deputies meetings with Teutonic efficiency. The chancellor of the exchequer, future prime minister James Callaghan, cleverly defended the interests of the United Kingdom, which as a chronic deficit country often ran parallel to those of the United States. He was supported by Leslie O'Brien, who headed the Bank of England and his diplomatic deputy, Jeremy Morse. Italy's on/off finance minister, Emilio Colombo formed a strong team with his central bank governor, Guido Carli. And the Dutch representatives Finance Minister Johannes Witteveen, who unexpectedly became IMF managing director in 1973, and President Marius Holtrop of the Nederlandsche Bank, as well as Emile van Lennep, the feisty top official at the Dutch Finance Ministry, who was appointed secretary general of the OECD in 1970, also played an active role. Louis Rasminsky, the brilliant and experienced governor of the Canadian central bank, was another individual from a lesser power who wielded disproportional influence. But Japan, although fast gaining economic power, kept a low profile within the G-10. Toyoo Gyohten, later deputy minister of finance of the land of the rising sun, explained why: "The experience and still-strong memory of wartime defeat and total subordination to United States policy during the occupation period greatly discouraged Japan from taking an active and visible role in international affairs."[110] And at the time "Japanese delegations to international conferences were ridiculed as the 'triple S' delegations: smiling, silent, sometimes sleeping."[111]

In a boat with an elephant

The dynamics of the Group of Ten meetings was a good example of a vulnerable giant negotiating with a few mid-sized powers and some smaller participants. The giant, the United States, was on the defensive in the beginning as it was attacked by an often aggressive French team, with a degree of support from the continental Europeans. Britain very diplomatically fostered its special relationship with the United States to the chagrin of the French in particular, who saw the English-speaking countries as purely defending their favored positions in the international monetary system. The German approach was more complicated: Germany had become an economic powerhouse but was politically weak and therefore reluctant to take strong positions. Japan, a staunch ally of the United States, was even more afraid of rocking the boat. Italy and the Netherlands from time to time played a brokering role: Minister Colombo in general, and Minister Witteveen between France and Germany. The IMF managing director, Pierre-Paul Schweitzer, a Frenchman, tried to steer the group toward a compromise, all the while insisting that the developing countries should not be excluded from the reform process. In the early stages of the debates, Schweitzer tried hard to get the process moving toward a compromise, but at the IMF's annual meeting in Tokyo in 1964, he could only conclude, in a masterful understatement, that there had been "a stimulating divergence of views."[112] A few years later, however, he saw real progress and welcomed the willingness of the Group of Ten countries to strike a bargain.

Successful cooperation[113]

Schweitzer, who had taken the helm of the IMF in 1963, had been director of the French Treasury and a deputy governor of the French central bank. He had also served in the fund's early days as alternate executive director for France. He was qualified for the job not only by his background but also on account of his diplomatic skills and personable character. Following in Jacobsson's footsteps, Schweitzer was not afraid to speak his mind from time to time, which in the end led to his not being elected to a third term as managing director. A nephew of the famous Albert Schweitzer, who was awarded the Nobel Prize for Peace in 1952 for his medical and humanitarian work in the jungle of Gabon, the charming new managing director walked with a limp caused by wounds received during World War II. A lieutenant in the French Army at the outbreak of the war, he had joined the resistance after France's capitulation in 1940. Captured and sent to the infamous concentration camp Buchenwald, he was liberated in 1945. Good at delegating, Schweitzer in his Washington days had time to relax in a tavern located near the IMF building with some frequency. On such occasions, and when he was traveling, the managing director's deputy, the gentlemanly American Frank Southard calmly held the fort.

As the G-10 got closer to a compromise, Schweitzer endorsed an unusual proposal by Polak for the IMF staff to present its own plan, drawing on the most promising parts of existing studies. Another push came from the American side, growing impatient with the slow pace of the discussions and driven in part by the continuing unrest around the dollar and continuing loss of gold. And a new reserve asset of which the United States would get around a quarter of every issue—in line with its financial contribution to and voting rights in the IMF—would be helpful to slow down the gold drain. American impatience was expressed forcefully by Secretary Fowler—against the background of slow world growth and reserve growth—in a speech on March 17, 1967, in which he urged immediate agreement on a reform plan.[114] His words were widely interpreted as a threat that further delays could lead the United States to suspend conversion into gold of dollars held by foreign central banks. Fowler's strong message got the Europeans moving, and at the IMF Annual Meeting in Rio de Janeiro in September 1967, a formal agreement was forged that foresaw the creation—out of nothing—of reserve assets to be known as special drawing rights (SDRs). After the necessary parliamentary ratification processes, SDRs were formally introduced on January 1, 1970.

The invention of paper gold

To the uninitiated, SDRs were something incomprehensible. Not only was the name highly obscure, but the features of the new instrument were also shrouded in mystery to all except monetary experts. Even many academic economists had difficulty understanding what SDRs really were, and outsiders saw them as "funny money." When a delegation of a small member country was visiting the IMF, their leader asked to see the SDRs supposedly held in the fund's vaults and had to be politely told that they only existed in the books.

Polak and his team had brilliantly designed a completely new element in the international monetary system, and the fund's chief economist was hailed as "the father of the SDR." But the final product had only been reached through an intricate compromise to create reserves on par with the dollar and gold. Was it a special credit line from the IMF, or was it a fully fledged reserve unit? In fact it was a combination of both. Otmar Emminger, the German central bank's number-two, compared the SDR to a zebra: "one could regard it as a black animal with white stripes or as a white animal with black stripes."[115] Countries who wanted to use their SDRs by exchanging them for dollars would obtain the money on demand —being *unconditional liquidity* in fund jargon—in contrast to currencies obtained through drawing on regular IMF credits, to which conditions were attached, known as *conditional liquidity*. But SDRs themselves could only be exchanged between governments and central banks through the IMF. They could not be used directly in the foreign exchange market or to conduct international payments, limiting their usability. Moreover, while SDRs could be created by international agreement, this was only possible if enough IMF members (having 85% of the total vote, giving the United States, with a 20% + share a veto) judged that there was or threatened to be a shortage of world reserves.

Although valiant attempts had been made to measure how much reserves were needed, the outcomes varied widely. Making pronouncements about their adequacy therefore relied heavily on the interpretation of symptoms of shortage or excess. An increase in trade restrictions, frequent devaluations, low or no economic growth and the absence of inflation or falling prices were taken to indicate that reserves were too low. But what if these various symptoms did not all point in the same direction—for instance in the absence of growth, inflation could still be too high as happened during the 1970s—and how much SDR creation would be needed to remedy any shortage of global reserves? But there was one thing about the SDR that mere mortals could understand: It was valued in gold, not dollars. So apart from calling SDRs "funny money," journalists started writing about "paper gold," and the name stuck.

A great moment in history?

The agreement on introducing the SDR was welcomed with some fanfare, especially in the United States. President Lyndon Johnson declared that "[for] the first time in the world's financial history, nations will be able to create international reserves by deliberate and joint decision—and in amounts needed to support sound growth in world trade and payments."[116] France did not share this enthusiasm but in the end went along with the new-fangled system, still clinging to gold and continuing to convert its dollars into gold. But most countries were ready to embrace the new reserve *asset* as it was increasingly called, despite being a hybrid between reserves and credits. They also went along with the judgment of the IMF staff that—despite that calculating a global shortage of reserves was as much an art as a science—a first issue of SDR 9 billion (equal to $9 billion) over a period of 3 years beginning on January 1, 1970, was needed. The first round of SDR creation would have increased world reserves as of end 1969 by 12%, a fair number. But after the 3-year period, the share of SDRs in global reserves had dropped to only 6% as a deluge of dollars in 1971 and 1972 completely changed the equation. The uncontrolled and unwanted jump in global reserves drastically lowered interest in the SDR. And the Nixon administration, which had come into power in 1969, was—in contrast to the previous American administration—highly skeptical about its usefulness.

The SDR soon all but disappeared from the monetary radar and attention was again focused on the dollar and its recurring weakness. Unlike earlier expectations of future American payments surpluses in the 1970s, it became clear in the new decade that a series of deficits was likely to occur. Not only was the United States importing more Volkswagens, Toyotas, clothing, steel, and oil, but capital was again leaving New York and other American financial centers on a massive scale. The financial numbers were awful: Outflows of U.S. dollars in 1970 were $10.7 billion, a record broken the following year when an astonishing deficit of $30.5 billion was recorded. Investors, traders, and central banks started ringing the death knell of the Bretton Woods system. Most of the dollar glut ended up in the coffers of the European central banks, many of which were routinely exchanging part of it for gold; the stock of the yellow metal owned by the United States now fell to a mere third of what it had been at its peak. No wonder that parties holding large dollar claims were taking the possibility that the world's premier currency was going to be devalued very seriously.

Toil and trouble

Even before the enormous increase in the dollars resulting from a jump in U.S. balance of payments deficits, severe tensions had developed among the main players in the international monetary system, including feuds among the European countries themselves. The gold pool run by the G-10 was terminated in March 1968 after unbridgeable differences how to deal with gold had occurred during the previous year. Jelle Zijlstra, a permanent feature at the monthly BIS meetings, relates how a highly unusual visit by the top monetary official of the U.S. Treasury, Fred Deming, to Basel to attend a gathering of central bank governors in December 1967, where the troubles with the gold pool were to be discussed, caused great unrest.[117] The BIS had always been closed to outsiders like ministers of finance, reflecting the cherished independence of the money masters. Now the sudden appearance of a senior American government official at the central banker's exclusive club was interpreted by the media and markets as ominous. The result was sales of hundreds of millions of dollars' worth of gold from the G-10 pool, leading cynics to describe Deming's failed trip as making it "the most expensive airline ticket ever issued." And there was another reason for Deming to be unhappy: The central bankers had refused him entry to the premises of the BIS, instead arranging to meet him in the nearby Hotel Euler.

Bizarre in Bonn

As governments are the ultimate deciders on exchange rates rather than central bankers the main differences of opinion between the United States on one side and Europe and Japan on the other, played out among ministers of finance and ultimately the heads of government. And while agreement had been reached on introducing the SDR, new waves of unrest on the gold and foreign exchange markets led to frequent emergency meetings of the G-10. These gatherings were often far from harmonious, the conference held in the leafy German capital of Bonn from November 20 to 22, 1968, being one of the strangest on record. Karl Schiller, the German Socialist minister of economic affairs, in a grand coalition of the Social Democratic Party and the Christian Democrats, chaired the meeting. Germany's minister of finance, the arch-conservative Franz Josef Strauss, was also present. Each felt he was the real spokesman for Germany and regularly left the meeting to brief the press when the other was speaking. And as the German duo often expressed different opinions, it was hard for other participants to know whom to react. Zijlstra, who attended the meeting, had low expectations, perceiving the continuing weakness of the dollar, as well as the increasing French–German tensions, as a harbinger of a breakdown of the international system. His highly respected American central bank colleague, William McChesney Martin, had earlier confirmed that belief by remarking that a certain degree of chaos in the international monetary system was inevitable.

The conference, which started at 4 pm on November 20, 1968 at the German Ministry of Economic Affairs, in an atmosphere full of uncertainty and nervousness, generated enormous interest. As this was a year of serious riots in France and student demonstrations and occupations elsewhere, the monetary high priests felt ill at ease. To make things worse a multitude of reporters milled in front of the glass-paned entrance of the Economics Ministry while demonstrators opposed to a revaluation of the mark loudly made their views known.

As the main item on the agenda was the highly sensitive issue of whether or not France should devalue its weak franc and Germany should revalue its beloved mark, having such a highly publicized meeting was asking for trouble. But U.S. treasury secretary Fowler, on a farewell tour of Europe, had insisted—on instructions from the White House—that the

G-10 meet. Fowler set a dramatic tone as he thundered: "This conference will be a historical one, for better or worse."[118] And the British minister, Roy Jenkins, reminded participants that the conference was taking place "in the shadow of the third currency crisis in 12 months, each one more serious than the former."[119] In the course of intense discussions about the value of the franc and the mark, Strauss brusquely stated that revaluation had not worked for Germany and that it was Germany's business alone to decide on the mark's fate. On top of that, he unexpectedly complained about American imperialism and of American corporations' buying up key German industries, sounding very much like a French nationalist. Chairman Schiller added to the tense atmosphere by insisting that the G-10 central bank governors, who had recently discussed exchange rates at their monthly meeting at the Bank for International Settlements, divulge what had been said in Basel. After Leslie O'Brien of the Bank of England cautiously offered to provide the ministers with the "collective wisdom" of the governors, Schiller turned to Jelle Zijlstra, the head of the Netherlands Bank, who at the time chaired the governor's meetings at the BIS, and told him to fully report to the ministers there and then. Zijlstra, not easily intimidated, answered that it was up to each governor whether or not to inform his minister, but that he could not speak for the Basel Group. In the words of one of the understudies at the meeting, Zijlstra "politely told Schiller to go to hell."[120]

As the meeting dragged on a second day, Schiller, who had also opposed revaluing the mark, offered a small quasi-revaluation consisting of an export border tax of 4% and import subsidies. Other countries were not impressed when Schiller "almost pathetically" pleaded with his fellow ministers, "[p]lease do not blame Germany, please take it. I beg you to accept [our solution]."[121] But Fowler was not convinced at all, responding that as he was soon to leave office he would be totally objective, insisting that Germany should revalue. His preference for a German revaluation over a French devaluation was motivated by a desire to shield the weak pound sterling, which had already been devalued only a year earlier. Chancellor of the Exchequer Jenkins of course fully agreed and came out in favor of a 7.5% revaluation of the mark.

French faux pas

The real drama revolved around France and its weak currency. The French minister of finance, Francois-Xavier Ortoli, hinted that a devaluation of the French franc of 11%, as suggested by the managing director of the IMF, Pierre-Paul Schweitzer—whose staff's calculations indicated the need for a devaluation of 15%—would be too much. The United

States strongly supported Schweitzer's proposal, whereas other ministers were playing a wait-and-see game. In his next intervention, Ortoli—who was on the phone regularly with De Gaulle—bizarrely suggested that since others opposed a 15% adjustment, France could devalue by less than 11% or not at all. Most delegates did not take this veiled threat seriously, but the ever perceptive Fed Chairman Martin confided to his staffer Charles Coombs: "I still don't see what the French have committed themselves to do."[122] And under the widely held impression that the French were prepared to devalue the franc by 11% over the weekend, Zijlstra was asked to do some fundraising among his colleagues so that the new parity of the franc could rely on a backstop if needed. Within half an hour, $2 billion was committed. But that was not the end of it, as Schiller wanted a session with only ministers to thrash out a final compromise. Having to leave the meeting room greatly irritated the proud central bankers, who had cooled their heels for hours in the corridors. And Pierre-Paul Schweitzer, who as head of the IMF was also present in Bonn, commented, "I would never have dreamed of attending a financial meeting from which [Fed chairman] Bill Martin would be barred."[123]

After the meeting broke up in the early morning hours of Saturday, weary participants rushed homeward under the impression that France would devalue during the weekend. Then came the shocking news that President De Gaulle had said *non* to the apparent outcome of the Bonn gathering. Wanting to avoid a serious incident, the U.S. government soon publicly announced its support for De Gaulle's decision. Amid widespread consternation in Europe, France rushed to introduce measures to stem capital flight and immediately announced austerity policies. But unimpressed markets continued to find ways to dump the franc. Only 5 months later, De Gaulle, who had lost a referendum over regional issues, resigned, and the more pragmatic Georges Pompidou took over as president, bringing back Giscard d'Estaing as his minister of finance. And in August 1969, after having spent $5 billion to prop up the franc, Giscard caught the market by surprise by announcing a perfectly executed—no leaks or hints had surfaced—devaluation of 11% while turning to the IMF for financial support. This overdue action was followed in late October, after a change of government in Germany, by a 9% revaluation of the mark aimed mainly at bringing down inflation, which was running at rate of over 5%, too high by Germany's strict standards.

The U.S. versus the rest

Bad memories of the Bonn debacle made political leaders leery of high-level gatherings on exchange rates in the glare of publicity. This sentiment became even stronger as the relationship among monetary officials from the United States and the rest of the G-10 deteriorated after Richard Nixon took office as president of the United States in 1969. Although there had been strains from time to time between the Atlantic partners during the most of the 1960s, the will to cooperate and keep the Bretton Woods system of fixed but adjustable exchange rates intact remained the dominant theme during the Kennedy and Johnson presidencies. President de Gaulle and his dramatic overtures on the role of gold had been a major irritant, but the usually feisty Lyndon Johnson later wrote that he had chosen to ignore the Frenchman's anti-American positions, believing that nothing the general could say would undermine the longstanding friendship between the French and American people—a statement at odds with Johnson's outburst after De Gaulle gave his famous gold speech in February 1965.[124]

During the period when fierce Gaullist Michel Debré had been the French negotiator on monetary reform, Paris had stood alone on many issues, not even supported by his European brethren. But with Nixon in the White House surrounded by hardliners who were not inclined to take European, let alone Japanese, complaints very seriously, the international monetary system and the world economy was in for a number of rough and eventually dangerous years.

4. Change of the guard

Richard Nixon came to the White House well prepared in January 1969. Having served two terms as Dwight Eisenhower's vice president and having waged two presidential election campaigns, as well as suffering a humiliating failed run for governor of California, he was a dyed-in-the-wool politician with wide experience in a number of fields, especially foreign affairs. He had famously stood up to the irascible Russian dictator Nikita Krushchev during their contentious so-called kitchen debate about capitalism in Moscow in 1959 and had taken a hard line against mainland China and its shelling of small islands under control of the Nationalists in Taiwan. Having inherited the disastrous Vietnam War from Lyndon Johnson, Nixon was determined to use his experience and political savvy to bring "peace with honor" in ending the conflict.

His very first personnel decision was to choose Spiro Agnew, governor of Maryland, as his running mate. Nixon's pick was part of his "southern strategy" directed at taking votes away from moderate Democrats in the U.S. South, a move that paid off. Agnew was given little to do by his president and only made his mark when he was indicted for extortion and bribery in late 1973, after which he resigned. At that stage of his second term, the unraveling Watergate affair was already damaging Nixon, and the Agnew debacle served only confirm impressions of a White House full of lawbreakers.

Assembling a team

The president's appointments in the economic domain were free of scandal but were of uneven quality. Nixon had already, during his presidential campaign in 1960, tapped professorial Arthur Burns, who had served in the Eisenhower Administration as the president's chief economic advisor, to enlighten him on economic issues. But this had not been a very successful arrangement, as Nixon found Burns's weekly letters "full of sage advice"[125] that was generally too esoteric and not usable in the campaign. Nonetheless, a warning from Burns that the Federal Reserve was following an overly tight monetary policy had registered with Nixon. The two kept in touch through the 1960s, and after winning the election in 1968 Nixon created a new position, special counselor, for Burns.[126] And in late 1969, when William McChesney Martin, whom Nixon did not like, was nearing the end of his term as chairman of the Fed, the owlish, pipe-smoking Burns was appointed as his successor. The victorious president was also quick in bringing in Paul W. McCracken as his chief economist. McCracken, a diminutive Michigan professor sporting heavily framed glasses and a forelock, had served in the Eisenhower administration and had also done work for presidents Kennedy and Johnson. Both Burns and McCracken were outstanding economists but never succeeded at getting Nixon interested in pure economics; the president viewed the subject exclusively through the lens of politics.

A mixed bag

Putting together his cabinet and top advisors, Nixon—with few exceptions—looked for persons sharing not only his worldview but also his contempt of left-wingers, antiwar protesters, and the Democratic Party. But he was pragmatic in selecting, at the advice of people he trusted, several moderate Republicans and even a few Democrats. David M. Kennedy, a moderate who had successfully headed Chicago's largest bank and who had once been an employee of the Federal Reserve, was chosen to head the crucial position of secretary of the treasury. But the portly, gray-haired Kennedy was not up to the job and got into trouble at the very beginning by not ruling out an increase in the official price of gold in his response to a question from a journalist. He lasted only 2 years as the United States' economics "czar" and was replaced by former Texas governor John B. Connally. Nixon was disappointed with Kennedy's weak performance and blamed him for not doing enough to get the stagnant economy moving again, finally pressuring his treasury secretary to resign. A close friend of Kennedy, and his deputy at the Continental Illinois Bank, Robert Mayo, was installed as director of the Office of Management and Budget (OMB). But Mayo's backslapping humor irritated Nixon, who complained that "Kennedy is weak and Mayo thinks he is still under him."[127] Little wonder that Mayo lasted only 1½ years. Among the president's other picks were John N. Mitchell as attorney general, later indicted for his involvement in the Watergate affair and Maurice Stans as his secretary of commerce, and who also became involved in the White House's dubious practices.

The most astute appointment was bringing in Chicago Professor George P. Shultz as secretary of labor; he took over as treasury secretary in 1972. Shultz, a soft-spoken but determined PhD in economics, cleverly elevated his status with the president not only by going around Kennedy and Mayo to explain to Nixon what was really going on in the economy, but also by successfully defusing tensions with the labor unions whose members Nixon had targeted as potential Republican voters. McCracken had not been the president's first choice as chairman of the CEA, having earlier sent out feelers to Alan Greenspan, who declined to move to the White House: He did not like Nixon. The then Republican presidential candidate had assembled a group of advisors, of whom Greenspan was one, to a beach resort on Long Island in July 1968 to discuss issues he wanted to highlight in his acceptance speech at the Republican Party's upcoming convention. Nixon opened the meeting with an angry tirade against the Democratic Party, "uttering more four letter words than Greenspan knew existed."[128] The economic advisor was shocked and "couldn't understand how a single human being could have such different sides." Still, the conservative Greenspan accepted an invitation to head the president's Council of Economic Advisors in August 1974. But Arthur Burns was not privy to Nixon's dark side, and on January 22, 1969, 2 days after the inauguration, he admiringly wrote in his diary: "Here was a man who knew how a President should act." A year later his opinion was changing, having seen a wild-looking Nixon in action, talking like a "desperate man" and "fulminating with hatred against the press."[129]

All the president's men

Nixon's closest lieutenants, known as "the Germans" in a play on their Teutonic last names, were his chief of staff, H. R. (Bob) Haldeman and John D. Ehrlichman, who became general counsel and who after a year ran the domestic policy side in the White House. Also belonging to the "President's men" was Charles (Chuck) Colson, named special counsel, who was to acquire notoriety as the president's hatchet man, and who eventually ended up in prison. Jeb Stuart Magruder, who initially served as the number-two man in the communications office and who was Haldeman's right hand man, also got into hot water over Watergate. Henry Kissinger, appointed National Security Advisor, had a very low opinion of most of the White House staff, describing them as "[m]oronic bastards" and "goddam anti-Semites."[130] He was not surprised when a large number of staffers belonging to the White House inner circle were indicted in Nixon's second term for their roles in the Watergate burglary coverup. Haldeman and Ehrlichman both served 18 months in prison.

Haldeman, who had been a successful advertising agency executive in California, had worked for Nixon since the 1950s, including during his unsuccessful 1960 presidential campaign as well as his run for governor of California in 1962. Stern looking and easily recognizable by his flattop hairstyle, Haldeman was known as a competent and demanding manager. But Henry Kissinger was already in early days highly critical of the new chief of staff, describing him as "a conservative middle-class Californian, with all the sentiments, suspicions, and secret envy of that breed."[131] He and several cabinet members also did not like how, together with the unsmiling Ehrlichman, Haldeman strictly controlled access to the president. The inflexible chief of staff, always carefully filtering information, from time to time briefed Nixon on breaking economic news, although not always capturing the president's attention. John Ehrlichman, a decorated World War II aviator, had also worked on Nixon's campaign in 1960 and was an advance man for his winning presidential run in 1968. While his name literally meant "honest man" in German, Ehrlichman was anything but honest. He created

President Nixon with R. H. Haldeman, Dwight Chapin, and John Erlichman in the Oval office, March 1970. (White House photo.)

the infamous "plumbers" who used illegal means to obtain sensitive information from Nixon's "enemies," including by breaking into the Watergate office of the Democratic Party National Committee, and who directed his assistant, Egil Krogh, to oversee, mostly illegal, covert operations. Later Ehrlichman soured on the president and told his young assistant Henry M. (Hank) Paulson, who was to enjoy a highly successful career at Goldman Sachs and to serve as secretary of the treasury, that Nixon "is a very complex guy," with a liberal side and an intellectual side, but that "he was also paranoid."[132] Evidence that Nixon had mental problems is supported by his visits to a New York psychiatrist when he was vice president, being diagnosed as suffering from "chronic, debilitating psychosomatic symptoms."[133] Paulson, disillusioned by the unfolding Watergate scandal, left the White House in 1973.

Monetary point man[134]

In contrast to the many bad appointments made by Nixon and his circle, bringing in Paul A. Volcker as undersecretary of monetary affairs at the U.S. Treasury proved to be a master stroke. When the 41-year-old Volcker entered the neoclassical building of the U.S. Treasury, situated due east of the White House, he was still largely unknown to those from outside the financial world. But when he resigned after 5 turbulent years, he had acquired considerable fame both within the United States and abroad. Volcker came to the White House with excellent economic and financial, if not political, credentials, having worked at the Federal Reserve Bank of New York in both research and hands-on market operations, occupied a senior position at the U.S. Treasury during the Kennedy administration and in addition gained experience in commercial banking at Chase Manhattan Bank, then run by the gentlemanly David Rockefeller. His academic background (Princeton, Harvard, and London School of Economics) combined with his practical experience made Paul Volcker an ideal candidate for the role of monetary point man at the Treasury.

Not everybody was thrilled to see a Democrat and former Kennedy appointee working at the Treasury in an important and sensitive position. Nixon, not directly involved in tapping Volcker, still believed that Kennedy had stolen the election from him in 1960. But future attorney general and Nixon confidant John Mitchell who was closely involved in the selection process for positions in the Nixon administration, had been convinced by Charls Walker—already designated as the number-two man at the Treasury—that Volcker was the right man for the job. Moreover, David Rockefeller, a stalwart Republican, also highly recommended his protégé. Volcker, although eager to take the job, struggled briefly with the idea of working under Nixon, whom he disliked, remembering how the then vice-presidential candidate had brutally attacked Adlai Stevenson, during his campaign against Dwight Eisenhower in 1952 and 1956, as being soft on communism. But as the job was such a good fit for Volcker, and he so relished dealing with the challenges of damping rising inflation and the mounting problems of the dollar that he soon decided to inhabit a corner office on the second floor of the imposing Treasury building. Perhaps he briefly reflected that Harry Dexter White had walked the same corridors 25 years earlier as America's monetary point man.

A pragmatist

Volcker did not adhere to a precise economic philosophy, except for the need for stability and keeping inflation low to maintain an economic environment that would be good for investment and growth. He did not subscribe to full-fledged Keynesian economics as most of presidents Kennedy and Johnson's top advisers did, especially Walter Heller, who headed the CEA at the time. Neither was the new under secretary a full-blown monetarist in the mould of Chicago professor Milton Friedman. Volcker, a pragmatist, was primarily interested in what would work in the real world, with all its uncertainties and political wheeling and dealing. His philosophy was that of a moderate monetarist who believed that close monitoring of the money supply was necessary but that it was not the only thing that counted. He also believed in a system of fixed exchange rates with changes in currency values taking place only when they were clearly over- or undervalued. Floating exchange rates were a copout, making life easy for politicians but at a steep price in the future. A supporter of the Bretton Woods system when he started his new job, he was in favor of remedying the crisis-prone international monetary system. But Volcker's position on exchange rates would change before long when the dollar crisis refused to go away.

At an elevated level of responsibility in a presidential administration there is always infighting, jockeying for position, and sometimes worse within departments and agencies that want to encroach on each other's turf. Volcker, a person of high integrity, mostly preferring his own company over that of others, was not a natural for playing political games. But far from being a pushover before persons of higher rank, he would stand his ground when confronted with trickery while at the same time learning the political ropes. Hardworking to the point of being a workaholic, and deeply interested in economics, Volcker shunned small talk.

And as he did not suffer fools, he sometimes made enemies among less talented individuals. He was considered hard to judge, his demeanor changing from pleasant and patient one day to curt and dismissive the next. Arthur Burns, chairman of the Fed from 1970 on, was not known for his insight into people's personality—he once described Agnew as an honest man—and wrote in his diary that Volcker was "an indecisive man, full of flaws, and anxieties."[135] Nixon also was also not impressed by the monetary point man, remarking to George Shultz in August 1971, "I don't have a lot of confidence in Volcker."[136] Yet, 8 years later, Paul Volcker was chosen to be Burns's successor as the world's most important central banker.

Balding at an early age and wearing rumpled suits as well as walking around with holes in his socks while puffing away on cheap cigars, Volcker did not resemble a well heeled East Coast banker such as David Rockefeller. Part of the reason for his somewhat sloppy appearance was that as a strong believer in public service, his earnings were meager, being a victim of the dogma that top-class civil servants should be underpaid. (They can then be lured away for a much higher remuneration on Wall Street and other lucrative positions.)

To his European and Japanese colleagues whom he met regularly at international meetings, the 6-foot, 7-inch American was something of an enigma. What they saw was a tough negotiator who would sometimes come across as agreeable but suddenly borderline rude and brusque at times. And some of them interpreted his habit of speaking with his mouth partly covered by his hand while supporting his chin by his arm, often making him hard to understand, as a lack of social graces. But almost everybody agreed that Paul Volcker was a brilliant man with great feeling for economic policy, always extremely well prepared and fully worthy of their respect. This judgment was only enhanced when soon after taking office, Volcker started to eclipse David Kennedy, the hapless head of the Treasury Department.

5. Nixonomics

Upon entering the White House for the first time as president on a cloudy, chilly day on January 20, 1969, Nixon felt a sense of entitlement, finally having reached the pinnacle of power he so richly deserved. "There was a look of exaltation about him."[137] After being sworn, in he had struck an optimistic tone in addressing the American public, declaring that "[w]e have learned at last to manage a modern economy to assure its continued growth."[138] At the same time he intoned: "We find ourselves rich in goods, but ragged in spirit."[139] Continuing in dramatic fashion, he asked Americans "to join in a high adventure—as rich as humanity itself, and exciting as the times we live in."[140] The American president would indeed experience "high adventure" within a few years, but of a very different kind he envisaged on the day of his inauguration.

Whether Nixon's belief in the manageability of the economy was based on Keynesian philosophy—that by running budget deficits, recessions could be avoided—or on Milton Friedman's dictum that regulating the money supply was the way to growth without inflation is not clear. But since the president's economic policies were to show many contradictions, being driven always by politics, his initial approach was probably an exercise in upbeat rhetoric. Nixon was unlucky in having inherited an overheating economy from his predecessor. Lyndon Johnson, certainly no economic wizard and advised by unabashed Keynesians, had increased government spending enormously without raising taxes until forced to act late in his presidency. Heavy spending on the protracted Vietnam War, which at its height required half a million troops in southeast Asia, had resulted in years of large budget deficits. And the income tax increase passed in mid-1968 came too late to tame an overheating economy. Unemployment fell to a mere 3.5%, the lowest level in 15 years, and although greeted with cheer, it had dipped below the level that economists thought would trigger inflation.

This is exactly what happened: During the last year of Lyndon Johnson's presidency, the good news was that the American economy grew by 6%; the bad news was that inflation had accelerated to 5%. "Failure of the U.S. economy to cool off must be rated as a major disappointment of the year,"[141] wrote the International Monetary Fund. On top of that, the Federal Reserve had been slow in reacting to the surge in inflation, tightening monetary policy only late in 1968 by raising its interest rate to 5.5%. Politicians generally do not welcome higher interest rates and see them at best as a necessary evil. No doubt Nixon would have preferred that his predecessor and a procrastinating Congress would have reduced the budget deficit earlier, helping to suppress the increase in prices that way. Now he had to rely on monetary policy, managed by Fed chairman Martin, whom he did not like and whom he saw as too independent, to bring down inflation in the short run. But the administration could take heart from a sharp improvement in the American overall international payments balance to a surplus of $1.6 billion in 1968 after a string of deficits in previous years. Large amounts of capital flowed to the United States as foreigners bought American stocks, and high interest rates attracted short-term funds, mainly from

Europe and Japan. And the dollar escaped most of the turmoil on the foreign exchange markets in 1968, which this time was concentrated in Europe.

A mismatch

But the United States was in a vulnerable position. It had lost a great deal of gold in recent years, and its stock of the precious metal was down to $10 billion when Nixon took over, uncomfortably low in relation to official dollar claims, which were about 50% higher. It was plain to see that if a number of foreign central banks wanted to exchange most of their dollars, the United States would have to empty Fort Knox. (In the following years, the ratio of U.S. gold to foreign dollar claims would fall dramatically.) A task force on balance of payments policies was put together to advise president-elect Nixon, chaired by Gottfried Haberler, a highly respected Harvard professor. It suggested that in case of a serious dollar crisis, the United States could suspend, or even abolish, the conversion of dollars into gold. The group also looked at the alternative of letting exchange rates float freely, a topic that would later be raised in several discussions between the monetarist Milton Friedman and the president.[142] Whether the suggestion of closing the gold window and the Chicago professor's view that fully floating the dollar would solve the United States' balance of payments in one fell swoop got Nixon's attention

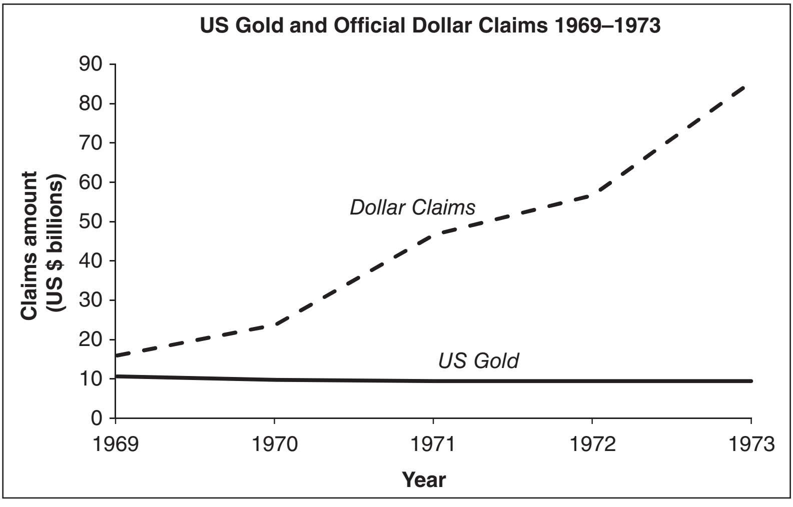

Figure 2.1 U.S. Gold and Official Dollar Claims, 1969–1973.

is not clear (like Burns's "sage letters"), but it certainly registered with Volcker, who wanted to keep the Bretton Woods system intact.

Such was the state of the economy when the Nixon administration took over. Since the American commander-in-chief's overriding priorities were ending the Vietnam War and capturing the support of the "silent majority," he did not focus much on economic policies. After all it was now known how to manage a modern economy as he had stated in his inaugural address. Also a fast-growing economy and low unemployment appealed to the labor unions, who Nixon wanted to enlist as allies with an eye to changing their voting preferences. But as the economy roared on and inflation threatened to become chronic, the likeable Paul McCracken, who headed the CEA, met on a weekly basis with the other members of the so-called Troika of top economic policymakers, which included, besides himself, Treasury Secretary Kennedy and Robert Mayo, the budget man. At times they would be joined by Fed chairman Martin, constituting the Quadriad. The meetings were held on neutral ground at the venerable Cosmos Club near Dupont Circle. The Troika economic experts and central banker William McChesney Martin were getting worried about the rapid increase in prices, wishing to avoid runaway inflation. They realized that after the public fully caught on that rising prices were making their dollars go less far, social unrest was likely to follow. McCracken's prescription to gradually cool off the economy became official policy, as Nixon also judged that braking too hard would cost him political support. Once gradualism had been decided on, Nixon's interest in economic policymaking waned anew. "Mr. Nixon may have even had an almost psychological block about economics"[143] and approached the subject "somewhat like a little boy doing required lessons,"[144] quipped McCracken.

An early setback

The gradual approach agreed on turned out to be not all that was hoped for. As economic growth slowed to 3%, unemployment shot up to 4.6%. At the same time, inflation roared ahead by more than 5%, making life difficult for the Nixon administration and the Fed. Although the idea was to gradually move to tighter policies, the reality was different. Instead of bringing down the budget deficit from $25 billion to a more modest level, the outcome for 1969 was an almost unprecedented surplus of $3 billion. The Johnson income tax surcharge of 10% had belatedly done its work. And when a ceiling was placed on government spending, the effect was fiscal overkill. On top of that, the Fed had raised interest rates in December 1968 and decided the following year to step on the brake even more, over time bringing down the growth of money supply from 7% a year to practically zero. According to monetarist theory, this meant that the economy would stall. Nixon, who had distrusted the policy of gradualism in part because Fed Chairman William McChesney Martin bore the main responsibility for slowing down the economy, was livid. The president viewed Martin as "a stereotypical tennis-playing Easterner, Ivy League banker who considered himself wholly independent of the Nixon administration."[145] He had "always feared that the Federal Reserve was about to put the economy through the wringer," and Nixon now saw his angst confirmed. Martin, who had a tennis court built outside the staid edifice of the Federal Reserve in Washington for his personal use and that of his colleagues, resigned in January 1970.

Yet the economic picture was not entirely bleak, the balance of payments of the United States posting a record surplus of $2.7 billion in 1969. But this improvement was wholly due to American banks borrowing massively abroad to escape the Fed's policy tightening. An increase in exports would have been preferable, but as flagged by the IMF, American goods had a hard time competing on world markets. Wage costs were rising faster than those in Europe and Japan, causing American cars and machinery to lose market share, while consumers in the United States were snapping up Japanese cameras and European luxury goods. The world's largest economy was also importing more oil, starting a trend that would contribute to the oil shocks of the 1970s. Thanks to capital inflows the dollar remained stable at a time of currency upheaval in Europe, ending with the French devaluation and German revaluation of 1969. Also feeding American complacency about its payments balance—later known as "benign neglect"—was an increase in the American gold stock of almost $1 billion as the Federal Reserve purchased $500 million of the yellow metal from Germany and $325 million from France, a rare reversal of earlier years.

Marking his territory

Although the gold transactions were welcome, Volcker and his staff at the U.S. Treasury saw that all was not well on the dollar front and were alert to a change of sentiment in currency markets. Henry Kissinger, the deep-voiced German-born Harvard professor, who had become the National Security Advisor, had his own reasons for a close monitoring of the monetary scene. Right from the beginning he tried to outsmart the Treasury, Volcker in particular, by calling for a group to study U.S. international monetary policy and then report to the National Security Council. Volcker would have none of it: "He did not want Kissinger sticking his Harvard nose where it did not belong."[146] A working group, chaired by Volcker, was set up, but was to report to the president and not to Kissinger, the undersecretary of the Treasury having carefully adjusted the mandate of the group. And the "Volcker Group," which included representatives of the State Department, the CEA, the National Security Council, and the Fed, was to play a pivotal role in designing the United States' international financial policy. As Treasury Secretary Kennedy was not well versed on the international side of his job, Volcker stepped smartly into the breach and soon was the American monetary negotiator. From the start he was traveling to international meetings such as the G-10 gatherings, regular get-togethers at the Organization of Economic Cooperation and Development (OECD) in the elegant Chateau de la Muette in Paris, the annual meetings of the IMF when held abroad, but most importantly in bilateral talks with foreign counterparts across the Atlantic and Pacific Oceans, sometimes flying in his own Air Force plane.[147] Physically imposing and intellectually brilliant, Volcker soon made his mark in international discussions and negotiations. But while foreign financial leaders shared Volcker's concern about inflation, they often blamed higher prices in their countries on the flood of dollars they were receiving. In its usual understated language, the IMF observed that "[c]apital inflows created a serious problem for domestic monetary management on the continent of Europe, and particular in Germany, where the authorities were attempting to maintain restrictive monetary policies in order to combat inflation."[148] This was the background against which tough talks were held as tensions rose over mounting price increases and the future of the dollar.

Getting acquainted

In his first year as the U.S. Treasury's third-in-command, but sometimes acting as number one, Volcker's foreign interlocutors were not only deputy ministers of finance and central banks' deputy governors, but often their superiors themselves. Among these was the German minister of finance, Karl Schiller, who had led the ill-fated G-10 meeting in Bonn the previous year and was now solely in charge of the finance and economics portfolio as his uncooperative fellow minister, Franz Josef Strauss, had to quit when his party dropped out of the government coalition. Karl Blessing, president of the mighty German central bank, known everywhere as the Bundesbank, also played a prominent role in talks about the dollar and European currencies, as did his successor Karl Klasen, an autocratic former commercial banker. The French team was led by Valéry Giscard d'Estaing, brought back as minister of finance by President Georges

Pompidou after De Gaulle's sudden departure in April 1969. Giscard, although not representing the most powerful European economy, often skillfully played the role of principal opponent of the United States in monetary matters. At the same time, Great Britain, also one of Europe's biggest economies, the closest ally of the United States within the G-10, but viewed as a declining power, was less visible at international monetary gatherings. But its representatives, the Labour Party's Roy Jenkins, who became president of the European Commission in 1977, and—the less gifted—Tory Anthony Barber were from time to time influential behind the scenes. Italy, also part of the larger G-10 countries but frequently changing governments and thus bringing new inexperienced ministers in the field every so often, had to rely more on its charismatic central bank governor, Guido Carli. And though with a population only a quarter of the size of neighboring Germany, the Netherlands traditionally made its voice heard in international meetings and could muster individuals such as future IMF managing director Johannes Witteveen and the president of the Netherlands Bank, the independent Jelle Zijlstra, who also for many years presided over the BIS in Basel. The Swiss, not formally a member of the G-10, were also punching above their weight, aided by their having accumulated large international reserves to become an important financial center, although their secretive bankers, famously labeled by British prime minister Harold Wilson as the "gnomes of Zurich," were unloved by many.

A black sheep

Although all these personalities enjoyed impeccable monetary credentials, one individual carried unfortunate political baggage. Karl Blessing, who became president of the Bundesbank in 1958 and remained in that position for 11 years, had a murky political background. He came across during those years as a "cheerfully resolute man" who had been "playing a towering role during most of the decade of the sixties," and who had "anguished memories" of observing "the breakdown of international cooperation in the early thirties."[149] Apparently his worldview had changed in the course of that decade. Blessing had joined the Nazi Party in 1937 while working at the Reichsbank under Hjalmar Schacht, whose protégé he had become. And while "he was a man of intelligence and wit," he was also "a prodigious opportunist." Blessing "led a double existence of complexity and intrigue." During Hitler's Third Reich, "he scaled the peaks of the Nazi economic establishment." And on a visit to Bucharest in 1941 to advise the Romanian central bank, he suggested that the alarming rate of capital flight it was witnessing was caused by

"Jews." Earlier, in March 1938, he had been tasked with taking over the Austrian National Bank after the integration of Austria into Germany. Not averse to bragging, Blessing hailed the successful operation as a "memorable day, which will remain unforgettable for us." And "in this short period, all the measures have been put in place with the goal of forging together the two economies into an unbreakable whole." During the first years of World War II, Blessing was engaged in shady dealings involving money, raw materials, and oil in occupied territories that were being plundered to support the German war effort. But toward the end of the war, Blessing, apparently sensing the turn in Hitler's fortunes, sought contact with the plotters against the Führer.[150]

Although the Americans arrested Blessing after World War II in his native southern Germany, after weighing the case, they decided not to charge Blessing with war crimes. But the British government was sufficiently unhappy about the German central banker's blemished background that it "discreetly rejected his nomination to the Board of the Bank for International Settlements in the early 1950s."[151] American officials were more forgiving and, after promising in the famous "Blessing letter" of March 1967 not to convert dollars into gold—the Bundesbank had between the mid-1950s and 1966 bought almost $4 billion of the yellow metal from the Federal Reserve—joked, "what a blessing we have Blessing."[152]

6. Showing his dark side

After a year in office, Nixon was not too happy, the Vietnam War was dragging on—the president would in due course announce the invasion of Cambodia—and the economy was slowing rapidly, with inflation remaining high. Worse, rising unemployment would not sit well with voters in the November 1970 midterm elections. After much handwringing, Nixon's economic advisors advocated continued gradualism, but this time by somewhat pumping up instead of slowing down the economy. Puzzled by the continuing high rate of inflation in a downturn, the idea of directly influencing wages and prices was bandied around. Nixon and his closest advisors, who did not believe in intervening directly in markets, were not in favor. But the president, brooding in the Oval Office while staring at the flames in the fireplace, which he also liked to keep going in summer while cranking up the air conditioning, was to show his flexible side the following year and embrace a so-called incomes policy, a euphemism for putting in place guidelines or outright controls over consumer prices and payrolls.

This turnaround was still far away in January 1970, as Nixon anticipated that Arthur Burns, the new chairman of the Federal Reserve Board, would turn on the money spigot to stimulate the economy while not focusing too much on inflation. After all, the president's experience had taught him that inflation did not cause election loss, whereas high unemployment did. This notion led to a paranoid obsession for Nixon with the Bureau of Labor Statistics' spokesman on inflation and unemployment numbers. Harold Goldstein's monthly briefing to the media bothered Nixon a good deal; he suspected that the lowly economist was presenting the numbers in an unfavorable light, rather than to the president's advantage. When in early 1971 Goldstein described a small decrease in unemployment as "marginally significant" but Labor Secretary James Hodgson called it "of great significance," Nixon wanted Goldstein fired but accepted a lesser punishment: Goldstein's monthly briefings would be terminated after 24 years.

In July 1971, at a time when the economic recovery was still hardly visible, the Labor Department announced a huge drop in unemployment. But this was not a hallelujah moment; Goldstein had written that the size of the lower number was mainly owing to a statistical quirk. Nixon immediately instructed his hatchet man, Charles Colson, to get Goldstein kicked out. A few months later, Goldstein was reassigned within the department to a position in which he could apparently do no "damage" to Nixon. The worst part of the incident, illuminating the president's dark side, was Nixon's request to find out how many Jews worked in the Bureau of Labor Statistics. Chief of Staff Haldeman dutifully directed an underling to conduct an "ethnic" survey of the Bureau. It turned out that not only was the share of Jewish staffers in the higher ranks of the Bureau relatively high, but most of these higher-ups turned out to be Democrats. Nixon's repeated unfavorable references to Jews reflected his anti-Semitism, but Greenspan—himself Jewish—averred that the president was not exclusively anti-Semitic, but he hated other ethnic groups as well: "He hated everybody."[153] And Leonard Garment—also Jewish—who served as a lawyer in the White House during its darkest days, remarked that Nixon "in his prime was a champion hater,"[154] but of the "equal-opportunity" type.

Political economics

Focusing as always on politics, the big question for the American leader was now whether a recovery of the sluggish economy would happen soon enough to convince voters in the November elections to vote for Republican Party candidates. As the year wore on, hopes for an early spurt of growth vanished and output actually fell toward the end of 1970. The unemployment picture became bleaker, the share of able-bodied adults out of work rising from 3.5% to a politically embarrassing level of 6%. But stubborn inflation—still running at 5% and threatening to become chronic—could also not be ignored, as the IMF reminded its largest member: "Despite the progressive elimination of excess demand through fiscal and monetary restraints, the inflationary forces built up over several years continued to exert strong upward pressure on costs and prices."[155] The international organization hinted that incomes policy could be an appropriate answer to break this bad trend.

The message was ignored by the White House, now concentrating on providing stimulus through the budget and relying on Fed Chairman Burns, whom Nixon considered his "own man," to pump up the money supply. But in October it became clear to the president that the poor economic picture was damaging him and that his hopes for a good Republican showing in the election were doomed. Nixon's party picked up only two Senate seats, falling short of gaining a majority, and lost nine seats in the House of Representatives. Although this time not suspecting a conspiracy, the White House incumbent did look for individuals to blame. There was of course Martin, the previous head of the Fed, who had shortly before his departure stepped hard on the monetary brake. And although his successor had reversed the central bank's stance, the results of that move were not yet visible. Another guilty party was the ineffectual David Kennedy, who was soon replaced as secretary of the treasury, causing Paul Volcker, who got along well with Kennedy, to briefly worry about his job.[156]

A sage at the fed

Not worried at all was Arthur Burns as he entered the hallowed halls of the Federal Reserve Board's imposing white marble edifice. Set back from Washington's bustling Constitution Avenue, it was just far away enough from the White House to symbolize a degree of independence. Born in Austria at the time of the Austrian-Hungarian monarchy, Burns came to the United States, like Henry Kissinger, as a boy. Already 65 years old, Burns had enjoyed a long and distinguished career before Nixon tapped him to run the most important central bank in the world. He had been an economic advisor to President Eisenhower and was a prominent expert on business cycles. Supremely confident, he took liberties with Nixon nobody else would dare. Burns, who once described himself as "a Neanderthal conservative"[157]—a trait he shared with the Bundesbank's Karl Klasen—also possessed the political skills essential for a head of a central bank to be fully effective. Treasury Secretary John Connally colorfully described Burns as being "as cagey as a tree full of owls."[158] The new man also lorded it over to everyone at the Fed, not hearing out his colleagues when making an important decision, such as changing the discount rate, but putting his views on the table in a take-it-or-leave-it fashion. A fair number of staffers came to dislike the chairman's dictatorial ways, and some even left the Fed, where they had once enjoyed working.

Arthur Burns was a pragmatist—a positive trait for a central banker—for whom empirical evidence was much more important than any particular economic philosophy. As an eclectic economist, he eschewed what he considered unproven theories: "The argument between Friedmanites and the Keynesians is a false argument. It's an argument how well this or that group of economists can forecast the future. They cannot do so, and thank God they can't."[159] Fully convinced of the wisdom of his own pragmatic judgment, Burns was not shy in doling out his views on policy issues. Paul Samuelson, who won the Nobel Prize for economics in 1970, once joked: "If he [Burns] were alone on a deserted island, he'd be giving orders to himself."[160] But although the president, having high hopes that Burns would be pliable and help him win elections, never gave Burns direct orders, he did make clear what he expected when announcing Burns's appointment, saying, "I respect his independence," but "hope that independently he will consider that my views are the ones that should be followed."[161] Such a message, even when packaged as a joke, would be unthinkable in Germany, where central bank independence had *de facto* made the Bundesbank the fourth pillar of the *Trias Politica*, right along with the executive, the legislative, and the judicial branches. In the United States, the Federal Reserve is independent "within the government," but in practice, its board of governors has demonstrated an independent streak. For Burns, Nixon's words constituted a challenge that he would meet with mixed results.

Nixon's helper?

Soon after taking over at the Fed, Burns started easing monetary policy, steadily lowering interest rates. Initially, most of the other Fed governors were opposed to easing monetary policy, still viewing stubborn inflation as the real threat, whereas Burns expected a recession to rear its ugly head. The Fed chairman turned out to be right, burnishing his reputation as an astute policymaker who was ahead of the curve. At the same time, critics interpreted Burns's easing as being helpful to Nixon and his electoral ambitions. But although the president's "own man" seemed to come through on money—at 6%, money growth was expansionary—the central bank chief proved that he was also his own man on some issues. Burns would not ignore ingrained inflation, unlike Nixon, who was now focused fully on bringing down unemployment. But to bring down inflation without curbing household spending and business investment was an immense challenge. Burns identified the problem as "cost push" inflation, an increase in cost and prices independent from the business cycle. A way out would be conducting an incomes policy, a solution he shared with several other policymakers, but not with Nixon and his top advisor McCracken. Although the president early on discovered that "Burns was not to be the President's operative at the Fed," the central banker did not succeed in bringing down inflation to an acceptable level during the Nixon years.[162]

Stating in a speech in May 1970 that inflation was America's biggest challenge, the Fed chairman hinted that cost and price guidelines should be considered, although he grudgingly admitted they had so far not been a success in other countries. Later Burns came out strongly in favor of government wage control. This was music to the ears of earlier advocates of an incomes policy, but Nixon was enraged by Burns's position, regarding it as an attack on his policies and as a disloyal act, shouting at his aide Erlichman that "Burns will get it right in the chops!"[163] And, considering that Nixon often took things personally, Burns backed off for the moment. Meanwhile, the president—who had a knack for chameleon-like twists—had started calling himself a Keynesian as he became more and more obsessed with his re-election in 1972. Determined to pump up the economy, Nixon invited the head of the Fed to the White House from time to time, pressuring him to print more money. Burns became uncomfortable with these sessions, convinced that "the President will do anything to get reelected."[164] The central banker was also unhappy with the campaign of harassment and false stories leaked to the press about him by the "pusillanimous" White House gang.

Burns tried to resist Nixon's fervent wish to have him print money liberally, stating that he was only prepared to do so if a wage and price board would be put in place, because inflation was still not under control and having more money in circulation would cause new attacks on the dollar. The standoff continued for months as Burns repeated his pleas for an incomes policy, regularly sending Nixon into a rage. The president also attacked the central bank chief at a meeting of the Quadriad in July 1971 for commenting publicly on "nonmonetary" issues and not sticking to the administration's policy line. His dark side taking over, Nixon's "features became twisted and what I saw was uncontrolled cruelty," Burns wrote in his diary. But while "[he] talked constantly about getting tough with Burns . . . he rarely followed through"[165] and was unable to make the Fed chairman drop his price and wage control rhetoric.

Unholy trinity

Burns's concern about the dollar may not have been shared by Nixon at the end of 1970, but it was Volcker's big worry. Both monetary experts understood perfectly well that rapid money growth spills over the borders as it stimulates imports as well as capital outflows, contributing to balance of payments deficits that increase unwanted dollar reserves abroad. The IMF pointed out that "[t]he quantity of international reserves, after growing sluggishly in the second half of the 1960s, increased in 1970 by exceptional and disquieting proportions by some $16 billion, or 21.8%."[166] Dollars accounted for the bulk of the $16 billion to which large amounts were to be added during the first 7 months of the following year. Halting this trend would require either putting in place capital controls—opposed by free market supporters—or by raising interest rates. But tightening the monetary screws was obviously out of the question. The United States was now faced with the unholy trinity of monetary policy, exchange rate policy, and capital flow policy. Monetary policy was only independent when exchange rates floated, and fixed rates, as under the Bretton Woods system, presumed that monetary policy would support the exchange rate. And both monetary policy and fixed exchange rates could be undermined by the free flow of capital, raising the question whether the existing international monetary system could be maintained. But such finer points about the system seldom hold the attention of politicians. As Volcker explained in 1992, "Presidents—certainly Johnson and Nixon—did not want to hear that their options were limited by the weakness of the dollar."[167] And some of the prominent economists taking office were ready to challenge the basic elements of the Bretton Woods system. In particular, they were willing to accept the phrase "benign neglect" as a fair description of their policy preference of more or less ignoring the problems of the dollar and the balance of payments. In early 1971, considered by himself as the low point of his first term, Nixon became desperate about ensuring his reelection the next year. He viewed the poor state of the economy as one of the biggest threats to his second coronation. This sentiment was echoed in the media: "If there is not sustained pick-up in the months ahead, the economy could turn out to be Richard Nixon's 'Vietnam.'"[168]

7. Texas hold 'em

John B. Connally, brought in as secretary of the treasury after David Kennedy's ouster, was neither an economist nor a banker, but a consummate politician and a believer in benign neglect once the concept had been explained to him. Nixon felt great admiration for the swashbuckling Texan, whom he fiercely hoped would cure the economy. Connally's background was impressive: Having started life as the son of a sharecropper, he became a decorated World War II Navy officer, was briefly Navy undersecretary during the Kennedy administration, and climbed the political ladder to become a three-term governor of Texas. During his first gubernatorial term, he was seriously injured when riding in the presidential limousine with President Kennedy in Dallas on November 22, 1963, the fateful day JFK was assassinated. After recovering from his wounds, the tough Connally continued as a forceful conservative Democratic governor until 1969. Although the Texas politician had been a protégé of Lyndon Johnson and, with his drawl and his physical appearance, created for some "an eerie reminder"[169] of his mentor, described by an insider as LBJ with "couth," Connally was leaning more and more toward the Republican Party, which he would eventually join. Nixon liked the rumors about the Texan's political shift and admired his star power. Connally impressed Nixon with his talent for drama and oratory, his confident and direct manner and unruffled demeanor, his political savvy, and his likeability, at least when he was not in a bullying mood.

The charmless president, famously feeling uncomfortable on many occasions, who did not like socializing, nor giving press conferences, and who as much as possible avoided personal confrontations, recognized in Connally "many qualities that he himself lacked."[170] Or, as Henry Kissinger wrote, "Connally's swaggering self-assurance was Nixon's Walter Mitty image of himself. He was one person whom Nixon never denigrated behind his back."[171] And: "Here at last was a man to smite the critics and tame Arthur Burns."[172] Nixon must have also appreciated John Connally's open mind or, as others saw it, lack of convictions, and his craftiness—"I can play it round or I can play it flat, just tell me how to play it,"[173] Connally was fond of saying. The former Texas governor further cemented his bond with the president by describing him as "the most misunderstood man in public life"[174] at a dinner for Nixon's inner circle. But in private, the former Texas governor's assessment of his president was mixed, seeing him as a "humorless man, and extremely private, almost antisocial" but who "nevertheless went against the trend and the grain."[175]

Spunky character

The new secretary of the treasury soon made his mark in the dog-eat-dog atmosphere of politics in the nation's capital. The well-known reporter James Reston described the former Texas governor as "the spunkiest character in Washington these days. . . . He is tossing away computerized Treasury speeches, and telling American business and labor off the cuff to get off their duffs if they want more jobs, more profits and a larger share of the competitive world market."[176] And Herbert Stein, who succeeded McCracken as chairman of the Council of Economic Advisors, described the Treasury chief as "tall, handsome, forceful, colorful, charming . . . and political to his eyeballs."[177] He might have added that the man from the Lone Star State was also rich, having made his fortune as a lawyer earlier in his career. At the Treasury, he was appreciated as a quick study, a hard worker, and a straight shooter. Although Arthur Burns had been "shocked" at Connally's elevation, his initial reaction to the newcomer was favorable: "I was impressed by the clarity and vigor of his rhetoric."[178] As with Nixon, getting to know the man better would make him change his opinion radically.

Although Nixon, who had a penchant for surprises and drama, was pleased with the new member of his cabinet, the reaction to Connally's appointment was mixed, both in the United States and abroad. His "Texas-sized ego"[179] and abrasive style often reminded foreigners of a gun-slinging cowboy in a B movie. There were also doubts about his qualifications for the new job, but he was intensively coached by former Fed chairman Martin—whom ironically Nixon had detested—and began putting in 18 hours a day. A nationalist, Connally believed that foreign countries were out to take advantage of America and therefore must be taken advantage of first. In the same vein, he was suspicious of international organizations and on his first visit to the IMF dismissed it as "a museum in which anything that was not stuffed ought to be [stuffed]."[180] More ominous, but not know to outsiders, were some of his private views about foreign policy and Vietnam, which were so extreme that they "alarmed" Volcker.[181]

Connally and Budget Director George Shultz, also part of the president's inner circle, delivered what Nixon wanted, preparing a highly expansionary budget which with some gimmickry was presented as a responsible shot in the arm for the economy. Together with Burns's easy money policy, the large budget deficit started to produce results, with the economy—which had shrunk slightly in 1970—showing signs of recovery. But the real effects of the stimulus came only in the course of 1972, nicely on time to influence the presidential election. Because prices were still rising at an annual rate of almost 5%, Connally and Shultz realized what Burns had already grasped: Inflation could no longer be ignored and could cause social tensions exactly when unemployment started to come down.

This brought incomes policy back on the agenda. Nixon's free market instincts still made him very reluctant to take that route, but Connally—like the president a believer in free markets, but also a pragmatic wheeler-dealer, started working on convincing Nixon of the need to make a U-turn. Elsewhere in the world where inflation was also threatening to spin out of control—in Great Britain prices rose by 11% in 1971—the call for incomes policies became louder. In its usual dry style, the IMF wrote that "[o]ne reason why many countries turn to incomes policy . . . is their disappointing experience in relying solely on demand management policies," adding that "relationships between demand/cost pressures and rates of price increase have been rather seriously misjudged in the formulation of monetary policy."[182] It is very unlikely that Connally read IMF documents, but at the Fed and other central banks that did follow IMF analyses closely, the message was welcome. Nixon, however, was not ready for such a radical step, having declared, "I will not take this Nation down the road of price and wage controls, however politically expedient that may seem."[183]

Benign neglect

With money printing by the Fed continuing at a fast clip and the stimulus budget adding to spending, foreign holders of dollars were starting to run scared. They viewed American policies as irresponsible and inflationary and feared that the dollar might be devalued. What truly bothered them was the huge outflow of dollars, especially to Europe and Japan, but also to places such as Brazil. Despite the evident dollar glut, the United States made clear that it was following a policy of "benign neglect," in other words basically ignoring its huge balance of payments deficit and the weak dollar. The policy of benign neglect was initially intended as a sop to countries who held and were absorbing large amounts of dollars in their reserves. Adding "benign" to "neglect" was meant to indicate that the United States cared about the international monetary system but was not in a position to do anything about its balance of payments gap. But the Europeans and Japanese interpreted it as meaning that the Americans wanted *them* to take measures that would close the gap. To some extent, the United States had a point: If the dollar was devalued, treasury officials argued, all other countries would follow, the only result being a higher dollar price of gold. The real worry of the United States' creditors was different: If the Americans did nothing to reduce their balance of payments deficit, they would continue to be flooded with dollars they did not want.

Hendrik Houthakker, a Harvard professor and member of the president's Council of Economic Advisors, "credited" a fellow Harvard professor as the first to suggest the "benign neglect" approach: "This policy, first formulated by a pre-election task force under the chairmanship of Professor Gottfried Haberler . . . was aimed at forcing a depreciation of our overvalued currency. [In 1968] there was no possibility of devaluing the dollar unilaterally, since several countries had made it clear they would devalue by an equal amount, thus nullifying our move. These countries therefore had to be persuaded by a continuing accumulation of inconvertible dollar balances."[184]

This doctrine appealed to many White House appointees, but not to Volcker, who clearly saw the danger of ignoring the tsunami of dollars in the rest of the world and its possible consequences for the Bretton Woods system. But to the likes of Connally and others in Nixon's inner circle, it was payback time: The United States had in their view been treated unfairly by its main trading partners, who were hurting American exports through their tariffs and administrative obstacles. The steel and textile industries were struggling and were lobbying strongly for protection. Moreover, there was a strong sentiment that U.S. allies were not contributing enough to the military defense of the free world. A large number of American troops were stationed in western Europe, especially in Germany, at considerable expense to U.S. taxpayers, and Washington signaled that now that Europe was booming, a different sharing of the burden was called for. The European Common Market's agricultural policy of price support to farmers and Japan's extremely protected agricultural sector—domestic rice prices were several times that of the price on world markets—also led to complaints from the American farm bloc. But there were also legitimate complaints from the European and Japanese side, including high U.S. tariffs on automobiles and electronics and what were considered unfair trading practices, including for chemicals (the so-called American selling price).

After studying the issue, Houthakker—the same person who defined "benign neglect"—explained to Congress that these protectionist measures came close to canceling each other out. On the military issue, Germany yielded to the pressure, agreeing to pay a larger share of the cost of the American presence within its borders. But Japan, whose exports had grown spectacularly, only eased some of its obstacles to foreign imports, provoking threats of a trade war by Washington. Nixon, a free trader by instinct, supported Connally's aggressive stance, acknowledging that power flowed from trade policy. The United States was not going to be pushed around any longer. And because the surplus countries did not want to budge by meeting the Nixon administration's demands on trade restrictions, the word was out that the foreigners were out to "get" America. When Johannes Witteveen, the Dutch minister of finance—a few years later chosen as managing director of the IMF—argued in the G-10 that burden sharing should be based on spending on both defense and foreign aid—where the European effort was bigger than that of Washington—the suggestion was shrugged off.[185]

Getting physical

The Nixon team was getting ready to play physical American football against the Europeans' less aggressive soccer as 1971 proceeded. The overwhelming feeling in Washington was that the Europeans were intentionally hurting Americans by not sharing the burden more equally and, on top of that, irritatingly complaining about the United States balance of payments deficit; the benign neglect doctrine developed by brilliant Harvard minds was the right medicine for the whiners across the ocean. The result was not only a tougher American stance in negotiations—for which John Connally was ideally suited—but also a loss of any interest in safeguarding the dollar. Originally the notion of benign neglect rested on the assumptions that the dollar was overvalued, but this was not yet generally the case in 1968 when Haberler submitted his report. Most of the European currencies were not undervalued, except the Deutsche mark, which was revalued in 1969.

The Japanese yen was another story, but before 1971 the United States had never pressured Tokyo to revalue—as it had Germany—which was a missed opportunity. Had Japan at the time bowed to strong American insistence on revaluation, it is likely that the cabinet in Tokyo would have yielded to avoid an open confrontation with its powerful ally, especially if John Connally, known as the "Typhoon," were to deliver the message. And with an upward adjustment of these strong currencies, the sting would have been taken out of the pressure on the dollar. Another assumption was that a dollar devaluation had to be across the board rather than only against a select number of currencies. This position "led directly to the conclusion that the United States had to use the shock tactics of renouncing its Bretton Woods commitments, suspending convertibility of the dollar, and confronting [its] trading partners with a choice between world monetary disorder or yielding under duress to . . . demands for a general revaluation of foreign currencies."[186] And benign neglect created "an open invitation to exchange traders to speculate against the dollar . . ."[187] causing "the dollar exchange markets . . . to resemble a sort of disorderly casino with the odds rigged in favor of the gamblers instead of the house."[188] But the champions of free floating exchange rates, such as Milton Friedman, believed that benign neglect would solve the currency problem all by itself through the magic of the price mechanism. Not so Paul Volcker, who from his perch in the Treasury overlooking busy Pennsylvania Avenue rejected it, believing that "benign neglect would work about as well eliminating the dollar problem as it did in solving racial discrimination."[189]

In Frankfurt, Tokyo, Paris, London, Rome, Amsterdam, Zurich, and other financial centers across the world, worry and unhappiness increased markedly as 1970 passed into 1971. Policymakers in otherwise tranquil European capitals were aghast at what was happening to the global system. It did not take a genius to see where benign neglect was leading. The mere mention of this notion would make European officials nervous and indignant, although they were more circumspect in what they said or wrote publicly. Still the message was clear, as conveyed in early 1971 by the head of the Dutch central bank, Jelle Zijlstra: "The American balance of payments deficit appears to have become so ingrained that a turnaround cannot be expected. This is clearly illustrated by the principal change in American policy in 1970, which despite the balance of payments gap changed from being restrictive to being expansionary purely because of domestic considerations."[190]

Although he refrained from making recommendations for reforming the international monetary system, Zijlstra—who was influential in the world of central bankers and beyond—had hinted earlier that a dollar devaluation and thus a rise in the price of gold would solve the convertibility problem. But this was not a sentiment that was widely shared, although the French and Swiss governments, as well as major gold-producing countries, would have welcomed such an outcome. Japan's position was ambivalent. It had almost no gold at the end of World War II and was eager to obtain more, because it believed that there was a strong connection between the size of a country's gold holdings and its influence in international monetary discussions. Tokyo tried unsuccessfully to buy gold from the IMF but obtained some from the Soviet Union. By 1970, its gold reserves were just a little over $500 million, a pittance compared to those of other rich countries. Converting its rapidly increasing dollar hoard into gold was not an option, anyway, as the mighty United States would more than frown upon such behavior. And because a higher gold price was no longer a viable proposition and the United States adamantly opposed it, any furtive Japanese desires to restore the role of gold would remain just that.

No monetary magic

During the first months of 1971, the new treasury secretary focused mainly on trade, whereas the CEA concentrated on the money angle, recognizing that a devaluation of the dollar would boost U.S. exports and lower imports. But "Connally dismissed currency realignment as so much monetary magic."[191] In its mood of indifference, "the American administration lacked a clear direction" of how to deal with the crumbling of the Bretton Woods system. Views within the government differed as capital flowed out of the United States at an accelerating pace, partly because of the difference in (low) interest rates in the United States and (high) interest rates in Germany, but also based on fears that the United States was not willing to actively defend the dollar. Volcker's voice was the moderating force within the administration and ran parallel to that of the Federal Reserve. The treasury undersecretary felt obliged to try to calm the markets as money was pouring into Germany and Japan. At a background briefing in early April 1971, Volcker told journalists not to expect changes in currency parities. But as the German central bank took in as much as $3 billion in April alone, it became clear that something had to give.

Germany was balking at all the money that was flooding it and fueling inflation. But because it was obliged to buy dollars to maintain the parity with the mark, the Bundesbank had no way to achieve its goal of keeping inflation under control. And capital controls such as the *Bardepot*, which prohibited German banks from paying interest on foreign deposits, had not been a success. Europeans were now very worried and held an emergency meeting in Hamburg on April 26. German Finance Minister Karl Schiller said that he was prepared to make a move on the exchange rate, but would prefer the European Common Market countries to float together or revalue collectively against the dollar. Giscard d'Estaing, speaking for France, favored a devaluation of the dollar, purely for prestige reasons as a common European revaluation would more or less have the same economic effect. As often happened, the Europeans could not agree among themselves, adopting a "wait and see" position.

Dark horizon

A major storm was brewing on the world's currency markets as Germany, other European countries, and Japan were swamped with foreign capital, triggering a contentious debate among German policymakers and politicians, pitting the Bundesbank, itself internally divided, against the government. Because it was the IMF's business to watch over exchange rates, its head, Pierre-Paul Schweitzer, visited Frankfurt—the seat of the German central bank—at the end of April 1971 to discuss with Germany's top economic brass what action was needed to calm the markets after a cut of the discount rate had not stemmed the dollar deluge. A meeting was arranged in the Bundesbank's drab building, which from the outside resembled an apartment building from the 1960s. The central bank was represented by its president, Karl Klasen, who was adamantly opposed to letting the mark float and who favored applying capital controls to keep out unwanted dollars, and his more pragmatic deputy Otmar Emminger, who leaned toward floating, as did a few other leading central bankers.

The dominant figure at the meeting was the feisty Karl Schiller, Germany's minister of finance, who had chaired the chaotic meeting in Bonn in 1968, and was an exponent of letting the mark out of its cage. On one side, the autocratic Klasen vigorously condemned floating rates, supported by Schweitzer, who feared for the IMF's future relevance if floating currencies were to become the norm. On the other side was the other Karl, like Klasen a Social Democrat, but a supporter of free markets, strongly recommending letting the German mark find its own way on the markets, where it would no doubt rise against other currencies. Schiller was supported by Emminger, no doubt to the chagrin of the central bank president. And as the government in Germany, as in practically all other countries, is ultimately responsible for the exchange rate, Schiller's position prevailed. But before that point was reached, things got worse before getting better.

8. Floating rudderless

A new chapter in the currency drama was heralded on May 3, 1971, by a recommendation from German economic research institutes to let the mark float, apparently with the blessing of Minister Schiller. The very next day saw a massive sell-off of dollars, forcing the harried Bundesbank staff to buy in excess of $1 billion greenbacks for the sake of keeping the mark/dollar peg intact. A new record for intervention in one day had been set. This event prompted Secretary Connally on the same day to release his first press statement, emphasizing that the U.S. government's position remained: No change in currency parities was necessary or anticipated. But this pep talk convinced nobody, and when the Frankfurt foreign exchange market opened on May 5, it took only 40 minutes of chaotic trading before the Bundesbank took in another $1 billion, swelling its reserves by an unprecedented $5 billion in a matter of weeks. Never before had the world witnessed a flight out of a key currency of such dimensions. It was clearly time to call it quits, and the German currency market was promptly closed. The mark was now floating as the central bank was no longer buying dollars. The German float was soon followed by Germany's closest smaller trading partners, the Netherlands, Belgium, Austria, and Switzerland, the last three returning soon to fixed rates by revaluing or stepping up capital controls. France and Italy begged off, as they did not consider their economies strong enough to float upward with the mark. At the U.S. Treasury and the Federal Reserve, the German decision was met with consternation, and Volcker mentions how in those anxious days he was visiting the men's room "with alarming frequency."[192] But Volcker also realized that the crisis provided an opportunity for the United States to step up the pressure on its trading partners to revalue their currencies.

The decision to allow the mark to float had not been taken lightly. As the dollar flood swamped the German economy, Minister Schiller attended an emergency meeting of the Bundesbank Council, comprised of its top management. Normally the German minister of finance did not attend council meetings, though he had the right to do so. But this time the excitable Schiller was very much present. Bundesbank president Klasen immediately repeated his opposition to abandoning the fixed rate between the mark and the dollar and thereby breaking the rules of the Bretton Woods system. Instead, he insisted that widespread capital controls be introduced to stem the inflow of unwanted dollars. A keen observer of markets, his deputy, the more pragmatic Otmar Emminger, leaned strongly toward floating. More important, Schiller pushed hard for cutting loose the mark from the dollar. But he was warned that by breaking the rules of the IMF statutes, which did not allow floating, Germany could be chastised by the international community. On cue the IMF caustically remarked that the German decision was "the easiest answer" by a "weak coalition government."[193] The alternative to floating would have been foreign exchange controls, but they could have insidious side effects like corruption and circumvention, or an excess of zeal by those officials who had worked on Germany's elaborate controls before World War II. In desperation, the European policymakers met again in Brussels on May 8 and 9, 1971, to discuss a coordinated float of their currencies against the dollar, but once again agreement was elusive.

Breaking the rules

Although the German and Dutch decision to float was presented as a temporary one, European countries were uncomfortable with the breach of the existing monetary rules. They had always kept in mind that in response to the monetary chaos and protectionism of the 1930s had led to the design of a system of fixed rates that could only be adjusted when the IMF gave its blessing after a finding of "fundamental disequilibrium"—in other words, that a currency rate was clearly over- or undervalued. In other instances of payments problems, the IMF was there to provide credits to tide over countries in difficult circumstances, but only if they met certain policy conditions. And the Europeans were fully committed to the central principle of the system that one's own currency held by foreign central banks was always convertible on demand. This meant that the Bretton Woods system would only work well when all countries were prepared to follow "disciplined" economic policies. In the eyes of the Europeans, if this discipline—forcing deficit countries, meaning the United States, to adjust their domestic policies in order to return to balance—was lacking, the system would implode.

Some Europeans considered the German–Dutch move an opportunity for European Common Market countries to float collectively against the dollar. German Finance Minister Schiller pushed hard for a common float at another meeting of European Ministers in Brussels, chaired by Giscard d'Estaing. During a marathon discussion lasting an astonishing 21 hours, Schiller could not get his way as the French stuck to their traditional position of maintaining fixed rates. Privately, Giscard said that he could agree to a substantial revaluation of the German mark, as he considered the best protection to keep the French franc competitive. When Giscard asked his German colleague why he did not want to revalue, the answer was that the German economic outlook was uncertain and that he [Schiller] wanted to be locked in at some fixed rate. Several such European clashes would follow for another 2 years. But the sting was taken out of the conflict as the crisis abated after the mark was cut loose. And contrary to widely held expectations of a huge jump in its value the mark appreciated by only 4% in May. But the modest currency movements turned out to be only a respite, with mayhem on the world's currency markets recurring in July 1971.

Volcker plans ahead

Meanwhile, Paul Volcker had been making headway in his crusade to save the Bretton Woods system to which he felt committed, contrary to some of Nixon's closest advisors, such as George Shulz, who long pushed to let the dollar float. Already in the early days of the Nixon administration—June 1969—Volcker had laid out various options to deal with pressure on the dollar, which he linked to the United States' high inflation and inability to compete in world markets for such goods as steel and textiles. As Volcker presented his findings to Nixon, who was more interested in other issues, "he saw the president's eyes flit away."[194] The monetary point man then went directly to his main conclusion that the German mark should be revalued substantially. In addition, he advocated a first round of creation of special drawing rights (SDRs), an instrument of which Nixon was suspicious but that would increase U.S. reserves by a few billion dollars. And currencies should be allowed to move against each other by more than the very narrow statutory margin of 0.75%. His recommendations were not revolutionary but evolutionary, Volcker explained. But then he unleashed a "bombshell" by opining that if forced by events, America could suspend the convertibility of the dollar: "[T]he major objective and potential advantage of suspension . . . would be to strengthen [our] negotiation position . . . by eliminating . . . a run on our gold stock . . . and forcing countries . . . [to] hold dollars or permit a gradual appreciation of their currencies."[195] Although Volcker had linked monetary measures to foreign policy, the subject the president cared for most, Nixon did not seem overly interested—but Arthur Burns, a firm supporter of the Bretton Woods system, pricked up his ears.

In the early spring of 1971, "Tall Paul," as he was often called, monitoring international events very closely, became more and more worried about the likelihood of a breakdown in global monetary relations. And after Connally took over as treasury secretary and was soon designated by Nixon the administration's mouthpiece on economics, Volcker's ideas got more traction. He advocated large revaluations for the West German mark and the Japanese yen; to "encourage" them to take this bitter medicine, the gold window would be temporarily closed. To appease the surplus countries, who had complained of importing inflation from the United States, wages and prices would be temporarily frozen by Washington. And, capturing the attention of his new boss, Volcker warned about the danger of heavy speculation against the dollar. The upshot was that the monetary point man's aggressive game plan would become central to U.S. policy in the near future.

Take that

By Connally's calculation, the time was not yet ripe for following the Volcker playbook. Moreover, the secretary was preoccupied during his first months in office with getting tough with America's trading partners. Still, he could not ignore what was going on in currency markets after Germany's drastic decision to float in early May. The first occasion for the U.S. secretary of the treasury to lay out the Nixon administration's thinking before a mainly foreign audience came on May 28 at a large international conference of bankers also attended by central bankers and treasury officials. As he was leaving Washington on a typically pleasant spring day for chillier Munich, where the two-day conference took place, Connally was busily preparing for this first test on the international arena. His forcefully, but "a few decibels too loud,"[196] delivered speech had a strong impact. Some thought it "telling it as it is" and "forthright," but others, especially Europeans and Japanese, judged it to be "tough" and "unconciliatory."[197]

Connally started by reciting the history of the United States in international monetary cooperation since Bretton Woods. He argued that although the United States had been running chronic payments deficits, it had continued to be a big exporter of capital, had spent large amounts on American soldiers and bases abroad, had provided large sums of foreign aid, and had not been protectionist. But the time had come to spread the costs of defense in more equal fashion among allies. In addition, the treasury secretary demanded that trading agreements with Europe and Japan become more "equitable," requiring those countries to speeding up the opening of their markets. "No longer can considerations of friendship or need, or capacity, justify the United States carrying so heavy a share of common burdens."[198] U.S. deficits and the huge movements of short-term money were not "uniquely American"[199] problems, and "joint responsibility for their solution should be accepted."[200] Turning to currency matters, the Connally emphatically stated it was the "unalterable position" of the United States that it not devalue the dollar nor change the price of gold.

When Volcker saw that the speech that he had drafted had a very different ending from what he had written, he asked Connally if he really wanted to talk of an unalterable position, the surprising answer was: "That's my unalterable position today, I don't know what it will be this summer."[201] Treasury officials and central bankers were now on warning that a tough new kid had arrived on the block, even though he could be charming in private meetings. In his own words, Connally now was "the bully boy on the manicured playing fields of international finance."[202]

Pierre-Paul Schweitzer had already on an earlier occasion experienced Connally's tough side when the swaggering American had visited the IMF, a short walk away along Pennsylvania Avenue from the U.S. Treasury. In a "dramatic meeting,"[203] Schweitzer had stuck out his neck and told Connally that he believed that the dollar should be devalued, a view that he would audaciously repeat on American television later that year. This rubbed the secretary the wrong way, causing him to growl that the real issue was trade, not exchange rates, and that the IMF should push Japan to revalue. This would curb Japanese exports, of which textiles were a particular concern in the United States, even becoming an election issue. Finally, Connally also threatened much broader political measures, stating that dealing with its payments imbalance would require the United States to revise its mutual security arrangements, especially relating to Japan and Germany. Tough talk indeed.

Volcker, who lacked Connally's flamboyance, but who was generally judged—also abroad—as knowledgeable, consistent, and reliable, echoed some of his boss's sentiments about a fairer shake for the United States in trade and defense. At the same time, in testimony before Congress in July 1971, he stated that "the administration did not want to destroy the system of integrated capital markets, generally free convertibility, wide freedom of trade and payments, and reasonable exchange rates." Letting Volcker do the talking on international issues for a while, Connally now zeroed in on domestic policies. Capturing the headlines, the treasury secretary sternly presented American economic policy in Chinese fashion as the "four no's":[204] no wage and price controls, no wage and price review board, no tax cuts, no spending increases.

Japanese jitters

The German revaluation had diverted speculation away from Europe's economic powerhouse, but with the U.S. balance of payments deficit reaching a staggering $22 billion during the first 6 months of 1971, bloodthirsty currency dealers were looking for other opportunities to make quick profits. The Japanese yen became the next big target of hot money. Toyoo Gyohten, Japan's "Volcker"—his official title was vice-minister for international affairs of the Japanese ministry of finance—described how inward-looking Japan had been before it was getting overwhelmed by capital inflows and experiencing American threats of trade restrictions. The prudent Japanese had for too long believed that they were still economically vulnerable, an attitude that remained unchanged even when Japan's trade balance was showing large surpluses from 1970 on. Revaluation was not considered an option, as it would hurt exports, on which the Japanese economy had become more and more dependant. "When the United States and the Europeans began criticizing Japan's surplus and its undervalued yen, we . . . did not realize how serious the situation had become and believed we could still fend off our critics by taking domestic measures to boost our economy."[205] No Japanese foresaw the rude awakening awaiting them later in 1971, akin to a Pearl Harbor in reverse.

The writing on the wall

Connally's warnings had left a strong impression on the Europeans, who were still dazed by the floating of the German mark and the Dutch guilder. Perceptive European policymakers saw the U.S. secretary's speech as the writing on the wall. The European surplus countries and Japan faced a serious dilemma. With the probability of a dollar devaluation increasing daily, covering the risk by converting dollars into gold was tempting, but could hasten the demise of the monetary system. Germany, in any case, could not follow the conversion route, as it had pledged to stop demanding gold in 1967. And Japan, fearful of American retaliation, stayed away from the gold window, too, even though its dollar reserves increased by a staggering $9 billion in 1971. The position of the United Kingdom was more complicated. It had lost reserves during the 1960s and by 1970 they were down to a little over $3 billion of which only one-third was held in gold. But as the flight out of the dollar accelerated in the course of 1971 the Bank of England took in more than $5 billion. London was caught between accepting the risk of big losses on its dollars or threatening to undo the Bretton Woods system if it asked for protection by converting a large part of its dollars. In the end it chose a middle road by arranging a swap transaction with the New York Fed for $750 million.

The Fed operated a whole network of swaps with other central banks which provided temporary protection against devaluation. By selling dollars against pounds to the Fed at the prevailing rate and simultaneously buying the dollars back 3 or 6 months later at an agreed rate, the British central bank was able to eliminate the risk of a dollar devaluation for a short period. But rumors, relayed to Connally who was to use them to justify his later actions, had it that the British were asking for $3 billion in cover for their dollars. Charles Coombs, who was responsible for the Fed's foreign exchange operations, later called these allegations "a travesty of the facts,"[206] but the damage had been done.

Rocking the boat

France did ask for a modest amount of gold but refrained from reverting to the massive conversions of the Gaullist era. A few small European countries, foremost among them the Netherlands and Switzerland both large gold holders, also knocked on the gold window, believing that their actions were not large enough to affect markets. But Volcker thought differently and together with Governor Dewey Daane of the Fed Board paid a visit to Amsterdam on July 7, 1971, to discuss the matter with President Zijlstra of the central bank. Seated in the Netherlands

Bank's modern board room with pictures of Zijlstra's stern faced predecessors looking down on him, Volcker insisted that a Dutch request to convert $250 million in gold be withdrawn. But this the central bankers in Amsterdam, wedded to the Bretton Woods system that had served them—and others—well, were not prepared to do.

Zijlstra recounted in his memoirs that "[t]he fact that such a high-level delegation came to Amsterdam to ask me to refrain from conversion, was the most convincing proof for me that the storm was now really on us."[207] The Dutchman explained to his American guests that the Netherlands Bank's policy—influenced by its bad experience with the pound sterling in 1931—was to limit its dollar reserves to working balances, beyond which it asked for gold or equally safe assets such as SDRs or claims on the IMF. To this, Volcker answered, "You are rocking the boat."[208] But Zijlstra stubbornly told his American visitors, "[I]f that boat is rocking too heavily because of a request for converting $250 million, then the boat is already sinking."[209] He later declared with some satisfaction that the Dutch central bank's losses on its dollars were small up to August 15, in contrast to that of many other central banks. But eventually the Netherlands would suffer "enormous" losses on the dollars it acquired in later years. The gold and dollar story of Belgium is similar to that of the Netherlands, except that Brussels had somehow especially irked Connally, who in private talked "about what he intended to do to the masculine parts of the Belgian ambassador if His Excellency came in to demand gold for his Eurodollars."[210]

Impending doom

At this dangerous time, President Nixon was much more focused on foreign policy on which he—together with Henry Kissinger—was a recognized expert. On July 15, 1971, Nixon announced that he would be going to Red China (as the country was then called) in February of the next year. The news was sensational and the most shocking event for Japan since Hiroshima. The opening to China was a coup for Nixon and briefly diverted attention from the dire situation on currency markets, which had been in unprecedented turmoil for months, causing insomnia and nervous breakdowns among traders and investors. But soon the onslaught on the dollar continued, Japan receiving billions of dollars it did not want. And Giscard d'Estaing, worried about France's position in a possible realignment of currencies, issued denials that the franc would be revalued. By late July and early August the exchange markets were in total disarray as the continuing floating of their currencies suggested that the German and Dutch governments had abandoned the dollar as the pivot of the world monetary system. At the same time the gold price on the free market rose to $42 per ounce—$7 above the official value—both a reflection of a flight out of the dollar and a symptom of impending doom.

The New York Fed's foreign exchange guru, Coombs, worried sick, traveled to a hot and humid Washington on August 6, 1971, to warn monetary officials that that the situation could turn into a panic and that drastic action was urgently needed. As he arrived at the Treasury, he was called on the phone by his staff at the New York Fed, informing him that the Bank of England had just put in a request to convert $3 billion into "gold." Coombs was "absolutely crestfallen." This clearly spelled the end of the Bretton Woods system. Volcker observes that "[t] he message to Coombs apparently had gotten a bit garbled; I was later told [presumably by Coombs] that the request was for some combination of "cover" to guarantee the value of their [the British] dollars but not necessarily for gold."[211] But alarm bells were now ringing loudly at the U.S. Treasury, where the confusing messages were met with some consternation.

9. Closing the window

Secretary Connally, who at first opposed closing the gold window, after hearing of the British request to cover its dollars, was now convinced that the gold in Fort Knox should no longer be accessible to foreigners. He also changed his position on the dollar: Devaluation backed with trade measures would be the best option. Fred Bergsten, who was an assistant to Henry Kissinger working on international monetary affairs at the time, states that the treasury secretary had been swayed to opt for a dollar devaluation by an analysis of Edward Bernstein, a former chief economist of the IMF, who had become a treasury consultant: "This analysis convinced Connally that the devaluation was good politically. Connally always looked at the politics of the economics." Nixon endorsed the plan on August 2 after Connally "sold it as a package that would help the domestic economy and place Nixon in a strong political position."[212] The ever forward-looking Volcker had already prepared for its technical implementation, having directed William Dale, the U.S. executive director at the IMF, and its future deputy managing director (second in command), to plan for ending the conversion of dollars into gold. But there was opposition from Arthur Burns, who, from the non-political perspective of a central banker, did not support the move toward floating exchange rates touted by George Shultz and Milton

Friedman. Since total secrecy had to be maintained, the president gave instructions that the talkative Friedman should not be informed about any of the administrations" intentions. Strict confidentiality had to be maintained until $ day.

A mountain of greenbacks

The plan was to close the gold window on September 8, 1971, but poor trade numbers and negative press reports—one headline read "Monetary Troubles Erupt Anew, Prompt Talk of Devaluation"[213]—unleashed further speculative forces. And news about gold purchases from the United States by the Netherlands and Switzerland, as well as rumors of a request by France to do the same, added more fuel to the fire. But there was no French demand for gold, and the total loss of U.S. gold was limited to $840 million from January to mid-August 1971. Clearly Giscard d'Estaing wanted to avoid having France blamed if—when—the system collapsed. But what was truly alarming was that central banks had absorbed a mountain—$21 billion—of greenbacks in the course of 1971. During the second week of August, dollar dumping reached its apogee, foreign official purchases of dollars tallying $3.7 billion amid chaotic scenes in dealing rooms across the world. And to protect the American stock of yellow metal, the New York Fed drew on its swap lines with other major central banks to—temporarily—obtain foreign currency to the tune of $3 billion. At this stage members of the U.S. Congress were becoming convinced that the dollar was overvalued, reflected in a report of the House Joint Economic Committee released on August 6. Its recommendation to initiate a general adjustment of currency values poured more oil on the fire. Volcker lamely responded that the committee's views did not reflect the general opinion of Congress.

The currency turmoil having clearly become untenable, Volcker concluded that United States and its trading partners were now "at the brink of a market panic that willy-nilly would force us off gold."[214] He called Connally, who was taking a brief vacation on his Texas ranch and apparently not fully aware of the impending meltdown, urging him to quickly return to Washington. Nixon, perhaps in the afterglow of his successful opening of relations with China, had not anticipated the swiftly deteriorating monetary situation and had planned to have a secret strategy meeting at Camp David only by September 7. As Connally hastened to the White House on August 12, Nixon was not in a mood to be rushed. He preferred to wait with the announcement of an import surcharge of 10% and wage and price controls, but had no qualms about closing the gold window forthwith. But appealing to the president's overly dramatic side, the politically savvy Texan argued in favor of seizing the initiative and presenting the package as a whole and once again succeeding in convincing the president. Nixon then gave the order for a select group to travel to the presidential compound at Camp David on the afternoon of Friday August 13, 1971.

Conspiracy at Camp David

Camp David is a rustic retreat for presidents and their families where they can relax in complete privacy. Located some 60 miles north-northwest of Washington in the scenic Catoctin mountains near the small, sleepy town of Thurmond, Maryland, several lodges, cabins, a chapel, tennis courts, a swimming pool, a skeet range, a golf practice area, and a helicopter landing zone dot its spacious grounds. Presidents and high-level guests usually travel to Camp David by helicopter—a mere 30-minute flight from the White House lawn. President Roosevelt, at the advice of his doctors to have a nearby retreat to escape the heat and political pressure of Washington, selected the Catoctin site for this purpose in 1942 and called it Shangri-La. FDR started the practice of inviting foreign dignitaries to his summer retreat to conduct informal meetings away from the limelight of Washington, by hosting Winston Churchill at the Maryland estate during World War II. President Dwight Eisenhower renamed the retreat Camp David after his father and grandson (who later married Nixon's youngest daughter, Julie). Richard Nixon used the mountain getaway frequently, adding to and modernizing the facilities. Most large meetings take place in the Laurel lodge, a pleasant walk away from Aspen lodge where the president stays.

On the afternoon of Friday, August 13, the president and a small entourage headed for Camp David in total secrecy and far away from the intrusive media. The party included John Connally, Arthur Burns, George Shultz, Paul McCracken, Herbert Stein (who would soon take over from McCracken as chairman of the CEA), Paul Volcker, Peter Peterson (brought into the White House as an advisor in early 1971 by Shultz, but not a Nixon favorite) and Casper Weinberger (director of the Office of Management and Budget). Haldeman and Erlichman were also invited as was William Safire, the president's speechwriter. Nobody from the State Department came along, as Nixon wanted complete secrecy and therefore did not want "foreign affairs types" around. On this occasion, the meeting took place in the Aspen lodge, overlooking a putting green and sand traps. There was excitement in the air as the men filed into the lodge. Although he sensed the momentousness of the occasion, William Safire was mystified as to what it was all about even after Herbert

Stein told him that the gold window might be closed. This after all was a concept known only in the financial and, to some extent, the political world, where it was now the focus of great apprehension. European policymakers had for quite some time worried about the threat of the window's being shut. But as is the custom on the Continent, most officials were taking their August vacation, a time when in most years little happens in the financial markets, and they were not focused on monetary issues when the Camp David strategy session took place. And the Japanese, who do not take much vacation, had not concentrated on the gold issue, because they owned little of the yellow metal, having refrained from "rocking the boat" by converting much of their dollar pile.

The president opened what would be an almost 4-hour meeting with a dramatic flourish, stating that the gathering would be discussing "the most significant economic policy action since the World War II." John Connally, fully in charge, followed with an overview of the American economy and international monetary issues, focusing in strong language on what action was needed to solve the United States' economic woes. Against a background of low economic growth, troublesome inflation, a huge balance of payments deficit, and a continuing dollar crisis, the United States needed to move. What was needed was a multipronged attack: a wage and price freeze intended to slow down inflation, a 10% import tariff surcharge to lower the trade deficit, and, as the *coup de grace*, the locking of the gold window. Connally then appealed to Nixon's vanity, arguing that such bold action would cast the president as showing "great statesmanship and great courage." In typical fashion, the canny Texan was displaying extraordinary flexibility, contradicting most of his own "four no's," formulated only weeks earlier. Connally had insisted that there was to be no incomes policy (now it was embraced), no tax cuts for business and individuals (now it was part of the package), and no closing of the gold window (now it was presented as absolutely necessary). And because Nixon had espoused all of these no's, he would be open to the charge of flip-flopping. But the shrewd politician that Connally was calculated that the wage-price freeze would be popular with most of the American public, as would the import tax; and the public did not care what happened to the gold window.

Burns balks

All those present got an opportunity to speak up, and Arthur Burns, the most senior among the participants, immediately challenged the wisdom of suspending the conversion of the dollar into gold. He carried with him an apocalyptic briefing paper by Charles Coombs of the New

York Fed, warning of "massive destruction of international liquidity"[215] and of pulling out "the cornerstone of the IMF and paralyzing that institution"[216] if the gold window was shut. Impressed by Coombs's dire prose, Burns eloquently painted a stark picture of the damage terminating the conversion of dollars would cause. Other countries were likely to retaliate, a vicious reaction could be expected from the media, and the Russians would hail the measure as ringing in the end of capitalism. It would also end the "mystique" of gold, cherished by many central bankers. Moreover, the system could deteriorate into widespread floating of exchange rates, hurting international trade. Better, therefore, to wait with shutting the gold window. If the other strong measures of the package which on their own would "electrify" the world did not do the job, the window could at that point still be closed, Burns argued.

Volcker almost apologetically relayed the centerpiece of his plan that Connally and Nixon had agreed to earlier that month: "I hate to do this, but I think it is needed [suspending convertibility]. . . . But let's not just close the gold window and sit. We need to negotiate a new set of exchange rate rates. This is an opportunity to repair a system that needs fixing."[217] And Connally who had already—mistakenly, as it turned out later—underlined the urgency of the situation by mentioning that the British had the very same day asked to cover $3 billion, reacted to Burns: "So the other countries don't like it, so what?"[218] And as if this was not enough to convince those who were doubtful, he added an agricultural and a biblical metaphor: "Our assets are going out by the bushel basket.

Secret meeting at Camp David, August 15, 1971: Arthur Burns, John Connally, President Nixon, George Shultz, and Paul McCracken. (White House photo.)

You are in the hands of the money changers." But Burns pushed back, warning that quitting the gold standard could politically damage Nixon.

Burns backs off

The rest of the meeting was mostly spent on a discussion of the border tax, Connally vigorously defending it as a way to get America's trading partners moving. Volcker felt uncomfortable with such an aggressive move and suggested holding the 10% surcharge in reserve. Nixon was dismissive: "The border tax is not too damned aggressive, just aggressive enough."[219] As the meeting came to a close, a decision on gold had not yet been taken. Nixon had been worried about Burns's semi-apocalyptic warning of a trade war with Europe and Japan. But when the Fed chairman had a private chat with the president afterward, Burns surrendered, pledging his support irrespective of Nixon's decision. This was music to the ears of the "ultimate decider." But he remained in doubt about whether he was following the right path on gold, only coming to a final conclusion in the afternoon of the next day: There would be no more conversion of dollars into gold.

Meeting with the participants in his cabin to nail down the final details, a by now confident Nixon was sitting by a lighted fire in a dark room, despite it being hot outside, a habit that his closest advisors had become used to. Haldeman noted that the president was "in one of his sort of mystic moods."[220] Nixon then proceeded to savage a draft speech prepared by Volcker that the "leader of the free world" would give the next evening, turning it—with the help of his speechwriter—from a somewhat apologetic narrative into a cheerleading, nationalistic one. And the president had explicitly instructed Safire to refrain from using "the gobbly gook about crisis of international monetary affairs."[221] Volcker took it all in stride, marveling at Nixon's skill in transforming a vulnerable situation into an upbeat new and bold initiative.

Nixon and Connally were fully satisfied with the Camp David outcome, after "Connally's tongue and Volcker's expertise won Nixon."[222] The president remarked with an American football metaphor that his treasury secretary had been the quarterback and that he had been more of a coach. They had turned around Burns on the gold issue, and the feisty president told his advisors in typical exaggerated fashion that Burns was getting so much out of the program—referring to incomes policy—that "he can't run to the Hill and piss on it."[223] Displaying loyalty, Burns refrained from criticizing Nixon's decision on gold during the rest of his tenure at the Fed. But although he was satisfied with the president's decision on gold, Volcker was disappointed on two counts with the outcome of the meeting: There had been no explicit support for his plea for also mentioning the need for the long-term reform of the monetary system. He also did not like Nixon's failure to emphasize in his public statements that the price of gold would not be changed. It was also far from ideal that the Trading with the Enemy Act of 1917 had to be invoked to justify the import surcharge, a ploy the Japanese in particular would find painful. But "the President apparently felt more strongly [about his campaign pledge to get tough with the United States' trading partners] than gold."[224]

A masterly performance

After stepping out of the whirring helicopter on the south lawn of the White House on Sunday afternoon, Nixon entered the Oval office to make his final preparations for the bombshell televised speech that he would deliver at 9 P.M. that day. The American leader enjoyed a long experience in addressing the public via television, starting in 1952 with his famous Checkers speech, which saved his vice-presidency by a skillful mix of *mea culpa* and sentimentality. But he was best remembered for his 1960 debate with John F. Kennedy, the first televised presidential debate in history. Nixon was much more experienced than his charismatic young opponent and seemed to have scored the most points, but his scowling, sweaty face hurt him, contributing to his loss at the polls. In later debates, Nixon not only demonstrated his superior knowledge of foreign affairs but had also learned to suppress his chronic discomfort during large gatherings and press conferences, from which he reputedly needed more than a day to recover. Now a more confident Nixon was ready to not only appear statesmanlike and bold to his countrymen, but also to shock the pesky foreigners in to playing by his rules. The announcement of the president's televised speech required reprogramming of popular Sunday evening shows, usually not appreciated by the public, but could not be avoided: The radical message had to get out before the markets opened on Monday.

Nixon delivered what most commentators judged to be a masterly performance. His rhetoric was all about politics but was skillfully blended with what sounded to most Americans as sensible economics, playing to their nationalistic feelings. The time had come, the president announced, for a new economic policy for the United States. After unveiling some tax measures, such as lifting the excise tax on automobile purchases and an acceleration of increased income tax exemptions coupled with some spending cuts, he turned to incomes policy. Inflation was, Nixon dramatically explained, "one of the cruelest legacies of the false prosperity"[225] resulting from the Vietnam War, and prices and wages therefore needed to be frozen. The freeze would last for 90 days, after which a special council would advise the president on how to proceed next.

Nixon now turned to gold, but instead of issuing some kind of apology, he announced that the gold window would be closed "temporarily," snatching victory from the jaws of defeat by blaming the "international money speculators" of "waging an all-out war on the American dollar."[226] To re-enforce the point, he added that "[t]his action will not win us any friends among the international money traders. But our primary concern is with the American workers and with fair competition around the world." In a more reassuring tone toward "our friends abroad," the American leader pledged that the United States would remain a "forward-looking and trustworthy trading partner"[227] and would cooperate with the IMF to work out reforms to build a new international monetary system. But Nixon then reverted to his aggressive style, announcing a 10% surcharge on import tariffs. This time the blame was shifted from international speculators to the "unfair exchange rates" maintained by America's trading partners, labeling it a major cause of the United States' weak trade balance. After the "unfair treatment . . . ended,"[228] he said, the surcharge would be lifted. Nixon's next complaint was that Europe and Japan were not pulling their weight in sharing the cost of common defense. It was also time to establish fair exchange rates, and for the major countries "to compete as equals." The United States would no longer accept the requirement "to compete with one hand tied behind her back."[229] And his new economic program, Nixon said, would "help us snap out of self-doubt, the self-disparagement that saps our energy and erodes our confidence and accept the challenges to stay number one in the world's economy."[230]

U.S. happy, Europe sad

In the United States, the speech was a roaring success. It cleverly exploited nationalistic sentiment among the general public that the United States was not getting a fair shake and that foreigners were acting ungratefully after all that America had done for them. Polls showed that 75% of Americans were in favor of Nixon's new economic measures. "In all the years I have been doing this business, I've never seen anything this unanimous, unless it was Pearl Harbor,"[231] commented the White House poll-taker. Few people seemed to care that their president had drastically moved away from his earlier stated positions. The price and wage freeze was popular with the large mass of consumers who were tired of inflation. But there was a need to pacify the labor unions, which were unhappy about the wage freeze, prompting the administration to massage them with alacrity.

Apart from criticism from the Democratic Party, there was loud opposition from within the Republican camp coming from the ever-vociferous Milton Friedman. An attempt by George Shultz to calm down the radical defender of free markets did not work. The feisty Chicago professor characteristically lashed out in public against price and wage controls, saying that imposing a freeze "will end as all previous attempts to freeze prices and wages have ended, from the time of the Roman Emperor Diocletian to the present, in utter failure and the emergence into the open of the suppressed inflation."[232] As it turned out, Friedman's dire warning was accurate, as inflation shot back after the freeze was lifted, but that was of no great concern to Nixon, who merely paid lip service to fighting inflation in the run-up to the 1972 election.

Salesman Connally

The day after Nixon's speech, which had already had rattled the rest of the world, Connally, with great panache, gave a press conference on the New Economic Policy, or NEP. Later the administration was—to its embarrassment—made aware that in the 1920s Lenin had dubbed his reform program NEP. But Connally probably would not have cared much about the irony. Explaining the new route taken, the secretary—ever the consummate politician—focused on the domestic side. And since he "understood that the upcoming presidential election, less than fifteen months away . . . began at the supermarket counter,"[233] he promised that the new approach would "fill the shopping cart." Jobs would be created, unemployment reduced, and inflation brought under control, all by the wonderful new programs that the administration had designed. Asked about the sudden new direction of economic policy, Connally confidently claimed: "There's nothing, as the wise saying goes, there's nothing constant except change."[234] And: "The American people would think they would have a dope for a President if they had one that they thought would take a position and never change it."[235]

Closing the gold window as well as the import surcharge seemed to bother few Americans except tourists in Europe, who found it hard to exchange their dollars, and the liberal Democratic Senator from South Dakota, George McGovern, who criticized these measures immediately after Nixon's speech. McGovern, who had declared himself a candidate for president in the following year's election, commented, "It is a disgrace for a great nation like ours to end in this way the convertibility of the dollar."[236] And former influential secretary of state Eugene Rostow even spoke of "a retreat to autocratic rule, a violent action, and shock therapy."[237] Connally's response was one of typical bravado, saying he did not want to predict what was going to happen in the foreign exchange markets, but that "there is no question we shook them up."[238] A sense of triumph prevailed as Nixon briefed his cabinet on the eventful weekend. Not only had the stock market reacted with an increase in the Dow Jones industrial stock index by 32 points, a record for a single day, polls also showed overwhelming support for the president's policies. On top of that, Arthur Burns remarked to the assembled cabinet that Nixon had "electrified the nation"[239] and had delivered a tremendous boost of confidence in business and financial circles.

Nixon shock

The reaction in the rest of the world to Nixon's announcements could not have been more different. In Japan both policymakers and the public were completely taken by surprise and deeply disturbed. The "Nixon shock" hit at 10 A.M. on August 16 in Tokyo, where the financial markets were already open. The impact of the New Economic Policy resembled that of an earthquake. A dollar sell-off started, immediately triggering a discussion whether to close the market or not. It was decided to keep the market open and resist appreciation of the yen, with the Bank of Japan continuing to buy dollars at the outer limit of the narrow yen/dollar band. Toyoo Gyohten, later to become deputy minister of finance of Japan, explained that there had been "a serious misjudgment on the part of the Japanese about the real intentions of the U.S. Treasury and the U.S. government as a whole."[240] The—then still—naive Japanese had all along believed the repeated pledges that the dollar would not be devalued and now thought that the Americans only intended to get rid of the gold sales and would aim at stabilizing the dollar as soon as possible.

In Tokyo's thinking, massive purchases of dollars to maintain the yen's peg with the dollar were "an act of cooperation." But private Japanese banks had fewer scruples about exchange rates and saw a one-way bet in the central bank's defense of the dollar, leading them to borrow dollars abroad and selling them in Tokyo for yen at a profit. To the dismay of diligent Japanese officials, exchange controls that were supposedly watertight turned out to be quite porous. And within 2 weeks the Bank of Japan took in $4 billion, increasing its reserves by some 50%. Finally, on August 28, Japan, which had always resisted revaluation or floating, threw in the towel and allowed the yen to appreciate gradually against the dollar.

The other part of the Nixon shock was the American import surcharge of 10%. Japan's exports had surged in recent years, especially to the United States, invoking the ire of Detroit carmakers, steel companies in Ohio and Pennsylvania, and textile manufacturers in North Carolina. Again, the Japanese had underestimated the resentment triggered by the explosion of Japan's exports, which was hurting industries in the United States as well as in Europe. And as the announced hefty increase in the American border tax was expected to affect one-third of Japanese exports—considerably more than for European countries—the mood in Tokyo was very dark. But Gyohten later reckoned that "[t]he events of 1971 sent a very strong and enlightening message to Japan. They told us that the Japanese economy had become closely intertwined with the world and that the isolated economic management we had been pursuing was no longer possible."[241] But in August 1971, the Japanese cabinet was in shock and not contemplating sending a thank-you note to President Nixon. Still, Tokyo did not go as far as the European Common Market countries, which lodged a formal complaint about the import surcharge with GATT, the forerunner of the World Trade Organization. In the same vein, the hard-hit Latin American countries for whom the U.S. share in their exports was in some cases very large, condemned the American one-sided action in harsh terms and asked for an exemption. After all, they argued, the surcharge was meant to pressure industrial countries and not developing ones. But their pleas fell on deaf ears.

In European capitals, the Nixon package was met with alarm but did not come completely out of the blue. Although Connally's earlier warnings about unfair practices had made an impression, the severity of the combination of breaking loose from the existing monetary system—closing the gold window—and slapping a hefty surcharge on imports was unexpected. Abandoning the Bretton Woods rules, even if in a way announced as temporary, and taking protectionist measures contrary to agreements on international trade, appeared from Amsterdam to Zurich as a big step backward in international cooperation. Many European markets were closed on August 16 and remained shut for the rest of the week.

But what to do next? The choice was between letting the national currency float upward, as was already happening in Germany and the Netherlands, or buying up dollars to try to keep tracking the greenback, as Japan was doing. Connally and Volcker were aware that the international part of the NEP would not go over well in Europe and that personal diplomacy was needed to ease the tension. It fell to Paul Volcker to board a military transport aircraft as Sunday, August 15 passed on to Monday, to meet with European treasury and central bank officials.

A few hours earlier, he had invited IMF chief Pierre-Paul Schweitzer to the U.S. Treasury to inform him of the gist of what Nixon was going to say. Schweitzer was not amused to be summoned in this way to watch the American president's televised speech in Connally's room. And he was indignant that the IMF's largest member matter-of-factly broke the IMF rules as established at Bretton Woods. While Volcker was briefing the IMF head, Yusuke Kashiwagi from the Japanese ministry of finance called to complain that Japan had not been consulted about the American measures. This did not make much of an impression on Volcker, as none of the other G-10 members had been brought up to date and he was soon to cross the Atlantic on his diplomatic mission.

10. Monetary diplomacy

Volcker was very much aware that the United States' strong measures had created a dangerous situation, raising the possibility of monetary chaos and trade wars. He therefore needed to calm the waters in European capitals. Arriving in London on August 16, the day after Nixon dropped his bombshell, Volcker, accompanied by Dewey Daane of the Federal Reserve, went straight to the residence of the American ambassador to the United Kingdom, where in a refined setting he met with representatives from several countries. The European faces, familiar to the newfangled American monetary diplomat, included Otmar Emminger, deputy governor of the Deutsche Bundesbank; Jeremy Morse, the Bank of England's executive director for international affairs; Rinaldo Ossola, a senior official of the Banca d'Italia; and Claude Pierre-Brossolette, director of the French treasury. During the gathering, Volcker indicated that the United States could live with floating exchange rates as a means of reforming the Bretton Woods system. But this approach was not generally shared, Morse commenting that "it might be difficult to get back to a fixed parity system."[242] The meeting proceeded in a civilized manner, and Volcker sensed that the Europeans "did not feel anger as much as anguish that the United States had not arrived with a prepared solution to save the system."[243] Meeting with the press afterward, Volcker made clear the United States wanted to "return to a stable system as soon as possible," but that "long-term monetary reform will be a slow process."[244] And there was another message to be relayed: President Nixon wanted to further reduce the role of monetary gold. Devaluation of the dollar—which would raise the price of gold—was not an option, Volcker said to the assembled reporters, because it would reward speculators and gold hoarders, a veiled reference to French proclivities.

A stroke of the pen

Traveling on to Paris, Volcker and Daane visited Valéry Giscard d'Estaing, the smooth, diplomatic and highly influential French minister of finance, and reported to Washington that he seemed "relaxed." Yet Giscard had told them that the American measures posed an enormous danger of protectionism and that the United States had breached the rules of the IMF. But Volcker did not seem concerned, simply acknowledging that the Americans were aware of the problem that their decision provoked. The response was straight out of the Connally playbook to keep up the pressure. Unhappy at not having been invited to the London meeting on August 16, a prickly Dutch delegation met with Volcker in the Hague. There Jelle Zijlstra told Volcker that he hoped the American officials had understood that they had just given the newly created reserve asset known as the SDR a very hard knock and that they had at the same time emphasized the importance of gold. After all, Zijlstra went on, Nixon had "with one stroke of the pen"[245] damaged the future of the IMF, leading him to the conclusion that in the uncertainty that had been created, gold would still provide the most security. Judging that Volcker and Daane were "rather taken aback" by his remarks, giving the impression that they had indeed not recognized all the implications of the United States' actions, the central banker noted in an internal memorandum, "[with] some feeling of triumph," that at the end of their meeting, Volcker had thanked him for his "philosophical approach," which he had found "most helpful."[246] Possibly a case of misinterpreted irony.

While in Paris, the globe-trotting American monetary diplomat also met with Emile van Lennep, secretary general of the Organization for Economic Development and Cooperation (OECD). Evolving from a club of countries receiving Marshall Plan aid after World War II, the OECD played an important role in restoring the convertibility of European currencies. By the early 1970s, the Paris-based organization had become more of an international forum and think tank for frank discussions ranging from economic issues to education and foreign aid. It also hosted regular meetings of the oddly named Working Party 3 (WP3), in which senior G-10 officials could exchange candid views in an informal setting. Van Lennep was proud of the high standard of discussion of WP3, of which the energetic Dutch aristocrat and former senior financial official had himself been chairman. He was glad to see Volcker, who stood a full foot taller than Van Lennep, not only because the American undersecretary was a highly respected member of the exclusive WP3 club, but also because the OECD chief aimed for his organization to play a prominent role in the upcoming talks about the broken monetary system. And for realizing this ambition, American support was indispensable. As the dapper and political savvy Dutchman felt that his views on the monetary system could in no way be considered anti-American, he saw himself as the right man to point the way out of the money morass.

Advocating devaluation

The weeks after the Nixon shock brought much activity but little progress. The countries of the European Common Market met in an emergency session in Brussels, the seat of the European Commission, to discuss a German proposal for a concerted float of their currencies against the dollar. The meeting had a strong quality of déjà vu: Giscard d'Estaing once again turned down Minister Schiller's familiar proposal for a "common initiative" for a currency realignment within the framework of the IMF. France, as usual, wanted to go its own way and opted for using strong exchange controls to maintain its peg to the dollar. Paris, with obvious political overtones, firmly stuck to its position that the dollar should be devalued. Other European countries were also in favor of a dollar devaluation, but only as part of a general adjustment of exchange rates. The clearest expression of this view came from Otmar Emminger, who conveyed his proposal to Volcker as Volcker was canvassing the attitudes on the other side of the Atlantic.

Pierre-Paul Schweitzer had a similar message for the American point man and went public—in two interviews on American television on August 23 and 24—to state, "[I]n my opinion, it would be normal for the U.S. to make a contribution"[247] to bringing back stability, adding that a devaluation of the dollar against gold would be helpful. This suggestion angered the White House, and Schweitzer "was immediately moved into the most-wanted category on the Nixon administration's enemies list."[248] Meanwhile, also on Monday, August 23, the currency markets opened again in Europe, but without any coordinated strategy. Currencies started to float upward against the dollar, but the pace was moderate as central banks bought dollars in what came to be known as a "dirty float"—in contrast to a "clean float," in which intervention is absent.

At the IMF its chief economist, Jacques Polak, in an emergency meeting of its executive board on the afternoon of August 16, had argued that "a satisfactory new pattern of exchange rates could not be found by letting all currencies float for a certain period."[249] What was needed was a new pattern of exchange rates to ensure that the United States' trade balance would again show a sizable surplus. On the basis of a back

President Nixon shakes hands with International Monetary Fund Managing director Pierre Paul Schweitzer. On the left, George Shultz; on the right, World Bank president Robert McNamara. (Courtesy International Monetary Fund.)

of the envelop calculation, Polak concluded that the dollar would have to lose around 10% of its value on average against other currencies. The confidential numbers, exclusively intended for the executive board, were soon leaked and eagerly made public by the press. This irritated the IMF's largest member countries, and with the IMF already in crisis mode, Schweitzer told board members of the organization "that the whole of the international monetary system was at stake and that . . . the Fund could, and should, take the initiative."[250] He added that "[t]he Fund was in a unique position . . . to propose . . . an impartial solution"[251] to solve the crisis. The IMF chief realized all too well that the fund, as the centerpiece of the system, was in serious trouble and could lose much of its influence. A major worry was that the industrial countries could bypass the IMF and work out solutions among themselves. Another concern was the likelihood that widespread floating of currencies would render the IMF's authority over exchange rates obsolete.

Keeping it in the G-10

Confirming Schweitzer's fear, the industrial countries, though publicly welcoming the activities of the fund board, preferred reaching decisions in the G-10. This approach was pushed by the United States, whose treasury secretary mistrusted the IMF. But the developing countries also had an important stake in what was to be decided and were unhappy being excluded from the real decision-making. Instead they wanted the IMF executive board, in which they were represented, to play a central role. The (then) 20-member board formally made decisions on almost all international monetary issues but was in reality steered by the ministers and central bank governors of the G-10 countries. Some directors from small industrial and developing countries considered themselves independent, based on the language of the IMF statutes, which stated that board members were "officers of the IMF." Among these were Pieter Lieftinck, from the Netherlands, and Alexandre Kafka (a nephew of the writer Franz Kafka), from Brazil, whose long experience and expertise made them more influential than some of their colleagues from larger countries.

Although excluded from the real decision making on monetary reform, the IMF did play an important technical role in the G-10 discussions. But it also tried to influence the G-10 process by expressing "a much more explicit criticism of the international role of the dollar."[252] In its view, to save the system based on fixed exchange rates, the dollar (and the pound sterling) had to be replaced as reserve currencies by the SDR. The immediate result of this suggestion was strong American displeasure with what it considered a too independent IMF staff. And at the G-10 deputies meeting of September 3 and 4, 1971, in Paris and the ministerial meeting of the G-10 in London almost 2 weeks later, the IMF was politely listened to but was not in the driver's seat. That seat belonged to Paul Volcker at the Paris meeting, where he laid out what the United States had in mind as a solution to ending the crisis. He argued that an improvement of the U.S. trade balance of $13 billion was needed to restore confidence in the dollar, allowing the United States to lift its special controls on capital outflows. This mammoth shift was to be achieved by a strengthening of the currencies of the surplus countries against the dollar, coupled with a removal of some of their trade barriers and a greater sharing of the cost of defense spending by Europe and Japan.

The other G-10 participants were flabbergasted and complained that such a large payments swing in a short period was impossible, realizing full well that large revaluations of their currencies would be needed for this to happen. Turning to Jacques Polak of the IMF, who had been making similar calculations to those of the U.S. Treasury, a number of Europeans asked him whether the $13 billion number was not much too large. "He [Polak] replied that he did not know that $13 billion was required, but the IMF's calculations suggested that [the needed adjustment] was a big one. I could have kissed him,"[253] Volcker recounted later. Tall Paul also repeated the official American line that there would be no change in the price of gold, in other words there would be no devaluation of the dollar. The Europeans—the Japanese remained silent—replied that a currency realignment without a modest adjustment in the dollar's value was a political non-starter. One—unstated—reason for this resistance was that France would not accept revaluing against the dollar. As a dearer franc would imply a lower price of gold in francs, the result would be bitter complaints from the many French hoarders of gold, often kept under their mattresses.

Posturing and leaking

After this preliminary skirmish, negotiations became more contentious at the meeting of the G-10 ministers of finance in London hosted in the elegant 19th-century Lancaster House in the center of the city in September 1971. But elegance was far away at the meeting, marked by "posturing and leaking to the press about the outrageous American demands."[254] The six countries of the European Common Market had met the day before and had agreed on a common position they would take at the meeting, implying a realignment of currencies, including the dollar, against gold. But Connally, meeting with his G-10 counterparts for the first time, quickly set the tone by calling on his "friends" to be as generous in sharing the United States' problems as his country had been in its dealings with them in the past. If others wanted the US to lift the import surcharge—the measure most loathed by the other G-10 countries—they would have to revalue their currencies, remove obstacles to U.S. exports, and share more of the cost of common defense.

These actions would have to lead to an improvement in the American trade balance of $13 billion, a number familiar to the ministers since Volcker had already shocked their deputies by mentioning the size of the adjustment the United States was seeking. To make the American position perfectly clear, Connally added that the $13 billion shift "isn't being produced as a negotiating number, it states our position accurately."[255] Giscard d'Estaing was overheard to snap "Intransigence!" as he removed himself from the meeting. And during a discussion of capital controls, after Germany's Karl Schiller agreed with Connally that they were undesirable, the French minister vigorously defended them. Trying to be constructive, IMF chief Schweitzer proposed a three-stage work program to make progress in the negotiations, but Connally gruffly rejected the idea, claiming that his instructions did not allow him to go that route. Giscard also objected to mentioning Schweitzer's "work program" proposal in the communiqué of the meeting. But his position was based on the French strategy not to rush negotiations that could lead to "exorbitant concessions" to the Americans, as French president Pompidou warned on September 23, 1971.

When at the end of the meeting the U.S. treasury secretary felt obliged to stress that his country was not going to change its position "one iota," other participants were upset. Yet some of them had mixed feelings about Connally as a person, "a character whose rascality they both admired and loathed."[256] The only person who benefited from the Lancaster House boxing match was the OECD's Emile van Lennep, who noted with satisfaction that "his" Working Party 3 was asked—together with the IMF staff—to examine how much the U.S. balance of payments needed to improve and what that would mean for other countries. Perhaps his earlier meeting with Volcker had produced results.

The "unnecessary roughness" on display at the London conclave which "ended in a spirit of greater antagonism than it had begun with,"[257] prompted Arthur Burns to relay his concerns about Connally's tactics to Nixon. And Henry Kissinger added his voice by warning about the likely consequences for foreign policy of an overly aggressive American stance on money matters.

Parleying and partying

The annual meetings of the IMF and its sister organization, the World Bank, bring together thousands of financial types ranging from delegations from all member countries, hordes of "special guests"—mostly bankers who do not come for the policy discussions but to network and discuss deals—and a mix of other visitors. While ministers of finance and central bank governors, supported by their entourage, make speeches and huddle in meetings, the commercial bankers would, in the halcyon days before the threat of terrorism and mass anti-IMF demonstrations, entertain lavishly. Driven in fancy limousines and staying at the best hotels, they hosted grand receptions in museums, ballrooms, and other pleasant surroundings. Champagne flowed and exquisite bites were plentiful, but those not invited complained about the enormous traffic jams.

The official part of the program, stretching over 4 days in the 1970s, was held in the cavernous Sheraton Park Hotel (previously known as the Wardman Hotel) on the corner of Connecticut Avenue and Woodley Street in northwest Washington. The plenary meeting took place in a hall that could host 2,000 people and was solidly packed on the first day, when the president of the United States customarily delivered a short speech.

The delegates were housed in a variety of mostly less expensive hotels; rooms at the Sheraton Park Hotel were used as delegation offices. To some it was a strain moving from one meeting to another, but for the less busy delegates it presented a relaxed atmosphere—and for the bankers a festive occasion away from the concerns of the office. But in September 1971 monetary officials were in a somber mood, fearing that the American measures of August 16 could trigger monetary chaos and dangerous trade wars. Europeans, Asians, and Latin Americans alike were still shocked that the United States had seemingly forgotten important lessons of the Great Depression, when wildly fluctuating exchange rates and rampant trade restrictions had done severe damage to the world economy.

This time, at a press conference after a G-10 meeting and in his speech to the assembled IMF delegates, John Connally was a little less belligerent, saying that the United States understood other countries' concerns. Some thought that a $13 billion improvement of the American trade balance was too much, others focused on a quick resolution of the currency and trade question There were also those, Connally continued, that wanted to have the United States surcharge removed before an agreement on currency values was reached. The latter was of course counter to American intention. The only concession Connally offered was to remove the offensive import charge on the condition that others show progress in meeting American demands. But he had made clear that "the gold question" was mainly "a political problem, not an economic one."[258]

Although this interpretation was accurate, it conveyed the message that the United States did not want to devalue the dollar and suffer the attendant loss of prestige. Other G-10 countries also harbored political motives: A large upward float of their currencies would not sit well with their electorate. They were also unhappy with Connally's observation that it would be better to have a "general clean float"—abstain from any intervention in currency markets—than making a "premature decision" on new fixed rates. At the end of the IMF gathering, an atmosphere of grave apprehension was palpable.

Perhaps the most worried person was Pierre-Paul Schweitzer as he recalled an earlier warning by Volcker to the IMF chief "that the objective of orderly rates alone was not the overriding U.S. concern. The US would not buy short-term order at the cost of a recurrence of difficulties and was ready to live with disorder."[259] Burns in the meantime, worried about the American–European clash, wanted to involve the head of the IMF more in the discussions and invite him to the White House to state his case. The president went along, although Connally had vehemently opposed involving Schweitzer. The meeting did not go well, Burns in his diary blaming the fund managing director, whom he felt had “acted like the damned fool that he is,” and uncharitably describing him as “ as a pathetic man, always on the defensive one way or another.”[260] Strangely, the Fed chairman ended his diary entry with the remark that nonetheless the meeting had “helped to improve international sentiment.”

Bad chemistry

To complicate matters even more, tension between France and Germany was escalating, partly thanks to bad chemistry between Giscard and Schiller. The German minister, in his usual assertive fashion, pushed for “a prompt adjustment of “unrealistic parities,”[261] while the French strategy was not to rush the negotiations for fear of giving away too much. Schiller also bashed the use of restrictions on trade and capital flows, while the French were actively discouraging capital inflows. Apart from philosophical differences, Germany felt uncomfortable that the mark had floated upward by over 9% against the dollar since May, while the French franc’s value had remained unchanged. A week after the Washington meetings, the undiplomatic Schiller accused France of “adopting a mercantilist stand reminiscent of the policies of Colbert in the seventeenth century.”[262]

Schiller was to enter into more conflicts as time went on and, after a bitter argument with the Bundesbank on capital controls, which he lost, tendered his resignation in June 1972. To his surprise, his resignation was promptly accepted by Chancellor Willy Brandt, who had grown tired of Schiller’s “argumentativeness and hauteur in cabinet meetings,”[263] also mindful of his attempt to introduce large spending cuts in the 1973 budget. It did not help the minister of finance that he had already threatened to resign four times before, apparently not very convincingly. Looking back 20 years later, a bitter Schiller wrote, “During 1971–73 the Bundesbank was completely on the wrong track. It was obsessed with the idea of fixed exchange rates—even if it meant calling in the *Bundesgrenzschutz* [federal border police],”[264] adding that some of its older managers “had experienced the time of capital controls with the Reichsbank [the German central bank during the Nazi regime]. They were no great advocates of market economics.” Actually Schiller had a few supporters at the Bundesbank. Its vice-president, Otmar Emminger, had been a long-time advocate of floating rates, but had been outvoted on several occasions in the council of the German central bank.

Covert action

As Arthur Burns’s growing concern about the impasse in the currency negotiations led him to the judgment “[Connally’s] freewheeling is dangerous," he decided to take an initiative of his own. Among the many receptions and dinners given during the September 1971 IMF annual meeting, Burns had accepted an invitation to dine at the Dutch ambassador's finely appointed residence on S street in northwest Washington. This was an annual event to welcome the Dutch delegation and "special guests" and enjoy the company of some prominent American personalities. As drinks were served before the guests moved to their tables, Burns had an aside with Jelle Zijlstra, president of the Dutch central bank, saying, "My friend, we are in deep trouble; we need an honest broker, and that is you. I talked it over with Secretary Connally; he agrees."[265] Zijlstra answered, "If you feel I could be of any help, I will not disappoint you." Burns realized that a general realignment of exchange rates could not be agreed on at an international conference. Someone had to visit the most important countries in utter secrecy to try to find out what they were prepared to accept—revaluation or devaluation—and by how much. And a report by an intermediary would be the basis on which the G-10 could reach an agreement.

Zijlstra soon learned that the American negotiators not only were looking for a general realignment of currencies, but also wanted to include other elements in the discussion: burden sharing in NATO, trade matters, and the agriculture support policies of the European Common Market. This was a setback, as these additional issues were not the central banker's fortes, nor those of the other representatives of the G-10. Decisions on defense issues, trade, and agriculture could not be made by ministers of finance and greatly complicated the negotiating process. It was, wrote Zijlstra, "one of the most difficult assignments that I ever took on in my life."[266] But the Dutchman, relishing the challenge, visited London, Paris, Brussels, Bern, Bonn, Rome, Stockholm, Washington, and Ottawa and met the Japanese officials in Paris. He traveled alone—without a bag carrier—to minimize the risk of leaks. Though difficult and tiring, Zijlstra experienced his mission as "captivating." But, feeling a little sorry for himself, he wrote in his memoirs: "In every capital [I visited] I sat on my own across the table from the minister of finance, the central bank governor and a few officials. I made my pitch and they gave their opinion. I wrote everything down and fashioned it like crazy in the evening."[267] Back in Amsterdam he quickly wrote his report, also covering defense burden sharing and agricultural policy, although, as he found out later, he could a have saved himself the trouble to write about anything other than exchange rates—that was the only thing the recipients were interested in.

Burns was thankful for Zijlstra's effort, but Connally and Volcker less so. The American treasury secretary, who did not like a foreigner to play the role of honest broker, had earlier angrily refused to see Zijlstra, though later allowing Volcker to receive him. According to the Dutchman, the American money men considered his report an annoying complication. And as Zijlstra later found out, Burns's assurance that Connally had agreed to his initiative was not quite the whole truth. But in the end, Zijlstra was pleased with the probable result of his mission; the numbers he had suggested were close to the exchange rate changes that were later agreed on.

Crunching numbers

A feverish numbers game was under way in October and November 1971, and real negotiations on exchange rates seemed to be getting closer. But Connally continued not to be in a hurry. Worse, a confidential gathering in October of Working Party 3, for which the staffs of the OECD and IMF had prepared calculations, led nowhere. Both staffs had taken the American demand for an improvement of its trade balance (more precisely current account balance) of $13 billion as the point of departure and suggested which countries—with what amounts—would have to accept a reduction in their surpluses. Normally countries tend to challenge the staff figures for their payments balances as being too pessimistic, but for obvious reasons, this time the opposite was the case.

The first to mention a number was economic powerhouse Germany, saying it could deal with a shift of $2 billion or a bit more. The British begged off, claiming chronic weakness, and the French saw no room for a shift either. Further irritating the Americans, the Dutch and Belgians, who had been active buyers of gold, assuming that their purchases were too small to shake the system, likewise argued that they were too small to contribute significantly to the envisaged adjustment. Clearly Volcker had not forgotten his visit to Amsterdam on July 7, when he warned Zijlstra that he was "rocking the boat." The Japanese who were expected to contribute the most applied their usual tactic of keeping as quiet as possible. The end result was that the surplus countries could accept only a fraction—around $3 billion—of the $13 billion swing sought by the United States. Compared to the lower $8–8.5 billion shift the OECD and IMF thought was minimally necessary, it was still a far too small number. The omens for reaching agreement were once again unfavorable.

The longer the impasse went on the more critical feelings about Connally became. There was talk of "Texas brutality"[268] abroad, as well as concern within the Nixon administration. But in a hard-hitting speech before Republican congressional leaders at the White House on

November 16, the treasury secretary—in a defiant mood—remarked that there was talk that "if that Big Cowboy doesn't mend his ways, we're all going down the drain. Well, this cowboy knows you can ride a horse to death, and the world has been riding a good horse to death . . . and this has got to stop."[269] Furthermore, Connally went on to say, the international crisis would not be settled soon, as it was not acceptable that the foreigners wanted the import surcharge removed while demanding a higher gold price and were only then prepared to negotiate. The president wholeheartedly agreed and criticized the "goddamn" state department for not having done a good job in bargaining for a better position in world trade for the United States, adding: "We are changing the rules of the game."[270] But Connally, still enjoying the full support of the president, was going too far in the estimation of other powerful players.

Burns, seriously worried about a trade war, made a list of possible measures in retaliation if the import surcharge was maintained much longer. The Fed chairman then showed his handiwork to Nixon, who did not react, and to Kissinger who, like Burns, was afraid of the fallout of Connally's high-stakes poker game. And that was not all: Burns decided to share his concerns with Congress, infuriating Nixon and his inner circle. George Shultz had his own agenda for going against Connally. Unlike Burns, Shultz wanted to get rid of the Bretton Woods system and to move to a fully floating exchange rate system, which he believed would bring about stability, just as Milton Friedman had long advocated. But Connally, not a visionary thinker, was only interested in the short term and was, in Shultz's view, too much under the influence of Paul Volcker, who did not favor floating. Shultz did not give up easily, first arranging a meeting between the diminutive Chicago professor and the tall Texan and later attempting to change a draft speech by Volcker intended for delivery by the treasury secretary at the IMF annual meeting. But Connally did not accept Shultz's rewriting of his undersecretary's draft with the intention to upend the international monetary order and move to general floating of currencies.

Changing fortune

The larger-than-life Texan's fortunes began changing when Henry Kissinger, sharing Burns's misgivings, decided that he had to do something to halt the diplomatic fallout of Connally's bullying and crude mercantilism. The first signs of protectionist retaliation had appeared: Denmark, though economically insignificant, had imposed an import surcharge of its own, and bigger countries could follow soon. Kissinger, who had come to understand that "economic policy discussions are not technical but political,"[271] wanted Nixon to tell his treasury secretary to be more cooperative. But Nixon was still standing behind Connally. He had even told his chief of staff, Bob Haldeman, to "[s]et Kissinger against Burns. They are playing an anti-Connally game. Kissinger must stick four-square with Connally."[272] Not to be outfoxed, the influential national security advisor made the case to the president in early November to go for a quick settlement of the currency drama with Europe and Japan. But Nixon was not yet ready for such a move, telling Kissinger to stop supporting Burns's action for a return to the gold standard. Remarking that Connally was "like all Texans and is just basically anti-foreigner,"[273] Kissinger emphasized that the time had come to negotiate seriously, convincing sufficiently Nixon to instruct his foreign policy guru to talk to Connally.

All this was tricky for Volcker and when asked by others in the administration about the Treasury's negotiating plans, Volcker had to be evasive, as its secretary was not communicating his innermost thoughts. And just to give Giscard and other Europeans the impression that the United States did not care, Connally journeyed to Indonesia, hardly a country with influence in monetary discussions. On his way back, the effusive Texan, towering over his hosts, swung by Japan, the country he considered the worst offender in international trade. He signaled that there would not be a monetary settlement soon, because the various countries were not yet ready. He then added somewhat mysteriously that he looked forward to a number of very relaxed meetings. The Japanese were anything but relaxed, but were relieved that "Typhoon Connally" had not struck hard.

It took a while for Nixon to realize that his treasury secretary's policies were also causing damage to the American economy. Paul McCracken, Nixon's top economic advisor, warned against an erosion of confidence, pointing to a weakening of the stock market as evidence. The president took notice, since domestic problems were practically the only ones voters reacted to, short of war. Another matter preoccupying Nixon was what he was going to say to his French counterpart, Georges Pompidou, who no doubt would raise the currency issue at an upcoming NATO summit. Realizing that a course correction was needed, he reluctantly told Connally that it was time to get the best deal in exchange for revoking the import surcharge and then settle, but not immediately. Burns wrote in his diary that Nixon "wanted the credit for achieving settlement," thinking ahead to the next summit meeting in mid-December.

The treasury chief got the message, indicating that he now favored a quick resolution too, although he maintained later that he had himself come to the same conclusion earlier. Relishing the moment, Arthur Burns told the press the next day that Nixon expected real progress at the upcoming G-10 meeting and that "the American delegation will do what it can to contribute to this result."[274] Some of the European negotiators interpreted the reference to "contribute" to mean the United States would be prepared to accept a modest devaluation of the dollar. And because adjusting the value of the dollar against gold would make it easier to reach an agreement, the continental Europeans were slightly upbeat when they arrived in Rome on November 30, 1971, for a G-10 meeting with the monetary system as its main talking point.

John Connally, actor

The G-10 ministers rotated the chairmanship, and as chance would have it, Connally would be presiding over the meeting. He clearly enjoyed the role and acted "as though he wanted an Oscar,"[275] making quite an impression when at the official dinner he gave a speech without notes that ranged from Roman times to the problems at hand. The meeting took place in Rome at the opulent Palazzo Corsini on the banks of the Tiber River, once the abode of a wealthy banking family. At the preparatory gathering of the deputies, Volcker kept quiet about the price of gold, as instructed by Connally, who had revealed to him that Nixon could accept an increase when needed to break a deadlock. At the same time Volcker presented the assembled deputies for the first time with the news that the United States was seeking an 11% change on average between the dollar and the European and Japanese currencies. Although not enough to obtain the $13 trade balance swing the United States had insisted on, he mentioned that 11% would be sufficient to lift the import surcharge. But Volcker made it clear that the gold window would stay shut. The next day, at the ministerial meeting, Connally soon called for an executive session, sending away the junior delegates to cool their heels in the corridors. But Volcker, although only a deputy, could stay, as the—supposedly neutral—chairman (Connally) could not represent his own country.

As a full participant in the exclusive gathering, Volcker felt like a fish in the water, years later describing the session as being "the most interesting international meeting of my career."[276] America's opponents, lead by France's Giscard, quickly made it clear that a discussion would be fruitless unless there was to be an American "contribution," meaning a devaluation of the dollar against gold. Volcker was sitting next to Connally purely because, as is usual in international meetings, the alphabet is applied to determine the seating order. As a result, the

Belgian Minister flanked the chairman on one side, and Volcker sat at his other side behind the United States sign. This made it possible for the American deputy to ask his boss, in a whisper, whether it was the time to set the cat among the pigeons by asking, "Well, suppose, just hypothetically, we were willing to discuss the price of gold. How would you respond if we increased the price by ten or by fifteen percent?"[277] Connally nodded and quickly asked his apprehensive counterparts what their reaction would be if the dollar price of gold would be raised by 10%.

A great silence settled over the meeting, the other G-10 members at a loss how to react, not having counted on a greater than 5% offer by the Americans. The Europeans took their time conferring nervously among each other while the chairman and the Japanese finance minister Mizuta waited patiently. At last Karl Schiller of Germany spoke up and, to the discomfort of others, declared that Germany could live with a devaluation of the dollar of 10%, and possibly some more. What is "some," he was asked? Schiller helpfully replied that in the German language, "some" does not mean "one." It means "two." The British, because of their weak ability to compete, and the Italians, who emphasized that they, too, had problems, quickly argued that they could not revalue their currencies.

Despite many lengthy interruptions to deliberate and to call government leaders, no progress was made, the French minister not saying a word, perhaps thinking that silence was golden. As revealed later Giscard had not received the approval of President Pompidou to take part in the numbers game; without a French reaction, further discussion of new exchange rates was pointless. The following day, Connally raised the trade issue, but that did not produce results either. The Common Market countries pleaded that since they shared a common agricultural and trade policy, the whole European Community would have to be involved. Raymond Barre, the trade commissioner for the Common Market and a future French prime minister, was present but explained that he did not have the authority to take a position. All that was agreed was that the trade representatives would meet soon. Connally, getting impatient, snapped: "Any offers that were construed as offers were ridiculous."[278] And with that, the chairman concluded that there was no sense in going on, but that another meeting would be held, this time in Washington, on December 17. After the meeting, Connally and Volcker were in a good mood, having brazenly put the Europeans on the spot. The European ministers were subdued, although the possibility of an agreement seemed closer than before.

Letting the cat out of the bag

As the conclave, described by an Englishman as "not economics, but jujitsu,"[279] drew to a close, it was agreed that Chairman Connally would be the only one to brief the press. This he did with gusto, first climbing atop an antique table in one of the Palazzo's exquisite rooms and then turning to the assembled press, who were shouting questions and flashing their cameras; he held forth with great eloquence while avoiding embarrassing any of the G-10 partners. In a conciliatory mood, he remarked: "We did not reach a decision: We did not solve the problem, but we most certainly did discuss the various elements of that problem."[280] Questions about the discussion on gold were referred to as hypothetical. Connally took the same line at a press conference at Andrews Air Base outside Washington on returning from the eternal city, describing a 10% devaluation as one of several "assumptions" needed to encourage discussion. But the press was not fooled, Lawrence Malkin of the *New York Times* quickly dashing off a report under the heading "The Coming Devaluation of the Dollar."[281] And in Washington, Nixon was not entirely pleased with what had happened in Rome. On December 2, he told some members of his staff that he had not meant to move on gold, contrary to what Connally had signaled in Rome.

The president took the line that he did not really care about the price of gold now that dollars could no longer be converted into the yellow metal, but that he was worried about getting approval from the Senate for raiding the price. "Change in [the gold price] is now irretrievable. How do we make it an asset and market it through the Senate?"[282] The reason for Connally's concession on gold in the G-10 talks remained unexplained. Had there been a misunderstanding between Nixon and his treasury secretary? Or was Connally's claim that the president could go along with a concession on gold, if necessary to reaching a settlement, not the full truth? But the die had been cast, Nixon realized, and some pride would have to be swallowed by the United States, knowing full well that when he would meet President Pompidou at the NATO gathering in a few weeks, the Frenchman would use every trick he could think of to get him to sign off on a higher gold price.

Japan in the dark

In the meantime in Tokyo, now a thriving metropolis after the devastation of World War II, confusion reigned as the currency crisis continued. The Bank of Japan—not known for its independence—following instructions from the minister of finance, had allowed the yen to float upward at a gradual pace, buying dollars to slow the rise of the Japanese currency.

By December 1971, the yen was worth around 12% more against the dollar than at the time of the Nixon Shock. This was already quite high, in the estimation of Japanese officials, but they were at a loss to discern America's negotiating strategy in reaching a realignment of currencies. Although they understood that their country could not escape revaluing, they were struggling with the question how large the adjustment would have to be. Like the Europeans, the Japanese were making their own calculations of a possible outcome of the negotiations. The scenario adopted in Tokyo in the run up to the Rome G-10 meeting was for the dollar to be devalued by 6% against gold, while Germany would revalue by 3% and Japan by 6%, meaning a total increase of 12% of the value of the yen against the dollar. On this basis the swing in the United States' trade balance would be $6.5 billion, only half what Washington had demanded. But because the 10% import charge was the equivalent of a 2% revaluation of the yen, the general feeling among the senior bureaucrats was that a bigger adjustment would hurt the Land of the Rising Sun's exports too much. The American demands were "exorbitant" in Japanese eyes and had to be resisted, but discovering how to go about it was like trying to walk in the dark without stumbling.

The Europeans also posed a threat, being worried about Japan's inroads in electronic goods and automobile industries in their economies. The French were particularly adept at discouraging imports by pressing for voluntary export restraints—the United States had experienced "good" results with them—and introducing administrative measures such as routing certain products through small towns for customs inspection. And Japan had to take into account irritation with its own dubious trade practices, such as the Japanese claim that European skiis were not suited to Japanese snow, whose texture was supposedly different from that of Europe's. Looking for support, Japan's negotiators awkwardly tried to form alliances with France and then Germany on currency issues, failing in both cases. They "were left with the impression that Japan's situation was so special that nobody would form alliances with [them] in opposing strong pressure from the United States."[283] Finally it dawned on Tokyo that it was a mistake to try to form alliances with the Europeans and that in fact all their G-10 co-members "were ganging up" against Japan. Being isolated made Japan react very defensively to proposals for realigning currencies. The relationship with the United States, which had been that of "a big brother with a little brother"[284] had deteriorated alarmingly, as the little brother did not fully realize how much it had gained in economic prominence. But there was more. Japan suffered another blow when it learned that Nixon had made an opening to China, a country that it feared because of wartime misdeeds as well as it its huge population and consequent potential as a possible future competitor both in war and in peace. In the past, the United States, with strong approval from Japan, had staunchly supported Taiwan in its cold war against Red China. Now, there was a feeling that the United States had "pulled the rug out from under Japan," and that Connally and Kissinger had a lot do with it. No wonder that the Japanese delegation applied its usual tactic of being as unobtrusive as possible at the G-10 meeting in Rome, though audibly sucking in their breath after the Americans suggested a 20% revaluation of the yen.

It's your problem

In the 2 weeks before the meeting between Nixon and Pompidou at the NATO summit on the Azores, Connally and the American trade negotiator, William Eberle, made a last effort to wring trade concessions from the Common Market countries and Japan. But the trade representatives from Brussels balked, as did the Japanese, though they must have liked it that their talks were held in balmy Hawaii. But Connally went on to the bitter end, warning that unless others removed obstacles to U.S. exports, Washington would not increase the gold price. All he succeeded in doing was angering other G-10 countries, already upset about his provocative remark, later to become famous: "[T]he dollar may be our currency, but it's your problem."[285] Flying to the mid-Atlantic islands of the Azores, Nixon was ill at ease about having to talk about monetary issues, in which he had little interest, with the French president who, as a former Rothschild investment banker was well versed in international financial matters.

The Azores are an isolated island group belonging to Portugal, mainly known by northern Europeans for the weather depressions forming there that bring rain and winds to their countries. But it was neutral territory and possessed an American air base, ensuring a decent landing strip, important in the event of poor weather. It was also a venue roughly equidistant from Paris and Washington, avoiding any squabbling about who was to visit whom. Comparing "Tricky Dick" and "Pompom"—as they were often called in Europe—as prizefighters in suits suggested an even match. The American president was known for being wily and had a reputation as an expert in strategic thinking, whereas the Gaullist Pompidou was a clever negotiator who would try to score a diplomatic victory over the United States. Washington's goal was to reach an agreement with Paris, likely to be followed by ones with other G-10 countries. For the French, it was important to come to an understanding that had a "French imprint." Doing so would also give them prestige to be informally negotiating on behalf of the Common Market countries. And, before seeing Nixon, in a huddle with the German chancellor, the affable Willy Brandt—present for the NATO part of the summit—Pompidou had agreed to resist American demands for a large revaluation of the mark. Because the discussion between the two presidents—which also covered global strategy—did not include their finance ministers, Connolly, Giscard, Volcker, and the French vice-minister of finance had to work—with bruised egos—in a rather spartan adjoining room on the outline of a comprehensive monetary agreement.

Eyes glazing over

From the start, Pompidou used his knowledge to advantage and dominated the discussion, launching into a discourse on gold and "the evils of the dollar standard."[286] Nixon, preferring to talk about security and defense issues, said little. The next evening, the American president settled the matter after long discussions on monetary matters, "a subject that fascinated Pompidou, but . . . made Nixon's eyes glaze over."[287] Nixon was more interested in a Washington Redskins football game and stayed up until 4:30 A.M. listening in on Armed Forces Radio. While Kissinger later claimed that he did much of the negotiating with Pompidou, the American leader, in the final session, anxious to move on, got his loquacious French counterpart to agree to an increase in the gold price of $3 an ounce.

Both sides could now claim that that they had received something. While Nixon was willing to accept a dollar devaluation, he held out for a 10% adjustment. The French had wanted a smaller number, but in the end Pompidou accepted an increase in the dollar price of from $35 to $38 an ounce—in other words, a devaluation of the dollar of 8.5%. In addition, the United States was prepared to remove the hated import surcharge. The statement issued after the meeting also recommended a return to a system of fixed exchange rates but acknowledged that the gold window would remain closed for the time being. This meant that Bretton Woods would be restored but without gold, placing the world on a dollar standard. No mean feat from an American perspective. The Americans and the French, having done their homework, could now look forward to the Washington meeting a few days later, at which the main focus would be on Japan and, to a lesser extent, Germany and its currency satellites.

11. Building an air castle

Among the more interesting of Washington's many monuments and official buildings, the Smithsonian Castle stands out for its unusual architecture and prestigious location. Built in the middle of the 19th century based on a design by James Renwick Jr., one of the foremost architects of the time, it is constructed of red sandstone in Norman style. It is centrally located on the southern side of the mile-long National Mall, halfway between the Capitol Building on the east and the Lincoln Monument on the west. It houses the administrative offices and central information center of the venerable Smithsonian Institution, which comprises many world-renowned museums. Curiously, the institution was the bequest of a wealthy Englishman, John Smithson, who never visited the United States, but whose remains are interred in a crypt at the entrance of the castle. In 1971, the distinctive building still housed some of the Smithsonian's collection of air and space artifacts, and a number of retired rockets and missiles were simply exhibited nearby in the open air. A few years later, the growing spacecraft collection would be transferred to the new sprawling Air and Space Museum. But on Friday, December 17, 1971, as the G-10 money masters, with their retinues in tow, arrived at the red stone building, they were accommodated in some of the smaller rooms, where delegates could confer in a serene setting. But in the atmospheric chapel-like meeting room, known as the Commons, modern lamps that did not mesh well with the décor had been placed at each place around the table. Some European participants mused that this was a typical American way to spoil the ambiance.

Moving into a restricted session, the delegates numbered 33—three per country, including Switzerland, which enjoyed observer status at G-10 meetings. The managing director of the IMF, accompanied by two staff members, was also present. With John Connally chairing the meeting, the United States was represented by the impressive trio of Arthur Burns, Paul Volcker, and Dewey Daane. For Germany, Schiller-Klasen, supported by the stalwart, sharp-nosed Otmar Emminger, attended. But all eyes were on Mikio Mizuta, the Japanese minister of finance, who was fervently hoping to persuade the Americans to lower Connally's earlier demand for a revaluation of 20% of the yen. Giscard d'Estaing and his British and Italian colleagues had little to fear, not being in Connally's crosshairs, and the Canadians were adamant in continuing to float their dollar and were expecting to get away with it.

Turning up the heat

Brimming with confidence, Chairman Connally stated right away that although trade could not be dealt with on that day, the American import surcharge would only be removed if accompanied by a realignment of currencies. And the dollar price of gold could only be raised after trade issues had been settled to the satisfaction of Washington. The tough

Texan then made clear that he would end the meeting at 3 P.M. the following day, not allowing it to drag on into Sunday, cranking up the pressure to come to an agreement. Proceeding, he gave the floor to the IMF's Schweitzer to report on a joint meeting of the G-10 deputies and the executive directors of the IMF, a session meant to appease the developing countries as well as Australia and other advanced countries outside the G-10. For a long time, these countries had complained of being excluded from discussions that also mattered—sometimes a great deal—to them. The IMF chief was politely listened to, but none of the G-10 delegates felt a need to react and Connally gave the impression that he couldn't care less. As the meeting moved into executive session, several high-level persons had to join the deputies and advisors in leaving the meeting room. Among these was Emile van Lennep, secretary-general of the OECD, a body that had no jurisdiction over monetary matters, as well as Raymond Barre, the European commissioner for trade, who had irritated Connolly at the previous G-10 meeting in Rome. But, sensing that he might need Van Lennep in the future to help him launch a forum for combining monetary and trade issues, the Texan promised the OECD head to keep him posted on how the meeting was progressing and to ask his advice. Meanwhile, the delegates who had been excluded from the negotiations killed time by playing cards and chatting in the corridors, the fate of lower-level mandarins at many international meetings.

Not impartial

As the chairman moved on to the negotiating stage and successfully resisted an attempt by the French minister to move the meeting to January 1972, some uncertainty remained among the Europeans about whether the Azores agreement would be fully adhered to. And the men in uniformly black suits from Japan were apprehensive about Connally's acting again as a "typhoon." Although not bullying ministers this time, Connally "was far from impartial." Applying a familiar bargaining tactic, the American chairman warned that if no agreement was reached, there would be no alternative but to float, adding in a milder vein that he liked floating rates but recognized that there were "other views." On cue, Volcker distributed a table showing a 9% increase in the gold price—reflecting the Azores compromise—and suggested numbers for revaluation of the other currencies. In addition to the dollar, yen, German mark, Dutch guilder, and Belgian franc, the weighted changes proposed for the other G-10 currencies were modest, yet still catalyzed skirmishes and quibbling over adjustments of 1% or less. At the suggestion of Giscard, the increase in the gold price was marginally reduced to 8.6% to exactly reflect the Azores agreement and score a point for France. The meeting then dragged on with criticism of Canada's refusal to give up its float and Japan's attempt to minimize revaluation of the yen to the ire of the United States and Europe. Wrangling by the Europeans over the rates between their own currencies and how much the dollar should revalue was another irritant to the Americans.

After an extended period of haggling resembling "carpet trading,"[288] Germany's Schiller was ready to move, having received the green light from German chancellor Brandt, who ended their telephone conversation formally and dramatically: "Mr. Minister, God save you."[289] The thus blessed minister then announced that the German cabinet, after careful examination, was ready to accept a revaluation of the mark of 13.6%, not a big surprise since the German minister of finance had mentioned 10% and possibly further at the Rome gathering. This was a bit more than the "more" of Rome (2%) and made it possible for the Netherlands and Belgium to settle for a revaluation against the dollar of 11.6%.

Fight and flight

It was now Japan's turn to play the numbers game, Connally declaring that it was "irresponsible that Japan does not move."[290] But the cagey Japanese spokesman Mizuta, an experienced three-time finance minister, rejected a yen revaluation of 20% out of hand. Connally did not push too hard, later claiming privately to other ministers that he feared that the Japanese negotiator might otherwise commit hara-kiri. Inviting Mizuta to a small room during a beverage break, the crafty chairman suggested an adjustment of the yen of 18%. But the Japanese Minister still refused to accept the offer and insisted that the number absolutely had to be below 17%. His argument—that "17% is a very ominous number for Japan"[291]—was an unexpected one; that number had been the magnitude of appreciation of the yen in 1930 when it unwisely returned to the gold standard and economic depression followed. He concluded: "The finance minister who decided upon this return to the gold standard was assassinated."[292] The American simply asked what Mizuta proposed and accepted 16.88%, or 308 yen to the dollar.

It later turned out that the Japanese negotiator had obtained authority from Prime Minister Eisako Sato to accept 20%. But when at the plenary conclave Mizuto formally accepted the number agreed with Connally, he dramatically called the—rather modest—yen revaluation "the greatest economic shock that Japan had experienced since the end of the world war." Pleased with the result, Mizuta immediately left the meeting to hide in the Japanese delegation room in the castle, preferring flight to fight, fearing that the Germans would try to block his deal with the chairman. There was a good reason for his anxiety; Karl Schiller had earlier declared that the yen should be revalued by at least 4% more than the mark. Germany's 13.6% was only 3.3% less than what the Japanese minister had cleverly negotiated, but an unusually flexible Schiller did not protest.

Little time was needed to settle the rates for the other Europeans. France and the United Kingdom revalued their currencies by 8.6% against the greenback, exactly the same percentage as the devaluation of the dollar, maintaining their old parities. Italy and Sweden, after some unproductive bickering, opted for a slightly smaller revaluation, whereas the Netherlands and Belgium, with economies closely linked to that of Germany, accepted an increase of the value of their currencies of 2% less than that of their main trading partner. That these numbers were not much different than those calculated by the IMF to be needed to achieve a sufficient shift in payments imbalances was a feather in the organization's cap, but the realignment would later turn out to be insufficient.

Making world history?

Just as the ministers and governors were getting ready to discuss the draft communiqué prepared in back rooms by their deputies, President Nixon put in a cameo performance, having left the White House after receiving word that a deal had been struck. He congratulated the assembled negotiators on their achievement. The group then followed Nixon to the adjacent Arts and Crafts Museum, eagerly awaited by the impatient media. Nixon, speaking from a platform, announced triumphantly that the G-10 countries had concluded "the most significant monetary agreement in the history of the world."[293] Although this was classic Nixon hyperbole, it was an unusual agreement in having placed the world on a dollar standard, the United States having refused to pledge to support the dollar exchange rate by selling gold or borrowing foreign currencies. This lack of commitment to maintain the dollar parity was downplayed but in private worried a number of the main players who wondered whether the agreement would hold. Clearly it would be effective only if the United States would back up the lower dollar rate with tight budget and monetary policies when the American currency showed weakness. And an average devaluation of the dollar of 10% might well prove to be too small to eliminate the United States' trade deficits. Volcker was among the skeptics, giving the new set of exchange rates a mere 3 months to hold, whereas increasing sentiment among the Europeans held that the time had come to form a European Community currency block, ensuring fixed rates among its members.

In other parts of the world the currency realignment produced mixed feelings. To those countries pegged to the dollar, the agreement was generally welcomed for making their own currencies cheaper and their economies more competitive. And the—declining—membership of the pound sterling area did not complain either; the pound had not been revalued against the dollar. Not surprisingly, the reaction in what was then known as the second—communist—world was to view the Smithsonian agreement as a sign of a crumbling capitalist system. "The results show that the U.S. 'new economic policy' has failed and that the hegemony of the U.S. 'dollar empire' has come to an end,"[294] wrote the *Peking Review*. Among the G-10 countries, the most negative reaction occurred in Japan, the media accusing the negotiators "of failing to bargain more shrewdly"[295] and claiming that their country had suffered a terrible diplomatic defeat. Even Prime Minister Sato's declaring that Japan could be proud that its currency now enjoyed such high international regard did not make an impression. But the Japanese business sector was more upbeat than the hostile media, welcoming greater exchange rate stability.

The Smithsonian agreement did not produce clear-cut winners or losers. The United States had succeeded in greatly reducing the role of gold but had suffered some loss of prestige for agreeing to devalue the dollar. And although France regretted the diminished position of gold, it did not, on a weighted basis, revalue the franc. The same was true for the United Kingdom, whereas the Italian lira even showed a small devaluation. As for Germany, "a high[-ranking] United States Treasury official" (Volcker?) expressed the view that "[t]he Germans got away too easily"[296] at the Smithsonian, an opinion that Emminger shared in his memoirs. He also felt that the IMF as overseer of the international monetary system had lost prestige for having remained mostly silent, concentrating on technical work.

Selling the settlement

Success in selling devaluations and revaluations at home depends largely on how they are presented. Here President Nixon again displayed his talent for turning what could be a painful event into a seeming victory. He and Connally agreed that they had "to hit the "more jobs for the United States' line,"[297] arguing that devaluation would make American goods more competitive and create jobs. Peter Peterson—then a White House aide soon to become secretary of commerce—was tasked to brief the press. He optimistically claimed that 700,000 new jobs would be added because of devaluation, bringing down the unemployment rate from 6% to 5.2%. No mention was made of the high probability that the lower value of the greenback would lead to a further increase in inflation. The price and wage controls had not brought what the administration had hoped. After some initial success in restraining wage hikes, the controls had lowered resistance to fiscal expansion and were already fueling inflation. But that did not disturb Nixon, who was determined to create an economic boom, all but ensuring his reelection. The Federal Reserve was also in expansionary mode, leading to the charge that Arthur Burns was helping the president in his election campaign. And "[i]t became part of Nixon folklore that the boom of 1972 was just another example of Nixon's abuse of power, that he and his friend Arthur Burns had recklessly pumped up demand to win the election."[298]

The bargaining at the Smithsonian Castle had sometimes been tough, and "while Connally deserved credit for breaking the monetary impasse . . . his strong-arm tactics undermined allied unity and trust, and his mercantilist premises were theoretically primitive."[299] Prominent Europeans such as Giscard d'Estaing, Zijlstra, and Carli, the respected Italian central bank governor—as well as Canadian monetary officials—had grown tired of the U.S. treasury secretary's abrasive behavior. As for the Germans, they were leery of Connally's penchant for unexpected actions. Surprisingly, Connally and his Japanese counterpart Mizuta got along well after the Smithsonian drama. On one occasion, they exchanged gifts, the American receiving a lacquered mask representing a Japanese demon, with Mizuta joking that "[t]his is the demon who . . . protects ladies. So if you keep it in your house, Mrs. Connally and your daughters will always be safe."[300] The Texan then promised the Japanese minister a pair of custom-made cowboy boots and proceeded to trace Mizuta's foot on a sheet of paper. Taken aback a bit, the minister said, "In Japan, there is a saying that a man with a big foot has a small brain."[301] Connally, displaying his Texas wit, replied "No, you shouldn't worry about that. On the contrary, in my country there is a saying that a man with a big foot is liked by the ladies."[302]

The crisis returns

"The two years following the Smithsonian agreement were the most economically turbulent of the postwar period up to that point."[303] The markets briefly greeted the realignment with a sigh of relief, but soon policymakers were again preoccupied by renewed pressure on the dollar. Only weeks after “the most important monetary agreement in history,” waves of hot money drove up the currencies of Germany, the Netherlands, Belgium, and Japan, and—whether they liked it or not—their central banks had to buy large amounts of dollars under the reinstated rules. Having thought a bit more about what had been agreed in the hallowed halls of the Smithsonian Castle, market traders started to worry that a devalued dollar might be devalued again: “[T]he unthinkable had now become possible, and even plausible.”[304] The United States did not give a single sign that it was going to defend the dollar, let alone restore its convertibility into gold. And Connally, reverting to his old style at a meeting of the Quadriad in late January 1972, complained bitterly that trade talks with other countries were not satisfactory, urging “punitive measures.” He also threatened refusing to make “one cent” of America’s international reserves available to the IMF to enable it to function. Burns explained that such steps would undermine the Smithsonian currency agreement, the more so seeing that markets were already nervous. He also emphasized the need to move quickly on getting the new gold price approved by Congress. Annoyed, the secretary started ranting, culminating in blaming the “damned foreigners.”

Nixon had quickly lost interest in monetary matters and was fixated on achieving high rates of economic growth supported by strong monetary stimulus. This stance did not sit well with America’s main trading partners, part of the pumped up U.S. money supply spilling over to countries where more dollars were not welcome. Unhappy central banks in surplus countries reacted quickly to the dollar flood with strong measures. The German Bundesbank was first off the mark, lowering its discount rate twice to 3%, making it less attractive to park money in solid Germany. But because the central bank’s action made credit cheaper, it also served as compensation for the dampening economic effect of the revaluation, pleasing Minister Schiller, who had pushed hard for such a move. But even stronger medicine was needed, and the German government, led by Willy Brandt—who resigned 2 years later after the discovery of an East German spy on his staff—opted for introducing capital controls to fend of hot money. The main instrument, known as the *Bardepot* (empty deposit), required that 40% of borrowing from abroad by German companies be held without interest paid. Because German corporations nonetheless could circumvent the measure by borrowing cheaply on the eurodollar market, the measure was later tightened. But all this did not happen without a fight within the German cabinet, pitting Karl Schiller, a maverick free market Social Democrat, against Chancellor Brandt and other ministers, who favored restricting capital flows. After Schiller lost the battle, in which he was also opposed by the powerful Bundesbank, he resigned and for a while threw in his lot with the opposition Christian Democrats.

A European snake

Between March and June the markets remained calm as the capital controls introduced by Germany and its economic satellites, as well as by Japan, were working for the time being. But the Europeans were not comfortable with the situation and on March 7, 1972, the members of the European Common Market started an experiment to tie their currencies closer together. The path chosen was to narrow the margins within which the European currencies could freely move against each other to 2.25% from the 4.5% agreed at the Smithsonian. In a popular graphic analogy, the European currencies could therefore wriggle like a snake in the Smithsonian tunnel. The arrangement had strong political roots, being not only an antidote to swings in the value of the dollar but also a first step toward a European Monetary Union, as proposed in a 1970 report by Pierre Werner, prime minister of Luxemburg. But the snake in the tunnel was not a success, and having become “a shooting gallery for the speculators,”[305] the reptile started suffocating in June as the pound sterling came under heavy attack. The markets had become nervous about the deteriorating British trade balance and a wage explosion that was fueling inflation. They also reacted negatively to the new Conservative Party government’s “dash for growth” in an already overheating economy. And the benign neglect message of the inexperienced chancellor of the exchequer, Anthony Barber, “that it is neither necessary nor desirable to distort domestic economies to an unacceptable extent in order to maintain unrealistic exchange rates,”[306] did nothing to instill confidence. Adding fuel to the fire, the Labour Party’s shadow minister of finance, Denis Healy, a political animal and future chancellor, suggested that the pound could be devalued in the next 2 months. All this forced the Bank of England to intervene heavily to support the pound sterling, in the process losing $2.6 billion, mostly in German marks and other European currencies, in a matter of a week. Realizing that the situation was untenable, British prime minister Edward (Ted) Heath threw in the towel on June 23 and announced that the pound would float “for a temporary period.” Not an auspicious start for the Conservative government, which in the following years would face several deep crises.

After sterling’s inglorious depreciation, currency markets moved large amounts of funds to continental Europe and Japan, fearing another devaluation of the dollar. Traders and investors, already nervous after so much turmoil, perceived a lack of commitment by the United States to the Smithsonian agreement and between June 28 and July 14, 1972, no less than $6 billion was transferred from New York, mainly to Frankfurt, Tokyo, and Amsterdam. For a long time the, U.S. Treasury opposed any countermeasures by the Federal Reserve but in the face of a new attack on the dollar authorized the central bank to sell a small amount of foreign exchange. Markets optimistically interpreted the action that the United States was, after all, willing to do something to quell speculative fever. But after the media hailed the Fed's intervention, the Nixon administration, feeling embarrassed by the Fed's sudden prominence in international monetary matters, subsequently ordered the central bank to halt its sales of German marks. While this reversal confused the markets and the dollar fell sharply, the White House did not show any sign that this was something to worry about.

12. Nixon triumphant

After a mild winter in 1972, spring in Washington was, as usual, brief but beautiful. Tourist flocked to take in the sight of the white and pink blossoms of the cherry trees around the tidal basin—a gift from Japan in the early 20th century when William Taft was president. And as always large crowds waited in line to ascend to the lookout point of the imposing Washington monument or swarmed to Washington's world famous museums. Another major attraction was visiting the White House, still open to the public without the severe security measures that had to be taken in future years. Nixon, although not endowed with a Reaganlike optimism, was looking forward to his increasingly likely re-election in November. But there remained the burden of the Vietnam War, still dragging on after Nixon had been in office for more than 3 years. Demonstrations against the war continued, and "Hanoi Jane" Fonda was added to the enemies list. By contrast developments at home were favorable: Economic growth was picking up (and would reach an impressive 6% that year), unemployment was coming down, and inflation was not yet a real concern. It was clear that the president did not worry about price increases in an election year even as pressures were building under the lid of price and wage controls—after all, falling unemployment numbers were key to capture the labor union vote. Nixon had also courted the acerbic union boss George Meany with considerable success, helping Nixon gather the vote of the "uneducated people" whom the president considered "strong" on issues such as drugs, crime, and defense, whereas "the educated people and the leader class no longer have any character and you can't count on them."[307] International monetary matters were the least of his worries, and Nixon lost interest in them quickly after the Smithsonian realignment.

Let's make a deal

Unfinished business included a smooth replacement of John Connally, who after his apparent success in arranging the realignment of December 18, 1971 was not ready to let trade issues go away, increasing the risk of reigniting friction with America's allies. Lifting the punitive import surcharge as promised had reduced the United States' bargaining power, trade concessions from its main trading partners had been meager—not going much beyond improving access of American citrus exports—leaving Connally frustrated. Again Henry Kissinger was concerned about the secretary of the treasury's combativeness as well as his ambition of becoming president in 1976 with Nixon backing him. But, astute politician that he was, Connally had opted for another strategy than head-to-head confrontation on trade and monetary matters.

He approached Emile van Lennep, the ambitious secretary-general of the OECD, with whom he had briefly discussed the role of the Paris-based organization, and made him an offer he could not refuse. Van Lennep, a skilled diplomat, was to create a high-level group with the authority to talk about both monetary and trade matters and their interaction. This was fully in line with the secretary-general's ambition to strengthen the OECD's position among international organizations. The American had insisted that the new monetary and trade group be composed of officials from the G-10 countries and also meet at the ministerial level. But the proposal soon ran into resistance not anticipated by the enthusiastic Van Lennep. The French were suspicious, because the proposal was American inspired. And as the idea was being pushed by the U.S. Treasury, the foreign affairs and trade ministers of most G-10 member nations feared that they would be outflanked by their ministers of finance. Nor was the IMF enamored of the American plan, which it perceived as an intrusion on its territory. The fate of the Van Lennep/Connally plan was to be decided by the OECD's ministerial council meeting, but just before the date of the meeting, Connally resigned, leaving Volcker holding the bag. Volcker did not protest when Valéry Giscard d'Estaing led the opposition to the initiative, effectively killing Connally's pet project. Instead, an existing group was to be adapted to perform roughly the same job as intended by the Americans and Van Lennep, but it provoked "almost hysterical opposition"[308] from outside the G-10. And with that, the project was buried.

In the saddle again

The announcement of the charismatic Texan's departure came as a surprise, but without recrimination from his side. Nixon had toyed with the idea of appointing Connally deputy president for international economic affairs in addition to his treasury job, hoping to entice him to stay. But the White House "Germans" and George Shultz did not like the idea. The trio agreed that the president needed his own loyal advisors, "who knew what was going on and would look out for his interests." "We are all Nixon men, not Connally men,"[309] said Shultz, who perceived that the treasury secretary had become disconnected from Nixon. Going on, Shultz opined that "Connally doesn't have the depth, breadth, or ultimate responsibility," adding that "Nixon is a much deeper, more subtle man than Connally; has values, Connally doesn't." When the message was conveyed to the president, he dropped his idea. The turning point came in April 1972 when Connally, who already sensed that the White House staff was working toward his ouster, exploded after being told that a Treasury official had been contacted by someone in the White House without checking with him. Turning on Haldeman, Connally bellowed that "this was the last straw" and "that . . . there's clearly a conspiracy."[310] Calming down after a while, he accepted that George Shultz would be his successor. But Nixon did not want to unceremoniously dump the man he admired in many ways, still considering Connally the only person with the right personality to become president in 1976.

In typical Nixon fashion, the president devised a clever ploy to announce the treasury secretary's replacement. After opposition from Republican conservatives to his initial plan to replace Spiro Agnew, the ineffective vice-president, with Connally as his running mate in the November election, the president asked the Texan to start a "Democrats for Nixon" project with the aim of luring conservative and southern democrats to move to the Nixon camp. Nixon announced Connally's resignation from the Treasury on May 16, 1972, encouraging his Texan friend to go abroad on an extensive goodwill tour. The former secretary was received politely but with no great enthusiasm in Europe. His reception in Tokyo by Minister Mizuta was apparently friendlier, and gifts were exchanged. Connally played his new role with gusto, delivering pro-Nixon speeches and hosting a barbeque for the president and 400 prominent Democrats at his Texas ranch. He also continued to provide Nixon with political advice, not always wisely, in the eyes of other counselors of the president.

Shultz versus Burns

When George Shultz, until then secretary of labor, took over as head of the Treasury, he was immediately faced with a challenge from Arthur Burns. The chairman of the Fed, a lone crusader for full adherence by the United States to the Smithsonian agreement, had given a widely reported speech in Montreal on May 12, 1972, to the same gathering of international bankers that Connally had so forcefully addressed a year earlier in Munich. Burns warned against a lack of commitment to make the revamped monetary system work. And if policy cooperation was delayed longer, "we might find the world divided into restrictive and inward-looking blocs . . . a world of financial manipulation, economic restrictions and political friction."[311] The sting in the speech was the central banker's suggestion to restore dollar convertibility into gold in some form. With Connally absent, Paul Volcker took it upon himself to react, and react strongly, to the chief of the Fed's having trespassed on what he considered the territory of the U.S. Treasury. Briefing the press, the Treasury point man emphasized that Burns was "not speaking for the United States government,"[312] implying that Burns should keep his mouth shut about gold and exchange rates. Asked why he had expressed an opinion on convertibility while there was no official position of the government, Burns responded tartly that "[in] the United States we have an independent central bank," adding that it had been his own decision to raise the issue.

A month earlier the central banker had already displayed an independent streak by complaining about the administration's continuing pressure to pump up the money supply. This had been a response to a scolding by John Erlichman at the behest of Nixon about a lack of loyalty and a warning "that the president would hold [Burns] personally responsible for the money supply."[313] But after the November election, the central bank chief was accused of helping the president getting reelected by loosening monetary policy and allowing a spurt in the money supply of 11% in 1972, giving the economy a potent shot in the arm. Volcker could not understand how Burns could square his preference for fixed exchange rates with such a lax monetary policy and told him: "Arthur, if you want a par value [fixed exchange rates] system you had better go home and tighten [money] right away."[314]

Elsewhere in the world Burns's speech in Montreal was welcomed by treasuries and central banks, who had interpreted American silence as a lack of commitment to play by the Smithsonian rules. The Europeans' well-founded suspicion was first aired in February 1972 in a letter from

President Pompidou to the American president, complaining, "I am not confident that the combination of a large budgetary deficit and a policy of low interest rates can strengthen the confidence of the international community,"[315] implying that such a policy mix could lead to another devaluation of the dollar. Nixon shrugged off Pompidou's sharp rebuke, focusing singlemindedly on his upcoming spectacular visit with Mao Zedong and on accumulating votes to get re-elected.

Who cares?

Nixon's neglect of international monetary matters continued even as the Smithsonian edifice started to crumble as illustrated by a conversation between Bob Haldeman and his boss on the latest episode of turmoil on currency markets. The brief exchange was faithfully recorded on tape by the recording system that had been installed in the White House a few years earlier on Nixon's orders:

> H: Did you get the report that the British floated the pound last night?
> N: No, I don't think so, have I?
> H: They did.
> N: That's devaluation?
> H: Yeah. Flanigan's [a White House staffer] got a report of it right here.
> N: I don't care about it.
> H: You want a rundown?
> N: No. I don't care. Nothing we can do about it.
> H: He argues that it shows the wisdom of our refusal to consider convertibility until we get a new monetary system.
> N: Good. I think he's right. It's too complicated for me to get into.
> H: Burns expects a 5% devaluation against the dollar.
> N: Yeah. Okay. Fine.
> H: Burns is concerned about speculation about the lira.
> N: Well, I don't give a shit about the lira.
> H: That's the substance of that.[316]

Economy and election

As the American economy improved impressively, growing in the second quarter of 1972 at a staggering annual rate of 9%, Nixon cheered, "we *have* gotten the economy going"[317] in a meeting with his economic advisors. As his ratings in the polls improved, his confidence in re-election rapidly increased. The Democrat Edmund Muskie, who was initially giving Nixon a run for his money in the polls, faded as the campaign progressed, making way for George McGovern, a liberal senator from South Dakota to be the Democratic Party's candidate for the November presidential election. Nixon and his inner circle could hardly hide their glee, instantly seeing that McGovern was too far left to capture the votes of the center. But just to make sure, Nixon attacked his opponent harshly, labeling him the candidate of "amnesty, acid and abortion."[318] While already ahead in the polls before McGovern's sudden elevation, Nixon now looked set for an easy victory. And on Election Day 1972, the hapless senator from the northern prairie won only a single state in what became a landslide victory for the incumbent.

Nixon was excited, flashing his trademark victory sign with outstretched arms and two fingers forming a V shape, his buttoned suit jacket stretched awkwardly across his stomach. All the hard work of the campaign had paid off handsomely. But instead of cherishing the moment, Nixon brooded over how to hurt his enemies, a list of whom was neatly kept by his general counsel, 34-year-old John Dean, and special advisor Charles Colson, who masterminded many of the dirty tricks of which the president later claimed to have had no advance knowledge. And in the back of his mind, Nixon felt somewhat uneasy that a break-in at the National Headquarters of the Democratic Party, already traced to the White House, might eventually lead to the president himself.

A third-rate burglary

At first a bungled burglary of the Watergate office of the Democratic Party National Committee by five masked men with Spanish accents in the early morning of June 17, 1972, drew little attention. A modest report by two young investigative reporters appeared in the *Washington Post*. Democratic Party leaders protested vigorously about the criminal act, obviously aimed at obtaining confidential documents. But the public, used to dirty tricks during election campaigns, hardly paid any attention. The main news in the days after the break-in focused on Hurricane Agnes, the worst storm to hit the United States in 50 years, leaving 119 persons dead and unprecedented damage in its wake. In Washington the Potomac River overflowed its banks and inundated the waterfront streets of Georgetown by up to 7 feet of water after the rainfall peaked at 13 inches. Even the White House did not remain unaffected, reporters noticing wet carpets in the basement press room. And Nixon, who had been snatching a brief vacation on a privately owned island in the Bahamas after a tiring, extensive trip abroad, including to Russia, delayed his return flight to Washington to avoid a very bumpy ride.

At the same time, journalists Carl Bernstein and Bob Woodward of the *Washington Post*, working together, uncovered more evidence in what came to be known as the Watergate scandal, prompting Nixon to declare at a press conference on June 22 that "[t]he White House had no involvement whatever in this particular incident."[319] The very next day, the president got involved in the coverup of Watergate by instructing Haldeman to let the FBI know, with the help of the CIA, to cease their embryonic investigation in the affair. The smokescreen was to be that matters of national security were involved. Nixon's incriminating instructions would remain secret for 2 more years, setting the stage for the coverup of the Watergate break-in—described by his spokesman as "a third-rate burglary"—to grow into an unprecedented national drama.

But for the remainder of 1972, Watergate would not be a threat to Nixon's presidency, although the evidence of serious wrongdoing was gradually accumulating. In late August, the *Washington Post* obtained a copy of a report by the General Accounting Office that listed 11 "apparent and probable violations"[320] of campaign financing laws by the Committee for Re-Election of the President (CREEP) and that also mentioned that Maurice Stans, former secretary of commerce and now in charge of raising money for the Republican Party, had a secret slush fund of $350,000 in his office to be used for paying hush money.

The president, wishing to lay the matter to rest, spoke to the press on August 29 at his home in San Clemente—the Western White House—with superb views of California's Pacific coast. There had been technical violations of the law regarding campaign financing on both sides, Nixon claimed calmly, calling Stans "an honest man and one who is very meticulous."[321] He also told the assembled reporters that on the basis of a Watergate investigation by his counsel, John Dean, it was clear that nobody in his staff or administration was involved. A still confident Nixon then gratuitously added that "[w]hat really hurts in these matters of this sort is not the fact that they occur, because overzealous people in campaigns do things that are wrong. What really hurts is if you try to cover it up."[322] Words that would come to haunt the president.

The mysterious Deep Throat

Bernstein and Woodward were determined to establish that the Watergate break-in, as well as other clandestine operations and dirty tricks, had been ordered by persons in the White House. Tapping a wide variety of sources, they were making progress in finding incriminating evidence against some staffers within the presidential mansion, including Jeb Stuart Magruder working closely with Haldeman and Dwight Chapin, Nixon's appointments secretary. Attorney General John Mitchell—whose boozy wife Martha was making all kinds of accusations and calling people in the middle of the night to get the message out—resigned as Nixon's election campaign manager after the bungled Watergate burglary. And in September a special Watergate prosecutor ordered the five "Cubans" who had been caught red-handed at the Watergate, plus their "handlers," slippery ex-spy Howard Hunt and scary ex-CIA operator Gordon Liddy, to appear before a grand jury. But the *Washington Post* journalists were convinced that there were bigger fish to fry. Digging deeper and obtaining important insider information from an anonymous source—40 years later revealed to be senior FBI official Mark Felt, at the time known only as "Deep Throat"—the *Washington Post* of October 10, 1972, revealed that "FBI agents have established that the Watergate bugging incident stemmed from a massive campaign of political spying and sabotage and conducted on behalf of President Nixon's re-election and directed by officials of the White House and the Committee for the Re-election of the President."[323]

The story was immediately dismissed by White House press officer Ronald Ziegler, whose continuous denials of new revelations would become an almost daily event. But entering the home stretch of the campaign contest, the president was not overly concerned with the news about Watergate, feeling that "the alleged conspiracy is perceived by most of the public as a distant and even amateurish intrigue far removed from the Oval Office."[324] And when the brash young *Post* journalists accused Bob Haldeman, White House chief of staff and Nixon's closest confidant, of being part of the conspiracy while lacking sufficient proof, they lost credibility. Watergate now all but disappeared from the radar, overshadowed by reports such as Kissinger's assurance that "peace is at hand" after intensive negotiations with the North Vietnamese.

Foreign policy to the fore

1972 was a successful year for Nixon: The economy took off like a rocket, the opening to China had been received around the world with surprise and awe, the conflict in Vietnam seemed to be drawing to an end, and, best of all, he was re-elected with an overwhelming majority. But just to make sure that the North Vietnamese did not drag their feet in the peace negotiations, he ordered heavy bombing by B-52s of Hanoi around Christmas. Not perturbed by the worldwide outcry over this sudden aggression, Nixon was looking forward to more foreign successes in dealing with China and Russia. Now, more than ever, the president felt that he probably did not have to concern himself much with monetary matters. He could safely rely on George Shultz to run the economy and to keep Arthur Burns from being too independent. Moreover, currency markets had remained free of turmoil in the second half of 1972. And at the annual meeting of the IMF in September, a special Ministerial Committee to study international monetary reform was launched, prompting Germany's Helmut Schmidt to declare optimistically that "the religious wars"[325] over currency reform had ended.

These apparently positive developments also provided Nixon with an excuse not to meet with other heads of government to discuss gold and the dollar. Never showing much interest in monetary matters, the American president preferred to engage with Mao Zedong and Chou en Lai from China and the Russian Party leader Leonid Brezhnev, to talk about strategic issues, rather than sitting down with Germany's Willy Brandt, France's Georges Pompidou with whom he had only a few weeks before grappled on the Azores, and the Italian prime minister, whoever that was now. And although Britain's conservative prime minister, Ted Heath, would no doubt wish to maintain his country's role as the closest junior partner of the United States, he led a country viewed as the sick man of Europe. As the apparently successful leader of the strongest country in the world, Richard Nixon had reached the peak of his career and believed he could with impunity ignore others' preoccupation with the exchange rate of the dollar.

Connally: political advisor

Typically, Nixon and Connally had not paid heed to Burns's serious warnings in his speech in Montreal of the danger of a worldwide economic malaise if economic stability was not re-established. Had the Texan, whom the president greatly admired, stayed on or become deputy president for international economic affairs as the Nixon had considered, the global picture could have been quite different. Connally was not likely to have abandoned his nationalistic and mercantilist instincts, raising the specter of trade and currency wars. No doubt, Volcker, Burns, and others would have objected to his "Texas economics," but Connally probably would not have listened to them, let alone to warnings from foreigners whom he did not trust. Nixon was the only person who could have stopped him from taking aggressive action, such as reinstating the import surcharges to punish Europe and Japan for not making enough concessions. And as Nixon was to come under increasing pressure over Watergate, spending more and more time fighting the allegations made against him, he was advised by Connally to tough it out. The former secretary of the treasury also fully supported the bombing of Hanoi in December 1972, which led to angry reactions and condemnation. Strikingly, Volcker, who also claimed admiration for his former boss, 20 years later confessed that: "Some of the views [Connally] was fond of expressing in private about foreign policy and particularly about Vietnam alarmed me."[326] Apparently the Texan in talking in private shared the hardcore views of World War II hero General Curtis LeMay, who had a few years earlier advocated using America's nuclear firepower to bomb Hanoi "to the stone age." And had the bellicose Connally attained more power, especially by becoming president in 1976, the world would have been a more dangerous place.

Fighting cancer

Although the *Washington Post* revealed on October 1, 1972, that persons in the White House had knowledge of the Watergate break-in, Nixon in mid-November 1972 still "felt sure that [Watergate] was just a public relations problem that only needed a public relations solution."[327] But such equanimity would not last long as more and more evidence was discovered about the break-in, other criminal acts and coverups. The president started to seriously worry when in February 1973 Sam Ervin, a folksy, elderly Democratic Senator from North Carolina, opened Senate hearings about Watergate and requested the release of relevant documents. Nixon, feeling the heat, declared emphatically at a news conference on March 2 that "no one on the White House staff . . . was involved or had knowledge of the Watergate affair."[328] But on March 21, 1973, his general counsel, John Dean, told the president in urgent tones that there was "a cancer within—close to the presidency, that's growing. It's growing daily."[329] After Dean revealed that the White House was being blackmailed by the dirty tricks team, known as the "plumbers," hush money was discussed and subsequently paid out.

The atmosphere at the White House was becoming increasingly grim; there was a pervasive lack of trust, and backstabbing was frequent, as was leaking to the press. Well-known journalist Elizabeth Drew commented that the president's residence was: "A place of suspicions . . . resembling the court of the Borgias." Adding to the increasingly isolated Nixon's headaches, the judge investigating Watergate, John Sirica, released a letter from one of the already convicted burglars, James McCord, citing misdeeds performed by others and claiming that he had been pressured to plead guilty. At this point Dean realized that "the dam was cracking."[330] And the question on the lips of politicians, journalists and the public was "what did he [Nixon] know and when did he know it?"[331] The situation had now become so serious that in early 1973 the American leader, hugely distracted by Watergate, had little time for paying attention to other issues. Already known for displaying limited interest in economic matters, Nixon now virtually ignored accelerating inflation at home and renewed currency turmoil on international currency markets. He gladly left Connally's successor, the soft-spoken and patient George Shultz, whom he rightly regarded as a safe pair of hands, to deal with the sudden bad economic news in the course of 1973.

Inflation on the rise

The official economic advisors, now led by Herbert Stein, had predicted inflation falling from 3.5% in 1972 to a mere 2.5% the following year. This was pure cheerleading, leaving the advisors with egg on their faces in the course of 1973 when it became clear that price increases were running at triple their forecast. With an economy growing at a clip in excess of 8%, demand-driven inflation was taking over from cost push inflation, which was still repressed by price and wage controls. But this shift was recognized too late by the Fed as it continued to follow an easy money policy, adding fuel to already strong consumption and investment. When the Fed finally—much later in 1973—started to apply the monetary brakes, it was too late, prices rising by a shocking 8.4% for the year. Loose monetary policy in the United States was also affecting the dollar exchange rate. The trouble started in late January 1973 as the Italian lira once again came under pressure and Rome introduced a separate floating exchange rate for capital transactions, much as France had done earlier. Like capital controls the dual exchange rate relieved pressure on the official rate for trade transactions but was prone to circumvention. Money from Italy flowed into rock-solid Switzerland. The "Swiss panicked" and soon let their currency float as large inflows of dollars pushed up their rate of inflation. Other countries were also receiving large amounts of hot money. Poor trade numbers for the United States made matters worse.

Having received permission from a reluctant Treasury, the Fed sold a small amount of German marks for a short period and briefly succeeded in calming the markets. But Europeans saw the American intervention as insufficient. The strongest criticism was vented by German minister of finance Helmut Schmidt, complaining about the United States' refusal to sell gold or foreign exchange to counter the speculative wave. In turn, he refused to revalue the mark and blamed the new crisis on the dollar's worldwide fragility. Mentioning at his press conference that he had been in touch with the American treasury secretary Shultz, who had recommended letting the mark float, Schmidt commented: "Had we followed his advice this would have driven France up the highest tree."[332] Still on a steep learning curve on how to comment in public about exchange rates, Schmidt could not have been happy with the reaction to his words. The demand for marks was enormous when the markets opened after the weekend, some $6 billion of hot money pouring into Germany. It was "far away the heaviest speculative attack recorded up to that point."[333]

The flying U-boat

To the main players in the international policy arena, Shultz, Volcker, Schmidt, and Giscard, the situation had become untenable. With the pound floating since June 1972, the British were less involved and what the Japanese thought remained unclear. The United States took the initiative to take drastic action, sending Paul Volcker once again on a secret mission to capitals with instructions to negotiate another devaluation of the dollar, this time of 10%. Tall Paul worried that the premature sudden termination of all mandatory price and wage controls was adding fuel to inflation. And he recognized that "the unanticipated lifting of controls across the board would send a signal of indifference to both domestic and international audiences," especially since loose monetary policy was already providing the same unfortunate signal. Accordingly, it was a good time to talk in full confidentially about another currency realignment. Volcker, this time accompanied by Sam Cross, a year later to be appointed the U.S. executive director at the IMF, took off on February 7,

Paul Volcker and Dutch Finance Minister Roelof Nelisse, with central bank governor Jelle Zijlstra right behind him, The Hague, June 1972. (Courtesy Netherlands Bank.)

1973, in his "flying U-boat,"[334] as the Germans jokingly dubbed his windowless government plane.

The respected undersecretary, who informally had attained the status of a minister, first landed in a wintry Tokyo and was immediately driven to the private home of Japan's new minister of finance, Kiichi Aichi. Secrecy was of the essence, as any leaks could cause chaos on currency markets. A practical problem was Volcker's height, making him easy to spot, but no incidents occurred. Negotiations on the second devaluation of the dollar went smoothly, in stark contrast to the duels in the run up to the Smithsonian agreement. Volcker's strategy was to tell the Japanese minister that the United States was willing to devalue the dollar against gold by 10% but that in addition the yen should revalue by 10% against gold for an overall revaluation of the yen of 20% against the dollar. Such a large number was justified by Japan's soaring exports. The European currencies would stay where they were against gold, so that they would become 10% dearer against the dollar. But Japan had to move first, the alternative being disorderly general floating, which would hurt world trade and promote friction among allies. Minister Aichi was prepared to let the yen float upward—he ruled out a fixed revaluation—but did not explicitly agree that it should be by 20%. Volcker reckoned that this was enough of a commitment to present to the Europeans.

The Americans took off for Germany but ran into logistical problems at Anchorage, Alaska, where planes flying between Asia and Europe had to refuel at the time. Delayed by several hours, Volcker arrived too late to meet with Helmut Schmidt, who was just on his way from Bonn to Paris to confer with his colleague and friend Valéry Giscard d'Estaing. Volcker worried that a meeting between Schmidt and Giscard would complicate negotiations, feeling that he could make more headway with the German before he had been exposed to a French mental massage. When the next morning Volcker met with Schmidt, joined by the redoubtable Otmar Emminger of the Bundesbank, the German minister was somewhat reserved, explaining in excellent English that he needed to deliberate with his fellow European ministers. At the next stop, foggy London, Chancellor Anthony Barber was happy to go along with the American proposal, Britain having less at stake than other European countries.

Chez Giscard

A more challenging meeting loomed with the experienced French minister whose ideas were crucial in coming to an agreement. In an inspired mood, Giscard decided to invite Schmidt and Barber to join him at his well-appointed apartment in Paris to jointly discuss the American proposals with Volcker. And since the Italians, afraid to be excluded, also wanted to hear from Volcker, he quickly flew to Rome, picked up the Italian finance minister, Giovanni Malagodi, and returned with him to Paris in time to join the secret discussion late in the evening. Giscard did not challenge the size of the dollar devaluation, something of a relief. But when Volcker proposed that G-10 countries should, when needed, sell gold in the market to discourage speculation, the French minister politely demurred. The other guests, although not gold fanatics like the French, supported Giscard rather than Volcker.

The American took the setback in stride and turned his attention to tying down the Japanese commitment. This was done in Bonn the next day, when Volcker struck a deal with a Japanese senior official who had been hastily dispatched to Germany. The man from Tokyo's opening bid was to let the yen appreciate by 17%. Apparently the ominous number 17%, so vigorously rejected by the previous Japanese Minister of Finance, was no longer taboo. Volcker pressed for an upward float of the yen of 20%, which had the support of the Europeans. This time, the undersecretary's skillful monetary diplomacy, a combination of the carrot (devaluation and loss of prestige on the American side) and the stick (chaotic floating without agreement) achieved an impressively quick resolution. The Volcker agreement was received with enthusiasm and hailed in Germany as a prestige "win." Central banks were more reserved in their comments, Arthur Burns having made a final appeal to avoid gliding toward floating. But Volcker did not understand how the central banker could support a return to the Bretton Woods system without tightening monetary policy, in the absence of which the dollar would crash.

A third devaluation?

Reality set in very soon as currency traders and investors reacted not with acclaim, but with skepticism to the new rates. After two devaluations of the dollar, a third one could not be ruled out, and return to the convertibility of dollars into gold seemed farther away than ever. Furthermore, the Watergate affair, now also firmly on the radar outside the United States, was contributing to undermining confidence. To some commentators, the second devaluation in 14 months was a "tragic and unnecessary degradation of the dollar" and "the near-total destruction of American official credibility."[335] The markets responded in kind, central banks on the continent of Europe being forced to buy $3.6 billion on March 1, 1973, to prevent their currencies' values from breaking through their agreed ceilings. Ramping up capital controls had not been effective and hot money pushed German overnight interest rates into unprecedented negative territory as dollar holders were willing to pay a "fee" for protecting their money against devaluation. Roiled European foreign exchange markets were promptly closed until further notice.

A week later, at the invitation of Giscard, the most experienced and respected of Europe's finance ministers, the United States, Japan, Canada, Sweden, and Switzerland, joined the European Common Market members—by then numbering nine countries—for an emergency meeting in Paris. The Europeans, still hoping to persuade the Americans to take action, asked for dollar intervention by the Fed and suggested the issuance of U.S. government bonds with an exchange rate guarantee to make it attractive for foreigners to buy them. They also appealed to the Fed to raise interest rates. These requests were—as to be expected—not received well by George Shultz, although he "stressed the willingness of the United States to be cooperative,"[336] more of a diplomatic remark than a solid promise in the eyes of the Europeans.

From dirty to managed floating

Two days later, seven European central banks, including those of Germany, France, and several smaller countries, but not of the United Kingdom or Italy, announced that their currencies would float collectively against the dollar. No longer would they buy dollars to stay within the limits agreed just a few weeks earlier, but they would intervene in each other's currencies to maintain their floating bloc against the dollar. The snake arrangement had thus been reactivated, but the serpent was no longer confined to the tunnel of limited exchange rate margins. Part of the deal was a revaluation of the German mark by 3% at the insistence of France. But with the yen, pound sterling, Italian lira, Swiss franc, and Canadian dollar floating, the only vestige of the Bretton Woods system that remained was the European bloc, which itself was floating against the dollar. When the 14 countries met again on March 16, the question whether a float should be "clean" (without any intervention) or "dirty" was settled in general terms.

Having earlier advocated that no intervention should be allowed, Treasury Secretary Shultz now went along with a half-hearted acceptance of intervention, recognizing that leaving currencies totally free to float up and down could be disruptive. And so "dirty" floating became "managed" floating. But these vaguely formulated principles brought only short-term relief, and by May 1973, speculative attacks against the dollar flared up again. Accelerating inflation, a weak stock market and worries over the ability and willingness of American political leadership to act in the light of escalating Watergate accusations were reflected in a soaring gold price and a weakening dollar. Traders were taking short positions in the dollar that were paying off handsomely as the dollar dropped by an astounding 2% a day in early July. On the other side of the coin, the German mark had risen to 30% above its fixed rate limit agreed in February, and other European currencies were up by around 20%. And to add to the chaos, the gold price shot up to $127 per ounce, a far cry from the former official price of $42. Such extreme conditions on currency markets demonstrated clearly that a free-floating dollar was not the solution to all currency woes.

Traders and investors had become hypernervous, as had central banks, all of it duly reported by the eager media. The Federal Reserve was straining at the bit to intervene to support the dollar and on July 8 announced that it was operationally ready to step in to calm the markets. But the U.S. Treasury, run by floating rate advocate George Shultz, authorized only a few small interventions which were interpreted by the markets as a timid reaction by the United States. With no clear rules, the currency markets lacked guidance and uncertainty reigned interspersed by low speculative activity during the traditional summer lull. But, like Watergate, the monetary saga was not over.

13. Money masters

Besides John Connally, who was no longer in office to experience the final contractions of the Bretton Woods System, and Paul Volcker—who did—three personalities stood out in the battle over the monetary system that would continue into 1976 and end in a kind of armistice. On the American side, George Shultz pushed to dismantle the fixed exchange rate system, while on the European side Valéry Giscard d'Estaing fought just as hard to preserve as much as possible of the Bretton Woods regime. Germany's Helmut Schmidt also supported fixed rates but bowed to the inevitable at a later stage. Fortunately international co-operation, based on personal relationships, improved markedly. Shultz, Giscard, Schmidt, British chancellor Anthony Barber (later James Callahan), and Japanese minister Takeo Fukuda formed the "Library Group," a "private club"[337] who could informally discuss currency issues in complete confidentiality. They had met frequently during the dying days of the old monetary system at G-10 meetings and in still larger groups, which they found unwieldy. The five major monetary players concluded that it was more efficient to exchange views without the presence of smaller countries that carried less political clout. The name of the group was inspired by the venue of the first meeting: the library of the White House. The close-knit circle, of which even the IMF was not aware, would develop into a permanent forum for the world's five largest economic powers, soon known as the Group of Five. It would later be expanded with Italy, which had been very unhappy at being excluded, and Canada, becoming the Group of Seven (G-7).

Steady Shultz

George Shultz has enjoyed an unusually long and varied career, covering many different fields. A wartime marine in the Pacific theater, he obtained a doctorate in economics from the prestigious Massachusetts Institute of Technology and pursued a successful academic career. At the University of Chicago, the long-faced, soft-spoken professor became an ardent supporter of free markets under the influence of Milton Friedman and George Stigler, both future Nobel laureates. Shultz joined the first Nixon cabinet as labor secretary at 49, earning a reputation as a skilled mediator. In mid-1970 he became the first director of the Office of Management and Budget, where he developed a profound knowledge of budget policy. And when John Connally rode out of the Treasury on a high horse, Shultz became his successor.

Not known as an effective spokesman or political tactician, Shultz was nevertheless appreciated by Nixon for his outstanding management skills, loyalty, and integrity. Still, in one of his combative moods, the president, afraid that his treasury secretary might object to his order to have some of his enemies' tax returns audited, told John Dean that he would fire Shultz if he protested. And for good measure, he added that "[Shultz] didn't get Secretary of the Treasury because he's got nice blue eyes . . . It was a Goddamn favor to him to get that job."[338] It turned out much later that Shultz had quietly suppressed the audits. When he was in a different mood, the volatile president made Shultz a special assistant for economic affairs, in practice elevating him to "the focal point and the over-all coordinator of the entire economic decision-making process."[339]

In contrast to the flamboyant Connally, the new treasury chief was modest, diplomatic, nonconfrontational, and a good listener. He was also gregarious, differing markedly from the Texan, who had not written the manual on how to make and keep friends. Even though Shultz's vision of where the monetary system should go did not accord with those of his European colleagues, he got along well with them, especially as a co-founder of the Library Group. His relationship with Nixon was ambivalent. Although the president appreciated his qualities, he could be unpleasant in his contacts with the former Chicago professor. Shultz, initially a loyal supporter of the president, became “thoroughly disillusioned” with Nixon in the spring of 1973 when he realized that the American leader was “up to his neck in [the] Watergate affair” and that “he is devious [and] unprincipled.”[340] Plodding on, Shultz considered resigning several times but was talked out of it. When it transpired that the president had soured on Shultz, calling his performance “unsatisfactory”[341] at a gathering with advisors, the treasury secretary, sadder and wiser, left the administration in May 1974, a few months before the final act of the Watergate debacle.

After enjoying a successful business career, the quiet American returned to politics in 1982 as President Ronald Reagan’s secretary of state, a position he held for 6½ years, during which he became a highly respected international figure. Nevertheless, Shultz never came to appreciate international organizations much and later in life questioned the *raison d’etre* of the International Monetary Fund, like many conservative Americans who emphasize the exclusivity of their country. A family man, Shultz had five children with his first wife, who passed away in 1995. Two years later, the celebrity politician married a San Francisco socialite; the marriage was hailed as the wedding of the year in the Bay Area.

A paradoxical patrician

Valéry Giscard d’Estaing is one of the great men of 20th-century France and acquired an international reputation as brilliant and diplomatic and a superb strategic thinker. Less nationalistic than President De Gaulle, the tall and handsome minister of finance and long-serving president achieved more for his country than the confrontational general. Born into a patrician family, the young Giscard enjoyed an excellent education, displaying high intelligence and a strong academic record. After World War II, during which he had briefly served with the Free French Forces, he attended the prestigious Ecole National d’Aministration (ENA), a famous grooming ground for future high officials. Something of a loner, Giscard did not enjoy his time at the ENA but thrived when he became a civil servant, rapidly climbing the ranks. The promising young man was appointed state secretary (deputy minister) for the budget at the tender age of 31 in 1957, a time of great political turmoil in France. And in 1962, 4 years after Charles de Gaulle had brought stability to France, Giscard was installed as minister of finance with an elegant office on the Rue de Rivoli across from the Louvre museum.

In 1966 Giscard suffered a setback, being replaced as the keeper of the French Treasury by the Gaullist Michel Debré, thanks to showing too much of an independent streak to the taste of his imperial president. But this interregnum lasted only 3 years, as VGD—as he was often referred to—was recalled to the cabinet by Georges Pompidou when he succeeded De Gaulle in 1969. And after Pompidou's death of cancer in 1974, Giscard won the succession election and became the French leader for 7 years. As president of a country with a tradition of a difficult-to-satisfy population—De Gaulle famously remarked how complicated it was to govern a country producing 246 types of cheese—VGD's greatest success was achieved in the European theater. Together with the German leader, Helmut Schmidt, with whom he had developed a close bond, the Frenchman launched an ambitious plan in 1978 to work toward a monetary union, culminating after a rocky road in the introduction of a common European currency, the euro, some 20 years later.

During his career, being in a number of ways an admirer of the United States, if not of John Connally, Giscard never uttered anti-American sentiments, in contrast to quite a number of French politicians. And when he worked at the ministry of finance, a framed picture of John F. Kennedy adorned his desk. But as president, he never displayed a wish to align his country closer to the United States and kept France on the sidelines of NATO. Not easy to read, he could leave other world leaders unsure where he was heading. British prime minister Margaret Thatcher was no friend of Giscard, despite having "a soft spot for French charm."[342] To her, the French president was "a difficult interlocutor," and "though he had the manners of an aristocrat, he had the mind-set of a technocrat."

Commenting on VGD's personality, his biographers wrote: "Valéry Giscard d'Estaing is a complex man. Paradoxical. And often inaccessible with . . . shadow areas."[343] Equipped with "a very fast cerebral mechanism,"[344] he also possessed an excellent memory and was a master of ad-libbing. Although not his strongest point, he had a sense of humor, but could be erratic in his personal relationships, being "sometimes amicable and convivial and sometimes curt and disagreeable."[345] He also could display sudden anger; Schmidt relates in his memoirs how he once, at the height of the dollar drama in 1973, had to intervene to break up a shouting match between Giscard and the normally placid Shultz. Sometimes described by political opponents as calculating (what successful politician is not?) and inflexible, as well as vulnerable to personal attacks, Giscard was not the type to compile an enemies list. And a trait that gave him an advantage over many others was his enormous capacity for work, never showing fatigue at international and European meetings, which could drag on through the night. Although there were rumors of affairs—more or less a tradition among powerful Frenchman; his successor as president of France, Francois Mitterand, kept two families—Giscard was known as a good family man and had four children with his sophisticated wife Anne-Aymone. Much to his credit, he was not blind to the shortcomings of his compatriots, writing: "I saw there [at French cabinet meetings] one of the traits of the French character that handicaps our great actions: the obstinate holding back of information and knowledge, the refusal to communicate with others."[346] This was clearly not Giscard's style. But another typical French approach to tough discussions, mentioned by George Shultz with some admiration, is "to never give way . . . in order to maintain good relationships."[347] The French negotiators "usually remain charming, but are quite willing, in pursuing French interests, to incur the wrath that falls on the obstinate member in a negotiating session." VGD falls in this category.

A charismatic chancellor

Coming from a solid middle-class northern German family, Helmut Schmidt carried a family secret about his father's lineage. It was publicly revealed only after he had left politics that Schmidt senior was the illegitimate son of a German–Jewish businessman. But this was fortunately unknown when at age 22 Schmidt junior was conscripted into the German army and saw action on both the Eastern and Western fronts and—disgusted with the Nazi regime—was captured by the British just before the end of the war. Energetic and very bright, Schmidt assiduously worked his way up the political ladder of the Social Democratic Party, first in his native Hamburg and later in the German parliament. Argumentative, the young German politician was nicknamed "loudmouth," but also *Macher* (doer). He was first called to high office in 1969 at age 51, as minister of defense in the cabinet of Willy Brandt. This gave him a thorough grounding in military and strategic issues.

When Karl Schiller left in a huff as minister of finance in July 1972, Helmut Schmidt took over, remaining only 2 years in that position. But because he had distinguished himself during those historical years, marked by the collapse of the Bretton Woods system, he was ready to take over the mantle of chancellor when Willy Brandt stumbled over a spy scandal. During his 8 years as leader of the German government, Schmidt developed a strong domestic and international profile. He had to resign in 1982 only because his junior coalition partner, the Free Democrats (FDP), switched its allegiance. Schmidt, like Giscard, admired the United States and had been deeply inspired by President

Kennedy. He firmly believed in an integrated Europe embedded in a strong Atlantic alliance.

A serious strategic thinker himself, Schmidt had a high opinion of President Nixon's foreign policy acumen and his policy of *détente*, describing him in his memoirs as "a global political strategist of high order."[348] What the American president thought of the German chancellor is less clear, but his treasury secretary, George Shultz, was a fan, calling him "an easy man to like and to admire—bright, well-informed, and, to put it mildly, forthright with his views."[349] The flexible Shultz did not let differences over policy affect personal relationships, which he strongly believed were essential to reach compromises. Schmidt, who also appreciated Shultz, was concerned that Nixon's successor might lack a knack for foreign policy To his relief, Gerald Ford displayed a sound grasp of global politics, but the German leader was not in awe of how President Carter—whom he considered weak—handled strategic or economic problems. The American president, in turn was not enamored of Schmidt, "who seemed to believe that he knew more about each of the G-7 nations than did their elected leaders."[350] And on another occasion, Carter described the German chancellor as having "acted like a paranoid child"[351] during a bilateral meeting. Although Giscard and Schmidt became good friends and Giscard and Carter got along well, the animosity between the American and German leaders nicely illustrates how two friends do not necessarily have shared opinions of a third person. Another major player in the international arena, Margaret Thatcher, though often strongly disagreeing with him, had "the highest regard" for Helmut Schmidt, lauding him for his "wisdom, straightforwardness and grasp of international economics."[352]

Slightly built with a neatly combed full head of hair, the German chancellor impressed not with his physique, but with his convincing and knowledgeable rhetoric. And as is common among northern Germans, he was direct and to the point, sometimes causing some discomfort to those with different cultural backgrounds. But this trait was no obstacle in forging a unique friendship with Valéry Giscard d'Estaing, much to the benefit of European integration and also to global cooperation. An important basis for his closeness with Giscard was that both were pragmatist and centrists, one on the right, the other on the left. Schmidt hated to be called a socialist, emphasizing that he was a social democrat. But there was a difference in lifestyle, Giscard enjoying living in elegant and luxurious surroundings, whereas Schmidt was happy to stay in his modest Hamburg townhouse when he was not in Bonn. Living a life free of scandal, in contrast to his predecessor as chancellor, he was married for 68 years to his childhood sweetheart Loki.

Part III
Watergate

1. Escalation

Richard Nixon may have won the election in November 1972 with an overwhelming majority, but only weeks into his second term, the Watergate scandal escalated as growing evidence of an elaborate coverup became public. Besides the ever-active *Washington Post*, the *New York Times* and other newspapers, such as the *Los Angeles Times*, provided new accusations that the White House, and possibly the president, was involved in the sordid affair. Feeling the pressure, Nixon came to the conclusion that he had to do something drastic. On April 30, 1973, he announced the resignation of his two closest lieutenants, Bob Haldeman and John Erlichman. John Dean also packed his bags, as did the similarly tainted attorney general, Richard Kleindienst. Although tearfully communicating on television that letting the "Germans" go was one of the most difficult things he had ever done, Nixon had carefully planned his course, convinced that throwing his closest advisors to the wolves was the best way to take the heat off himself. An anonymous aide commented that "[f]or Nixon . . . the shortest distance between two points is over four corpses."[353] Declaring sanctimoniously that he would "do everything in [his] power to ensure that the guilty are brought to justice,"[354] only served to further raise suspicion that the president was somehow involved.

On cue, John Connally expressed his support for Nixon while announcing that he had switched to the Republican Party. The outspoken Texan also soon joined the White house staff as an advisor without pay. For one, Arthur Burns was not overjoyed by this semi-comeback, by now considering Connally an "amoral" man. And he resented the former treasury secretary's presence at important meetings, where he aired "some damned fool ideas."[355] Appointing his confidant as advisor hardly detracted from Nixon's growing isolation, having lost several key players from his staff, plus two attorneys general. Further trouble lay ahead as the Ervin Committee commenced its televised hearings. Viewed by a spellbound multi-million-member viewing public, witnesses were relentlessly grilled, many confessing to having lied and obstructed justice. But Haldeman and former Attorney General John Mitchell were not among them, sticking with the president. And because the investigation had not led directly to Nixon, Nixon felt that his presidency was not really endangered—that he could tough it out. He was, after all, used to dealing with crises as he had proudly described in his book *Six Crises*, which he often urged his beleaguered staff to read again. But this time, the stakes were higher than ever, and "Nixon was spending almost every waking moment on Watergate."[356]

There were ramifications both politically—the Soviet leader Leonid Brezhnev was aware of Nixon's Watergate distraction, giving Brezhnev an advantage when the world's two most powerful leaders met in June—and economically; the president took no effective action to reign-in escalating inflation. Touching to some, but viewed as being pushed by her father, the president's youngest daughter, Julie, had started to publicly defend him, revealing that he had considered resigning but had been dissuaded by his family because a resignation would be seen as an admission of guilt. As the pressure to release documents related to Watergate increased, Nixon in early July stated angrily that he would "not testify before the Committee [investing the Watergate scandal] or permit access to Presidential papers."[357]

A treasure trove

It was hot and humid on July 16, 1973, as Alexander Butterfield, Haldeman's former chief administrative aid, testified before the Ervin Committee. Public interest in the former aide's testimony was limited, as little that was new was expected to be revealed. But the energetic young investigative reporter Bob Woodward had entertained a hunch that Butterfield might be worth interviewing, because his duties in Haldeman's office had been defined as "internal security." After pressing the issue with reluctant staff members of the committee, Butterfield was questioned. The outcome was spectacular: It was established that "Nixon bugged himself."[358] When interrogated the next day by the Ervin Committee, the witness was ill at ease, knowing that a bomb was about to explode. Asked directly about the existence of taped conversations, Butterfield unburdened himself by revealing that "there's a recording system in the White House."[359] The whole world took notice, and speculation about the president's future was rampant. The news was shattering for Nixon, who could now expect urgent requests to turn over the tape recordings. John Dean's earlier testimony had been damaging to the president but had not provided "the smoking gun," the former council's revelations about conversations with Nixon lacking proof. Now the truth could come out, but it was not going to be easy.

The president, in the Bethesda Naval Hospital recovering from pneumonia, immediately ordered removal of the recording system, following up by anxiously asking advice from his lawyers and advisors on what to do with the tapes. Again John Connally was quick off the mark, strongly recommending destroying the tapes. Asking Haldeman to use his influence with Nixon, he made a dubious suggestion: "Have Ziegler [Nixon's spokesman] assemble the White House press corps in the Rose Garden, pile up all the tapes, set a match to them, and let them film the bonfire."[360] And like the impulsive Connally, Kissinger and Republican Party grandee Nelson Rockefeller, "whose recorded conversations with Nixon were [also] not exactly *Readers Digest* material,"[361] also favored getting rid of the tapes. But most advice went the other way, the new White House Counsel, Leonard Garment, arguing that lighting a fire under the tapes would be an obstruction of justice and was likely to be interpreted as an admission of guilt. The president did not want to destroy the tapes, being "intensely preoccupied . . . by symbols of his place in history."[362] And the recordings were also "financially priceless." Nixon decided to take the line that the tapes belonged to him and were covered by executive privilege (the power claimed by a president of the United States to resist certain subpoenas and other interventions by Congress and the courts). This would be his mode of defense against attempts to have him release the tapes. But this strategy turned out to be a serious miscalculation as the Watergate investigators and Judge Sirica were determined to obtain the tapes and were strongly backed by public opinion. Nixon also underestimated the independence of the Supreme Court, despite his having appointed four of its nine justices.

Executive privilege

The very day after the Butterfield bomb detonated, the Ervin Committee requested that the president turn over all documents and tapes under control of the White House relating to Watergate. Nixon refused, claiming executive privilege. Not satisfied, the committee insisted—by means of a subpoena—on the president's release of the tapes on which his discussions with John Dean were recorded. And Judge Sirica directly subpoenaed Nixon to produce relevant tapes and documents for the grand jury, allowing it to better determine whether prosecution would be justified. These unprecedented actions were adding to the president's already serious discomfort. Nixon took some heart from Erlichman and Haldeman's testimonies before the committee, standing squarely behind their former boss, accusing their former colleague, John Dean, of lying and vouching that the president had not been involved the Watergate affair and coverup.

The lonely man in the White House continued to fight: "In a lifetime of playing tough, Nixon had never played it tougher."[363] In a typical Nixonian outburst of anger and self-pity he said: "Let others spend their time dealing with the murky, small, unimportant, vicious little things."[364] He, Nixon, would spend his time building a better world. His anger was reflected in ordering a massive bombing campaign in Cambodia, aimed at pushing back the Vietcong and Khmer Rouge, during the first 2 weeks of August 1973. Only because Congress had cut off the funding for these operations did the commander-in-chief call off the air force. Once again, the 37th American president had demonstrated that when felt cornered, he could take drastic and sometimes dangerous action.

On August 7, the Ervin Committee completed its hearings on Watergate. A week later, the president declared on national television that he was innocent. Again he refused to release the tapes, claiming that in doing so he would "set a precedent that would cripple all future Presidents." But the argument impressed nobody except Nixon loyalists. John Connally sprang into action, telling reporters, "I believe there are times when the President would be right in not obeying a decision of the Supreme Court."[365] Once again, Nixon's now favorite confidant, who was clearly interested in being named vice-president in case Spiro Agnew resigned, came up with bad advice. In fact, the possibility of Agnew's departure had soared as the vice-president was likely to be convicted of corrupt practices dating to his tenure as governor of Maryland. Agnew did resign in November 1973, pleading *nolo contendere* (failure to contest, but without admitting guilt) to a charge of failing to fully report taxable income, lucky to get off with three years' probation and a modest fine. But Nixon, at the advice of Republican Party mandarins and warnings by the Democratic leadership that the confirmation process could become very contentious in view of some incidents in the Texan's past, passed on his favorite candidate.

2. War and oil

At a time when it seemed impossible to push aside Watergate from the headlines, a surprise attack on Israel by Egypt and Syria on the Jewish holy day of Yom Kippur in early October 1973 quickly shifted media attention to the Middle East. Sensing how dangerous the situation was, Nixon ordered his newly appointed secretary of state, Henry Kissinger, to address the problem. As Israel's staunchest supporter, the United States felt a strong obligation to guarantee the well-being and existence of the small Jewish state. The fighting was fierce, and Israeli troops were thrown back, causing great concern in the West, amid fear of a wider conflict in the Middle East or even beyond. The American president's first reaction was to assure the Israeli leadership that his country would supply all their needs for military equipment, especially important because they were losing arms at a much faster pace than in earlier wars.

The Soviet Union had been quick off the mark to supply its Arab friends with arms, but since Kissinger wanted to have the Israelis realize how dependent they were on the United States, and because of bureaucratic dithering within the Pentagon, it took days before Israel received American materiel. Strikingly, as soon as hundreds of flight missions by U.S. transport planes loaded with all kinds of state of the art military equipment—known as Operation Nickel Grass—reached Israel, the tide turned, and the Arab forces were pushed back into their own territory. That was not the end of it, as Nixon, the pragmatic strategist, well knew. He would now have to deal with the unhappy Soviets, who did not want to let down the Arab countries. This was an immediate challenge that Nixon, with a long history in dealing with strategic crises, felt he could meet more successfully than the slow-burning Watergate mess.

Soon the American president and the Soviet leader were sending each other messages aimed at reducing tensions and at getting the warring parties to agree to a ceasefire or, as was Nixon's preference, a lasting peace in the Middle East. But Kissinger, who was sent to negotiate with the Soviet leader Leonid Brezhnev in Moscow, believed a ceasefire was all that could be achieved, and ignored his president's instructions. Meanwhile, in a dramatic turn of events, Israeli forces forged ahead to encircle the 20,000-strong Egyptian III Army Corps in the Sinai, threatening to destroy it. As the shocked Arabs appealed directly to Nixon to avoid such a disastrous outcome, he joined Brezhnev in proposing a ceasefire in place. The president, now preoccupied with picking a successor for Agnew, had let the eager Kissinger deal with the Middle Eastern dilemma. The secretary of state, using all his powers of persuasion, got the Israelis to accept holding their fire. As a followup, a United Nations resolution, sponsored by both superpowers, mandated a ceasefire in the Middle East on October 22, 1973. But the fighting soon resumed, and a second UN resolution was also ignored.

A game of chicken

Having gained the advantage on the battlefield, Israel was not reacting to American demands to agree to a regular ceasefire, prompting the Soviet leadership to warn Jerusalem that any further military action would lead to the most serious consequences. Israel called Moscow's bluff, drawing the conflict into a risky American–Soviet standoff. Brezhnev was furious, firing of a message to the White House, insisting on sending both Soviet and American forces to Egypt to enforce a halt in hostilities. And he followed up with a threat: "I will say it straight that if you find it impossible to act jointly with us in this matter, we should be faced with the necessity urgently to consider the question of taking appropriate steps unilaterally." Interpreting the message from Moscow as an ultimatum, and with General Alexander Haig—Haldeman's successor as White House chief of staff—advising against waking Nixon, who had been drinking, Kissinger decided to take drastic action.

With the backing of the top military brass and the secretary of defense, an announcement was made slightly after midnight on October 25, 1973, that American forces were put on high alert, including the strategic nuclear units. Reactions were strong, ranging from disbelief to great anxiety among American politicians and citizens as well as causing deep concern in other parts of the world. Since the Cuban missile crisis of 1962, the world had never been closer to a nuclear confrontation, despite Nixon's campaign for *détente*. Brezhnev, whose message turned out to not have been intended as an ultimatum, did not react. After a third UN resolution, Israel's tough-as-nails prime minister, Golda Meir, finally acquiesced in a ceasefire under strong American pressure. But while a serious political and military crisis had been defused, the Yom Kippur war triggered a dangerous economic crisis.

President Nixon received by Soviet leader Leonid Brezhnev with members of the Politburo, Moscow, June 1972. (White House photo.)

Oil as weapon

The Organization of Petroleum Exporting Countries (OPEC), established in 1960 at the initiative of Venezuela, was a largely unknown body of large producers of oil involved in negotiations with the powerful western oil companies. It started making waves when at a conference in Tehran in 1971 its members decided to moderately increase the price of oil to catch up with recent inflation. The real push came in 1973, as oil exporters realized that with world demand for oil rising rapidly, they were in a strong position to not only control oil prices, but to use their near-monopoly as a political weapon. And in August 1973, King Faisal of Saudi Arabia and President Anwar Sadat of Egypt agreed at a secret meeting in the Saudi capital, Riyadh, to use oil as a political weapon as part of a plan to attack Israel. In the followup, and right after Egypt and Syria had launched their attack on their neighbor and old enemy, a number of Arab oil exporters raised their prices by a still modest 17% while announcing production cuts.

With the war turning in Israel's favor, the leaders of the Organization of Arab Oil Exporting Countries (OAPEC) agreed to fully deploy the oil weapon by imposing an oil embargo on October 19, immediately after Nixon asked Congress to appropriate $2.2 billion in emergency aid to Israel. The embargo applied to the United States, by far the world's largest oil importer, but also to Japan and a number of European countries, including the Netherlands, which faced a total embargo for being "a friend of Israel." But France and Britain, refusing the use of their air bases by American planes transporting supplies to Israel, hardly experienced cutbacks of oil flows. Other OPEC members followed up the Arab embargo, severely cutting their production of the black liquid, first with 25% on November 5 and another 5% for "non-friendly" countries on December 9, but reversed 2 weeks later as hostilities in the Middle East subsided.

Price quadrupled

The biggest shock of all for governments, corporations, and households in the West and Japan, but also in many developing countries, was a quadrupling of the price of oil from $3 to $12 per barrel. Besides the use of oil as a weapon inspiring the embargo, the price explosion was defended as simply recouping the loss of *real* oil revenue caused by inflation and 2-dollar devaluations. While a price adjustment was in itself reasonable, its magnitude and abruptness were harder to explain away. But there was plenty of blame to go around in the West. Easy money had fueled inflation, and overly low stocks of foodstuffs such as wheat and soy created a situation in which crop failures could trigger a price explosion. And when in early 1973 the Soviet Union urgently needed to import large amounts of wheat, its harvest being hugely reduced, the results were predictable. Food prices in the United States went through the roof. In May 1973, the price of soybeans shot up by 45%, that of wheat by 22%, and that of corn by 30%. Meat prices were frozen by Nixon to reassure consumers that he was doing something, but caused supply to shrink. Another clumsy decision of the American Administration was ordering soybean farmers to limit their exports to 50% of what had already been committed, causing outrage by farmers and importers. Charges of "economic nationalism"[366] by the French and complaints of a "soya shock" by the Japanese had no effect. Freezes and embargoes helped to artificially keep overall U.S. inflation for 1973 at 6%—undesirably high, but not as serious as in Japan, where prices shot up by 12%.

The world was now embarking on the *Great Inflation*, causing anger among OPEC members, who felt underpaid for their scarce commodity. On top of that, a steep fall in the value of the dollar—in which world oil prices are expressed, increased the ire of oil exporters. Reflecting the oil exporter's sentiment, the shah of Iran exclaimed: "You [Western nations] increased the price of wheat you sell us by 300% and the same for sugar and cement . . .; You buy our crude oil and sell it back to us, refined as petrochemicals, at a hundred times the price you've paid to us . . .; It's only fair that, from now on, you should pay more for oil. Let's say ten

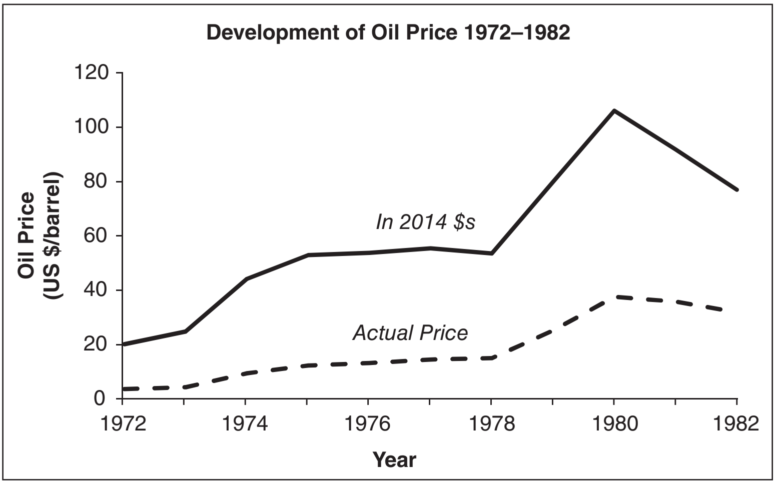

Figure 3.1 Development of Oil Prices, 1972–1982 ($/barrel)

times more."[367] Similar language came from the energy minister of Saudi Arabia, Sheik Zaki Yamani, who warned: "We are in a position to dictate prices and we are going to be very rich."[368] But such warnings were generally not taken too seriously in the complacent oil-importing countries.

Studies done earlier in the United States had shown that there was no spare oil producing capacity and that domestic energy production was on a downward trend. But no heed was paid to this unwelcome news by American political leaders. Oil companies—better informed—were more concerned, singer Johnny Cash asking consumers to drive slower so that "there will be more gas for everyone"[369] in Chevron radio commercials. But big gas-guzzlers continued to be part of the American dream. Buildings in the United States and other rich countries were poorly insolated and energy-hungry, rising car ownership everywhere pushed up gasoline consumption, and energy conservation was not on anybody's mind. As oil-importing countries had become complacent about supplies of the vital commodity, the stage was set for OPEC to deliver a shock to western consumers and energy intensive industries from Austria to the United States. Most developing countries were also dependent on cheap energy and even more vulnerable to cutbacks and higher prices. The only group to remain unaffected was the citizens of the oil exporters themselves, protected by their governments against higher energy prices: In Venezuela, gasoline was cheaper than a bottle of mineral water of the same volume.

Complacent no more

The shock of the oil embargo and the outlandish price hike was immense. Such actions fell outside the range of what politicians and the public had thought possible. OPEC's totally unexpected action caused deep concern, soon followed by panic among the population in a raft of countries, already shaken by the war in the Middle East. On November 7, 1973, Nixon finally issued a stern warning: "We are heading into the most acute energy shortage since World War II."[370] After the gravity of the situation sank in, long lines formed at American gas stations, some panicked motorists "topping up" their tanks for as little as $0.25 in gasoline. Gas stations began serving customers on odd or even days depending on their license plates. Pumps were ordered closed on weekends. And as supplies frequently ran out, the chaos intensified. Truck drivers blocked roads to protest higher gas prices. Some official actions were taken: The maximum speed limit in the United States was lowered to 55 miles per hour, thermostats were advised to be turned down, car pooling was encouraged, lights were turned off, and environmental standards were relaxed.

Mainly as a psychological boost, Nixon grandly announced a national plan to achieve energy independence by 1980, in an effort "as ambitious as the Manhattan Project or Project Apollo."[371] Experts realized that this was totally unrealistic, and the public was skeptical. Adding to the gloomy atmosphere, American cities were unusually quiet and dark during Christmas of 1973, and as a symbolic gesture, no Christmas lights shone at the White House. After a while, people's behavior started to reflect their hoarding and survival instincts, violence against gas station attendants and fellow motorists becoming commonplace.

In Europe, even more dependent on foreign oil than the United States, an even grimmer atmosphere prevailed. In Britain, people suffered from a lack of heating and other scarcities in the middle of winter as strikes by coal miners triggered drastic emergency measures. While in continental European countries the need for conservation measures was generally less severe than in Britain, lights were turned out, and thermostats were down. But in the Netherlands, placed under a full Arab embargo, automobile traffic was banned on Sundays and—less effective, though capturing the prevailing mood—the Dutch population was called on to close all their curtains at night (street-facing windows being traditionally left open to show off homes' interiors). Christmas in Germany was also a drab affair as its booming economy soon slowed down and its traditionally prudent citizens pushed their wallets deeper into their pockets. And in Japan the effects of the oil shock went beyond economic stagnation, instilling a fear of collapse among its citizens, deeply aware of their country's total dependence on foreign energy.

3. Recycling

As a third 5-year term for Pierre-Paul Schweitzer as managing director of the IMF had been blocked by the United States, the search for a successor was on in the summer of 1973. An informal understanding between Europe and the United States to elect a European as head of the IMF and an American as president of the World Bank narrowed the search to a candidate from the European community. But not only European ministers and central bank governors were involved in the process as American officials were actively searching for a candidate from the Continent acceptable to them. Washington wanted to avoid the new managing director's being "inclined to monetarism," meaning that the candidate should not "wish to apply discipline to the United States."[372] This led the U.S. Treasury to prefer Emile van Lennep, the experienced secretary-general of the OECD, to head the IMF. But the Americans had not reckoned with the preferences of the developing countries, who objected vigorously to picking a person anointed by the United States.

There was also resentment against the largest shareholder's treatment of Schweitzer, who had demonstrated a positive attitude toward smaller countries. Another candidate had been Dutch central bank governor Jelle Zijlstra, who had already been approached in early 1973 by Arthur Burns with the assurance that the White House would support his candidacy. Zijlstra recalled in his memoirs that 10 years earlier—after the death of Per Jacobsson—he had also been asked to become the fund's managing director. He had been interested then but had not been chosen on the basis of political considerations. Pierre-Paul Schweitzer had been the preferred candidate, "an attempt by Washington to appease the French who were always causing difficulties in the international monetary area."[373] But in 1973 the Europeans were no longer divided, and the French and German ministers of finance, Giscard d'Estaing and Schmidt, implored the Dutchman to move to Washington. "Schmidt . . . said with typical directness: 'We cannot resign ourselves to a refusal from you. We need you and you should do it.'"[374]

After some consideration the Dutchman declined, citing his convictions—he could not abandon his country, then led by a spendthrift doctrinaire socialist and suffering from a seriously weakened economy. Giscard's reaction was to call Zijlstra and tell him that his refusal was only acceptable if the central banker could suggest another candidate from the Netherlands. The name of Johannes Witteveen, a former Dutch minister of finance whom Giscard knew well from many meetings, came up. After assurances of support from Byanti Kharmawan, the influential Indonesian executive director in the IMF, speaking on behalf of the developing countries, as well as from Giscard, authorized by the IMF board to offer the job to Witteveen, he accepted. It was a position he had not been seeking but that provided the kind of challenge that attracted him. The new man arrived in Washington in September 1973 with a 5-year contract as head of an organization struggling to find its identity in a time of rapid change. Perhaps somewhat naïvely, the new managing director only found out years later that his compatriot Van Lennep, whom he knew very well and in fact had for a time been his top civil servant when he was minister, had been a candidate as well. Witteveen, 52 years old, had left politics 2 years earlier when the coalition government in which he served as vice-prime minister and finance minister, collapsed. Having returned to teaching at Rotterdam University, Witteveen was available to make the move to Washington. It would turn out to be the crowning achievement of his career.[375]

A Keynesian with a twist

The Great Depression of the 1930s had made a deep impression on the young Witteveen, spurring his interest in economics. Soon after he entered the University of Rotterdam, World War II engulfed the Netherlands. After a while, the budding economist's studies were interrupted as the German occupiers presented students with an unattractive choice: Either sign a declaration of loyalty to Germany, or become a forced laborer in that country. Going into hiding, the young man was still able to study books on economics, laying the foundation for becoming a brilliant academic. Witteveen soon distinguished himself as an expert on business cycles, being a follower of John Maynard Keynes and of the winner of the first Nobel Prize for economics in 1969, Jan Tinbergen. At the tender age of 27 years, he was appointed full professor of economics at Rotterdam University.

Although a self-confessed Keynesian, the tall, skinny, bespectacled professor was, unlike some supporters of the great British economist, a staunch advocate of economic freedom. Although Witteveen did not believe in *laissez faire* economics, he did favor a certain role for the government to avoid serious disruption of the economy. He was—unlike quite a few Keynesians—evenhanded in his approach to deflation and inflation: Both had to be avoided. And when in the postwar period his country—having made good use of Marshall Plan aid—enjoyed rapid economic growth and experienced large wage increases, Witteveen warned against inflation. He argued that upvaluation of the national currency was preferable to wage increases as a means to higher *real* wages. Revaluation dampened inflation and affected all groups in society the same way, whereas an explosion of *nominal* wages led to inflation and affected the population unevenly. At the time—the 1950s—this was thinking "outside the box" and was often heavily criticized. But when the German government decided to raise the value of the mark by 5% in March 1961, the Dutch policymakers had absorbed the lesson and revalued the guilder by the same percentage.

Combining theoretical insight with a sound understanding of economic policy, Witteveen became a successful, if mainly technocratic, politician. He had joined the Party for Freedom and Democracy, generally known as the liberal party (in the European sense), and in 1963, aged 42, he became minister of finance in a coalition government of Christian Democrats and liberals. But the coalition fell apart after only 2 years, and Witteveen had to wait several years before returning to the cabinet benches. During his rather short political career, he was active in financial meetings of the European community and the G-10, in which his diplomacy and language skills (he spoke English, French, and German) proved useful in helping to shape compromises. Although Giscard and most other ministers spoke English, Karl Schiller always needed a translator, a role the Dutchman could play in small informal gatherings in the margins of plenary sessions.

A sufi at the helm

Known to few outside his immediate circle, Witteveen was also a philosopher and an adherent of international Sufism, setting him apart from other monetary officials. And the new monetary chief proudly added to the press announcement of his appointment that he would remain vice-president of the International Sufi movement. Sufism is a mystic tradition within the Islamic faith that has as one of its tenets the belief that many religions ultimately have the same basis. Reactions to Witteveen's appointment were positive, though most commentators did not know what to make of his Sufi credentials. *Time Magazine* wrote under the heading "A Mystic at the IMF": "A brilliant academic who twice was Minister of Finance of The Netherlands, Witteveen is also a vice president of the Sufi movement [. . . .] Last week the modest and withdrawn Witteveen, 52, got a job in which he will have need of inner peace: he was appointed managing director of the 125-country International Monetary Fund. That body must construct a new world financial system to replace the one that has been destroyed by dollar devaluations."[376]

Growing up in Rotterdam in a well to do family, Witteveen's parents imbued him with moderate international Sufism, which he has practiced throughout his life. In his autobiography, the Dutchman relates that during his often challenging tenure as IMF managing director, he drew strength from his faith and its philosophy. Professorial and ascetic—he drank no alcohol and had a wineglass filled with fresh grape juice in front of him at official dinners—he came across as somewhat reserved. Witteveen tried to avoid reacting emotionally to successes or failures, based on "a certain indifference . . .,"[377] a tenet of Sufism, and to stay focused on the "Spirit of Leadership," which for Witteveen in his new position meant to "keep finding and following the way that is best for international cooperation and the world economy." Describing himself as "not a warm person, being a philosopher," the former Dutch technocratic politician was nevertheless unfailingly friendly and cooperative. Often referred to as the "professor," he was respected by the fund staff but was not as popular as his more affable, less intellectual predecessor.

And senior staffers had to get used to his being his own economist, often shaping new ideas and initiatives by himself. In the international arena, "[h]e provided an impressive and dominating intellectual presence at ministerial meetings, and . . . gained respect from figures as diverse in their political views as Helmut Schmidt and . . . William Simon,"[378] who succeeded George Shultz as the American treasury secretary in March 1974.

The arrival of a new managing director of the IMF and new housing for the organization practically coincided, adding a symbolic touch to Witteveen's entry. The old building the fund had partly shared with its Bretton Woods sibling, the World Bank, had become too small to house the expanding staff of the monetary institution. Its membership had grown steadily since 1946 and various activities, such as technical assistance, had been added to its tasks. The new edifice was attractive, though not spectacular from the outside and spruced up the drab neighborhood along the stretch of Pennsylvania Avenue between 18th and 20th Streets. The prize-winning interior of the new IMF headquarters, built on the site of former George Washington University fraternity houses, featured a large atrium bringing in cheerful light to the interior of the building.

The contrast with the uninspiring edifice that had housed the IMF staff and that of the World Bank across 19th Street was striking. As to the IMF's other near neighbors, to its immediate north were a small stone faced church and beyond it an ugly block of concrete, housing the electricity company Pepco (the fund would later acquire both properties to meet its further need for expansion). Toward the south stretched a dull series of gray faced edifices with small windows interspersed with an attractive small red brick German church, built at the time when Foggy Bottom neighborhood was still called Hamburg, many of whose residents had been German-speaking workers from the Heurich brewery. To the east were two little parks, planted with magnificent magnolias, on both sides of Pennsylvania Avenue—which over the years proved to be well suited for demonstrations—flanked by the somewhat seedy Roger Smith Hotel, which was razed some years later. A few blocks to the east the scene was totally different, the White House dominating everything around it.

When Witteveen entered the fund building on September 1, 1973, he did not have much time to scrutinize the surroundings, having his work cut out for him. The old fixed-rate international monetary system had come undone, and the floating currency rates that had replaced it were subject to wild swings. Work on reform of the system in the so-called

Committee of Twenty (C-20) established a year earlier, bringing together representatives from industrial as well as developing economies, was going nowhere. And the position of the IMF had been damaged by the breakdown of the Bretton Woods system. The new man also soon discovered that relations between the fund and the United States were "exceptionally difficult and cool,"[379] seriously complicating his task.

A most pleasant conference

A few weeks later, fully aware of the challenges that lay ahead except one, Witteveen flew to Nairobi, Kenya, to his first major appearance as managing director: the annual meeting of the IMF. The fund and the World Bank hold their yearly get-togethers outside Washington every third year, and in 1973 it was Africa's turn to be in the limelight. Although there were no high hopes for any breakthrough in the ongoing monetary discussions held in the brand-new Kenyatta conference center, the atmosphere was generally congenial, many delegates being exited by the prospect of seeing more of the exotic country they were visiting. Helmut Schmidt described the Nairobi meetings as "the most pleasant conference that I ever attended," the main players all staying in the same hotel and meeting at its bar in the evening, "the economic troubles behind us."[380] In a mere few days this relaxed mood vanished as snow before the sun. And although Witteveen made a good first impression on the assembled monetary officials, he noted in his diary that "[a] s regards monetary reform little was achieved at this conference." The only matter the C-20 could agree on was a proposal by Giscard that agreement on reform should be achieved no later than July 31, 1974.

As Witteveen flew back from Nairobi on October 6, 1973, accompanied by his personal assistant Andrew Crockett—seconded to the IMF from the Bank of England and destined to head the Bank for International Settlements—the pilot announced that a small detour would be necessary to avoid Egyptian air space. After landing in Europe, the travelers were informed that Egyptian forces had crossed the Suez Canal and attacked the Israeli army. The ensuing sudden oil embargo and wholly unanticipated quadrupling of oil prices galvanized the otherwise calm IMF chief to think hard about what the organization he had lead for only a month could do to ease the dangerous situation.

A massive transfer of money from oil importers to OPEC was about to take place: the oil exporters were expected to run a payments surplus in 1974 of $65 billion, 13 times more than their surplus of 1973, all of it to be paid by oil-thirsty countries. On the other side of the ledger, the industrial countries would be running a payments deficit of $22 billion, and the rest of the world an unprecedented $43 billion. Such a tectonic shift in incomes posed a serious risk of deep cutbacks in spending to finance exploding oil bills. And reduced spending on imports other than oil in one country would shrink the export of others, leading to a recession spiral. Oil exporters were going to get rich, as Sheik Yamani had predicted, but they would not any time soon be able to spend the enormous sums of money they were to receive. The largest OPEC members initially could not absorb more than a fraction of their newfound wealth, as it would take time to build new dams and roads, and only so many Western luxury goods could be imported in the short run. Saudi Arabia, by far the largest oil exporter, had a population estimated at only 8 million and could not possibly spend more than a small share of its hugely expanded dollar income. Other "low absorbers" were Iran, Iraq, and the United Arab Emirates. Countries such as Nigeria and Venezuela would spend more of their oil income, but the effects on exports of the United States, Europe and Japan, would be small for the time being. The bottom line was that world demand could drop like a stone, generating falling incomes and a jump in unemployment.

Brainwave

The risk of a severe global recession was very real, Witteveen concluded. But what could be done about it? While as usual meditating one evening just before Christmas 1973, the Sufi economist, whose mind "worked like a factory, always humming,"[381] had a brainwave: Here was a situation in which the IMF could play a most useful role in providing a special financing facility to tide over hard-hit oil-importing countries. And because the central idea was to avoid severe cutbacks in domestic consumption and investment, the usual policy conditions—mostly tighter budgets and less credit creation—for obtaining IMF credits should be waived. Setting out his case for a central role for the IMF in the challenging new monetary environment at the International Banking Conference in London on January 15, 1974, he warned that the international monetary system was faced with strains "far in excess of any that have been experienced since the war."[382]

The Committee of Twenty (C-20) met in Rome a few days later, providing Witteveen with an excellent opportunity to promote his proposal for a special oil facility within the IMF, to be funded by oil exporting countries. To the IMF chief it was obvious that it would be much more urgent to discuss how to ease the oil problem than to continue wrangling over monetary reform. Witteveen advocated placing monetary reform on the backburner, concluding that "[i]n the new situation, a large measure of floating is unavoidable and indeed desirable."[383] But he had much more to say, turning the Rome meeting into an historic event by launching his oil proposal. Not only was Witteveen's plan intended as a reaction to a serious threat to the world economy, it would also restore the IMF's position as an effective organization playing a crucial role in the international monetary system. As Leo van Houtven, a long-time secretary of the fund board put it, "[T]he oil initiative proved to be crucial in solving the IMF's identity crisis."[384] Witteveen's well thought-out idea to recycle oil money from where it was plentiful to where there were huge financing needs was received well by almost all ministers attending the Rome gathering. But there was a major exception, the United States being unwilling to support the initiative. Perceiving the situation with a "sense of impotence,"[385] George Shultz—who had just been received by the Pope Paul VI—wryly commented: "[t]he pope told [me] that in arranging for a warm winter in Europe, God had managed a more constructive response to the oil crisis than all the assembled ministers and central bankers together."[386]

Washington wavers

The real American reluctance was based on the concern that financing oil deficits would make it too easy for the oil cartel to raise oil prices. But Washington's reaction did not take into account that many other countries would have to cope with serious problems if they had to run down their foreign currency reserves to pay their oil bills. The danger of an excessive reduction of imports other than oil—it would be impossible to drastically cut oil imports immediately—would not only cause a global recession but could also instigate trade and currency wars. And other industrial countries and developing countries, many of them heavily dependent on oil, shared the sentiment that "[nothing] short of war had ever before brought about the need for such sudden and immediate global external financing."[387]

While the United States imported 35% of its oil in 1973—up from 29% the year before—economic powerhouses such as Germany and Japan, but also a host of other European and Asian countries, had to buy all or a very high share of their oil from abroad. Moreover, developing countries from Bangladesh to Zambia were desperately in need of financial support to pay for their oil imports. While most of the rich countries would be able to borrow the needed funds from international banks, whose coffers would be swelled by deposits from oil exporters, this route was not open to most countries. Lacking access to international financial markets, they could only be helped by borrowing directly from the newly wealthy countries—who found it too risky—or tapping oil money through an intermediary. And such recycling via the IMF was the task that Witteveen envisaged.

Getting the United States on board

It was gratifying to the IMF Chief that widespread support for his proposal was forthcoming in Rome, but without the blessing of the United States—the largest IMF shareholder by far—it would be unwise to proceed. Treasury Secretary George Shultz and William Simon, who as head of the U.S. Federal Energy Office was known as the oil czar—and who would soon succeed Shultz—had serious misgivings. They judged the expected world payments surpluses and deficits to be unmanageable, despite the pope's intercession. In the American view, strongly influenced by Secretary of State Henry Kissinger, OPEC should be pressured to roll back some of the recent oil price increases, the United States using its political clout for that purpose. There was also the overoptimistic view that if oil importers worked together to cut back their consumption of "black gold" and develop alternative sources of energy, its price would soon come down. And the oil czar, whose background was in bond trading and who held extreme free market views, took the position that oil shortages were not all that serious and that there was spare capacity in the oil industry; the problem, he judged, would be taken care of soon.

Outright political considerations also played a role, as Kissinger feared that accepting outsize jumps in the oil price would undermine America's leadership role in the world. Smooth financing of oil deficits would be facilitating the maintenance of high oil prices. The U.S. Treasury also worried that a number of developing countries borrowing from an oil facility could default on their loans. This could make it necessary for the U.S. government to bail them out through grants. Some senior fund staff members—thinking along traditional lines—also aired doubts about the wisdom of their chief's plan, fearing that it would go far beyond the organization's capability and was therefore too risky and controversial. Witteveen, an original thinker, was not impressed by these arguments and since he wanted to push ahead as the first signs of economic slowdown were already appearing, proposed to his executive board that he visit a number of oil exporting countries to raise funds for the proposed oil facility. All directors went along except the American, Bill Dale, who reserved his position. Witteveen, realizing he had to get the nod from George Shultz, sought him out. The lanky Dutchman ran into the Treasury secretary on the steps of the Department of Agriculture building just as he was leaving a meeting. Witteveen asked Shultz right away if he could agree to the trip he had proposed to the IMF board. It was hard for Shultz to object, under the circumstances, and he acquiesced. Soon after the unusual meeting, the energetic IMF head began his tour.

4. No rest for the wicked

Life became even tougher for Nixon after the White House tapes were discovered. He was fighting for his political life at a time when very few people were left with whom he could talk in full confidence. Haldeman and Erlichman were gone, as were many other White House staffers, either because they were indicted or because they had become disillusioned with the president's handling of the Watergate scandal. Eventually as many as 40 Nixon aides and associates went to jail. And every time the president was advised to come clean or resign, he simply dug in deeper, hoping to somehow ride out the storm. After all, he kept telling himself and others, he had been fighting political battles all his adult life. "It reflected a mindset and pattern of behavior that were uniquely and pervasively Nixon's: a willingness to disregard the law for political advantage, and a quest for dirt and secrets about his opponents as an organizing principle of his presidency."[388] Connally, not exactly a paragon of honesty, as revealed later by a milk scandal, still stood behind the commander-in-chief, as did Nixon's shady Cuban-American friend, Bebe Rebozo. But Barry Goldwater, a prominent Republican who had unsuccessfully run for president against Johnson in 1964, saw the writing on the wall. And the president's one-time staunch labor union supporter, George Meany, commented on Nixon's "dangerous emotional instability."[389]

Saturday night massacre

The American president's fanatic fight to keep the secret tapes out of the hands of recently appointed Special Watergate Prosecutor, Archibald Cox, and the insistent Ervin Committee only led to more misery for the White House. In a desperate effort to continue sitting on the tapes Cox was after, Nixon summarily fired the special prosecutor on the evening of Saturday October 24, 1973, after he refused to cease further attempts to receive Watergate evidence from the president. Taking such drastic action was "the only way to rid the administration of the partisan viper we had planted in our bosom,"[390] Nixon wrote in his memoirs. At what came to be known as the "Saturday Night Massacre," press secretary Ron Ziegler also announced that Attorney General Elliot Richardson had resigned and that his deputy, William Ruckelshouse, had been fired (both had refused to do the president's dirty work by pushing out Cox). When a very unhappy Richardson entered the Oval Office with his resignation letter, the president defended his action by remarking, "Brezhnev would never understand it if I let Cox defy my instructions."[391]

Reactions to Nixon's brutal action were fierce, some politicians starting to talk openly of impeaching Nixon. Senator Robert Byrd of West Virginia even used the terms "Brownshirt operation" and "Gestapo tactics."[392] Cars driving by the White House honked as part of a "honk for impeachment" demonstration, and signs reading "Jail to the Chief" were going up. A few days later, the House Judicial Committee, chaired by New Jersey Democrat Peter Rodino, announced that it was starting an impeachment inquiry into the president's role in the Watergate affair. It was the first time in more than 100 years that such a drastic step was taken. But actual impeachment was still far off, and Nixon went on the attack again. Staying calm and sharp during the first part of a televised news conference on October 26, 1973, he then lost his composure after a grilling by journalists on the Cox firing and suggestions that he resign. Nixon, spouting fire, ranted: "I have never heard or seen such outrageous, vicious, distorted reporting."[393] Asked whether he had put the country through too many shocks, he sneered that when the public "is pounded, night after night, with that kind of frantic, hysterical reporting, it naturally shakes their confidence." Calming down, the president insisted that physically he could take the strain of all that was going on. Referring to the Yom Kippur War and dealing with Brezhnev, he claimed that "because I have been through so much, that . . . when I have to face an international crisis, I have what it takes." While true, this was not the message most people took from the news conference. They had seen a vengeful president subject to sudden anger and self-pity and perhaps capable of dangerous behavior. Rumors circulated that Nixon was not in control of himself, that he was drinking, and that he could not last much longer.

Ford's the man

The president still had to deal with the choice of a successor to the dishonored Vice President Agnew. Although his personal preference was to nominate his former treasury secretary and confidant John Connally, he was told in no uncertain terms by Republican Party elders that this was a bad idea. Instead Nixon picked Gerald Ford, a longtime respected member of the House of Representatives from Michigan. And when Ford was confirmed on December 6, 1973, relief was palpable: Risk had evaporated that the weak and boozy House Speaker, Carl Albert, would become president by default, the speaker being third in the line of succession according to the U.S. Constitution. At the same time, Ford's arrival encouraged Nixon's detractors to push harder for his resignation or impeachment, no longer holding back for fear of the possibility of getting rid of one president to end up with an almost certainly ineffectual successor.

Even some Republicans were now reaching the point of openly calling for the president to step down. Especially bitter for Nixon was that his own lawyers, Fred Buzhardt and Leonard Garment, told him that resigning was his least bad option. Another setback came in the guise of the new Special Watergate Prosecutor, Leon Jaworski, who turned out to be anything but a pushover, driving hard to receive more of the White House tapes. But Nixon was still holding out, telling his press secretary Ronald Ziegler, "We will take some desperate, strong measure, and this time there is no margin for error."[394] Was Nixon turning into a desperado? Under the circumstances, other men might have committed suicide or started a war to distract attention from their plight. But the president believed in fighting to the bitter end, although his behavior toward the end of 1973 sometimes resembled that of a cornered animal.

I am not a crook

Nixon was also regularly losing his touch in his contacts with members of the press, whom he despised with a passion. Although he still received applause at a few carefully picked gatherings, he stumbled badly in a televised forum discussion with journalists in Orlando, Florida, in mid-November 1973. After somewhat shakily fielding a number of Watergate questions, attention turned to Nixon's personal finances, which had come under severe scrutiny by the media. Losing his composure, he disingenuously stated: "I welcome this examination, because the people have got to know whether or not their President is a crook. Well, I am not a crook."[395] A most unfortunate choice of words, he soon realized, as his clumsy denial became the instant butt of numerous jokes. More and more people were turning against the president and hounding him: "[H]e couldn't even go to church without being heckled."[396]

Republican Party members of Congress were becoming nervous about the November 1974 mid-term election, many distancing themselves from their wounded leader. John Connally confirmed to the president that trouble was brewing and that the "Arizona Mafia"—influential Republicans from the Western United States—wanted to force Nixon to resign. Others who were in contact with the nation's leader were shocked by his emotional state, often judging him paranoid. Admiral

Elmo Zumwalt, chairman of the Joint Chiefs of Staff of the United States, observed Nixon "engage in a long, rambling monologue, which at times almost seemed to be a stream of consciousness, about the virtues of his domestic and foreign policy. He repeatedly expressed the thought that the eastern liberal establishment was out to do us all in . . ."Attacks on Nixon were "part of a vast plot by intellectual snobs to destroy a president who was representative of the man in the street." The admiral's verdict was that Nixon saw himself as fighting the good fight against evil forces.

Fighting on

As 1974 approached, no relief was in sight for the beleaguered leader of the free world, as he liked to be called. The oil crisis was exacting its toll, adding to the country's depressed mood, and on the foreign front, the bloody confrontation in the Middle East was still not fully resolved and the South Vietnamese army was being outgunned by communist forces despite Henry Kissinger's Nobel Prize–winning peacemaking. But, worst of all, the Watergate imbroglio moved to a new stage when Nixon refused to comply with a request from the Ervin Committee to turn over a vast number of tapes and documents, convinced that giving up the tapes would be his downfall. He was already suspected of tampering with one of the released tapes from which an 18½-minute section had been erased, although it could not be proved that this had not been an accident, as the president's secretary, Rose Mary Woods, claimed. Despite sinking deeper into the quagmire, Nixon once again resolved to fight on.

Briefly buoyed by a ceasefire in the Middle East on January 17, 1974, he was soon again feeling the heat from his adversaries, prominent among them Special Prosecutor Jaworski, who told Alexander Haig, Nixon's new chief of staff, that he had become convinced that his boss had participated in the Watergate coverup. Talk of impeachment was everywhere now. On occasions when he felt especially angry, the nation's lonely man in the White House lapsed into abusive rants, castigating "every ethnic group in the U.S. as against him—the Jews, the blacks, the Catholics, the Wasps &c."[397] Nixon's paranoia had become so severe that "no one can bear to spend the long hours with him he demands." To his new vice president, Gerald Ford, he appeared to be "a prisoner in the Oval Office."[398]

Again and again Nixon denied in his State of the Union address, at press conferences, in speeches, and in private conversations that he had known about Watergate involvement of the White House staff before

March 21, 1973, when John Dean had warned him about "the cancer in the White House." He kept insisting that he had not been a participant in the coverup. And most emphatically he pledged not to resign. On one occasion, Nixon declared that it was time to end the Watergate investigation. "One year of Watergate is enough," he added wearily. Another time he stated that impeachment requires that a criminal offense be committed and that he did not expect to be impeached. He also claimed that he had never authorized payment of hush money to the persons who had been indicted. And he stressed the need to keep certain of his conversations as president confidential, exclaiming that "[w]ithout confidentiality, future presidents would be surrounded by eunuchs."[399] Many Americans were now questioning their president's honesty, and most of the eager media had already declared him guilty.

Installing a czar

To the extent he spent time on other matters besides Watergate, Nixon also displayed a belligerent mood, warning the Arab countries that the United States would not give in to blackmail in the guise of a continuation of the oil embargo. Lacking time to deal extensively with the oil crisis, Nixon appointed William Simon by executive order as his "energy czar," giving him "absolute authority," similar to "the kind of authority . . . that Hitler had given Albert Speer to produce armaments in the Third Reich."[400] While the president got his history right, the statement—even if meant as a joke—was an astonishing comparison, perhaps representative of his troubling mindset at the time. Simon, a thin, intense former bond dealer and a heavy smoker, wearing severe dark-rimmed glasses and sporting greased black hair, brought more eagerness than insight to his new job. Embracing his new role "with unseemly zeal" and "his chance to wield power over the oil industry and become a hero of the embargo,"[401] the "czar" plunged forward with a comprehensive plan for allocating scarce oil.

First priority was accorded to the military, then to corporations, then for heating oil. Gasoline production had no priority, increasing drivers' panic and lengthening lines at the pumps. After long discussions how to deal with gasoline shortages, the administration—surprisingly for a convinced free market supporter as Simon—decided not to follow the Canadian example of letting higher prices reduce demand. Simon also shied away from rationing through coupons, his approach resulting in "congestion rationing, the most inefficient form of all,"[402] as Nobel laureate Paul Samuelson characterized the situation. Reversing course, the president overruled Simon's gasoline policy on February 19, 1974, ordering him to release more fuel from inventories. At first, Simon released too little, failing to make a dent in gas lines. But a few days later, Nixon, wanting to avoid further outcries from harassed drivers, pushed him hard to allocate more refined oil to relieve motorists' anxieties. This action had the desired effect, and after the oil embargo by Arab countries was lifted on March 18, 1974, following extensive diplomatic maneuvering by Secretary of State Kissinger, tensions eased. But in the meantime, higher oil and gasoline prices were exacting a toll on American manufacturing, construction, and transportation, among other areas of economic activity. In many other parts of the world, the impact of the jump in oil prices was even more severe than in the United States. Joblessness was on the rise in Europe, and public disaffection mounted. In Japan, the oil shock had come on the heels of the soy shock and the Nixon shock. Economic malaise was spreading across the globe like an oil spill. Only incurable optimists could deny that the world economy was inexorably heading for deep trouble.

5. The scourge of stagflation

The effects of the oil shock were similar to those of a massive tax increase: Higher energy prices, like a tax hike, caused the demand for goods and services to shrink even as they pushed up already high inflation. The answer to how to deal with such a combination of ill effects was not readily available in economics textbooks. "This situation constitutes perhaps the most complex and serious set of problems to confront governments since the end of World War II,"[403] wrote the IMF somberly. The economies of practically all oil importing countries were slowing down rapidly, while inflation in industrial countries was running at a frightening 12% on average, Japan leading the pack with a jump in the prices in excess of 20%, which, if continued, would double its price level in 3½ years. In Europe, Italy registered inflation of 16%, and Britain of 13%, severe labor unrest contributing to a toxic mix. Most of the non-Communist world was in the grip of an inflation psychology, contributing to a price–wage spiral that was extremely hard to break. But because of the severe economic stagnation—industrial countries would suffer an actual decline in output in 1974 after having grown by 6% the previous year—coupled with rising unemployment, fighting inflation became a double-edged sword.

Such was the new world of stagflation, combining two trends that had never before coincided in the modern world. Making things worse, the enormous shift in international payments was causing problems for a host of countries, whose oil bills rose dramatically. The surplus in the balance of payments on current account (exports minus imports of goods and services plus investment income) of oil exporters jumped from a modest $5.6 billion to a never before imagined $70 billion in 1974. In present-day dollars, this equals about $200 billion, but representing a larger part of world trade—and therefore with a bigger potential for disruption. On the other side of the coin, the rich Western countries slid into a deficit of $11.5 billion from a surplus of $10.2 billion in 1973, a swing of almost $22 billion. But for the developing countries, the situation was even direr, their current account deficit increasing fivefold to around $40 billion, dwarfing the funds they received through foreign aid and investment.

Dealing with the fallout

It was obvious to policymakers and academics alike that without sufficient money to finance these unheard-of deficits, oil-importing countries would have to severely reduce their purchases of foreign goods. Unable to cut back indispensable oil imports in the short run, they would have to economize on other imported products, ranging from food and clothing to big ticket items like airplanes and machinery. And this would have to be achieved by abruptly repressing household consumption and business investment. As declining imports in one country equal lower exports of its trading partners, these would in turn consider slashing their imports. The overall result could be a vicious circle of shrinking international trade as occurred in the 1930s. Not only was such a process a formula for a deep recession, but it could also tempt countries to lower the value of their currency to boost their exports, or to impose tariffs, surcharges or quotas on imports to improve their trade balance. If energy-poor countries were to follow the example of the United States in August 1971 by imposing import surcharges or such like, the chances of retaliation and a downward spiral in world trade would be high. Fortunately, Johannes Witteveen and most government leaders were alert to the danger, recalling the disastrous policies of the depression years.

No roadmap

It was an extremely challenging time for those responsible for budgets, the money supply, and international trade policies. Stagflation was *terra incognita*, which made it of the utmost importance for nations to cooperate and avoid beggar-thy-neighbor policies. Sorely needed, the IMF served as a crucial forum for developing best practice in responding to the oil crisis. If the problem were solely to avoid recession, the solution would be straightforward: Fiscal stimulus and monetary easing in the right doses would be called for. Likewise, if breaking the back of inflation were the only issue, the policy prescription would be to reduce the budget deficit and push up interest rates. Economists are known for a tendency to comment on an issue in "on the one hand, but on the other hand" terms, once prompting President Harry Truman, frustrated by the mixed advice he was getting, to ask for a "one-armed" economist. And as expected, the debate on stagflation saw policymakers and economists supporting a wide variety of views. There was the camp of the Keynesians—in the United States personified by Walter Heller, who had advised presidents Kennedy and Johnson, and who advocated running larger budget deficits and printing more money to protect growth and employment while not worrying much about inflation. And there was the anti-inflation camp—led by the German Bundesbank and monetarist economists—which recommended tight demand policies to wring out excessive price increases. According to this school of thought, routing inflation could admittedly cause pain in the short run but would restore stability and growth in a longer timeframe: "short-term pain for long-term gain."

Stimulate, or disinflate?

The IMF staff, known for its impartiality, wrote in mid-1974: "Inflation is a world-wide problem that must be dealt with before it gets further out of hand. . . . It is clear that policy decisions must now place more emphasis on controlling inflation"[404] in contrast to previous years, when policy had been "shaded" toward growth and employment. This time, the IMF argued, "unemployment might have to be somewhat higher . . . in relation to traditional targets." A tough message, although in "on the other hand" style, Chief Economist Jacques Polak threw a bone to the Keynesians by writing that a "special problem of demand management at the present time is to assess and deal with the possibly deflationary effect of higher oil prices."

In Washington, the Nixon economic team, grappling with the stagflation dilemma, after much handwringing, chose to make fighting inflation its main objective. The White House's chief economist, Herbert Stein, spoke of an "excruciating question of policy," asking: "Should we now turn to pumping up the economy . . . and increase the risk that inflation doesn't slow down?"[405] Or should we stick with a "steady policy, risking a longer slow down . . . [but] cutting the rate of inflation?" To future Nobel Prize winner Franco Modigliani, mixing economics and politics, the solution was clear. Testifying before Congress, he stated that to stimulate the economy, it was urgent to impeach the president. Nixon shrugged off the barb as an attack by an "enemy" and opted for making the fight against inflation—running at around 10%—his first priority, as advocated by his staff and the IMF. This time the American president's choice was not influenced by short-run political motives, as he was no longer fixated on a next election, but solely on political survival. In the meantime, Paul Volcker stayed on the sidelines of the debate on domestic monetary policy, but in future years, he would have to deal with the legacy of an unsuccessful battle against inflation.

Tokyo's troubles

Similar tough policy choices had to be made by harried officials from other industrial countries and by a raft of developing countries. Japan, the world's second largest economy and totally dependent on foreign oil, had to deal with a quantum jump in energy imports from $4.5 billion in 1972 to $21 billion in 1974. Soon, to the dismay of ordinary and wealthy Japanese alike, inflation surged, and the economy fell into a swoon. Politicians and the public in the land of the rising sun were still not much accustomed to Western thinking and were prone to misjudging economic relations with foreigners. As a result the Japanese policy response to the bad news was disingenuousness. Tokyo fiercely defended its floating currency from depreciating against the dollar, now—temporarily—regarded as a safe currency because of America's limited dependence on foreign oil. Japanese policymakers mistakenly believed that their successful country's trade balance was still fundamentally strong despite its ballooning oil bill. They were also worried that a falling yen would worsen the inflation outlook by making imports—including oil—more expensive. In addition Tokyo was afraid of upsetting the United States if it allowed its currency to depreciate. Following government instructions, the Bank of Japan sold huge amounts of dollars against yen—$7 billion—between the outbreak of the oil crisis and the end of January 1974.

Toyoo Gyohten, then a high official at the Japanese ministry of finance, later wrote, "[W]e were like a child who had burned its lips with very hot soup and then tried to cool them off with ice cream."[406] And "[t]he lesson learned was that, having been overwhelmed by a sense of panic, we had failed to understand and to trust the price mechanism of the floating-rate regime." But Japan wisely shunned protectionist measures to reduce the deficit, choosing to borrow from foreign banks to cover its trade gap. And there was no shortage of money to borrow; oil exporters were investing much of their newfound wealth in short-term deposits with Western banks. The banks then lent on the money—usually for a short-term only—to cash-strapped oil importers, but only those they considered creditworthy. This recycling process proceeded without much difficulty for most industrial countries, although a "Japan premium" arose since the country of the samurai was the most dependent of all on foreign oil. And anxiety prevailed in Japan, fed by output falling by 2% in 1974 as well as concern that loans from banks could become more expensive and harder to get. As a precaution, Tokyo borrowed $1 billion directly from Saudi Arabia in the summer of 1974, keeping the deal quiet for fear of looking weak.

The German icebreaker

Serious damage was also done to European economies, but their reactions to the effects of dearer energy differed strongly. Germany and its closest economic partners (Netherlands, Belgium, Austria, Switzerland, and Denmark) went for strong adjustment and energy conservation policies, whereas France, Italy and the United Kingdom opted for slower adjustment and more borrowing. German policy was deeply influenced by a longstanding aversion to inflation, rooted in a disastrous experience with hyperinflation in the 1920s and the monetary chaos after World War II. Facing accelerating inflation, already outside its comfort zone in 1973 at 6%, the German Bundesbank—the most independent of the world's central banks—applied the monetary brakes. No longer constrained by a fixed rate of the mark, German central bankers were unanimous in judging that bringing down inflation was the best remedy for economic stability and growth in the medium term. And unlike other large industrial countries, Germany avoided double-digit inflation in 1974, taking on the role of the "world's anti-inflation icebreaker."[407] The other side of the coin was that the economy slumped into recession and even contracted by 2.5% in 1975. The public, though not happy, swallowed the bitter medicine, but many of Germany's trading partners were highly critical of the Bundesbank's policy.

Already in the summer of 1973 British prime minister Edward Heath had fired off a politely worded, but critical letter to his German counterpart, Willy Brandt, complaining about Germany's tight monetary policy. Heath argued that Germany's high interest rates were forcing Britain to raise its own rates to levels damaging to its economy. In his somewhat self-righteous reply, the German chancellor remarked that the Bundesbank's discount rate, at 4.5%, was much lower than that of the Bank of England. Although this difference in rates was primarily a matter of lack of confidence in the pound sterling and British economic policies, Germany's tough inflation stance did prevent weaker countries from lowering their interest rates as much as they would have liked.

Britain was not the only country critical of the German central bank. As Otmar Emminger, at the time the Bundesbank's vice president, later wrote in his memoirs, his bank's "uncompromising anti-inflation measures in 1973/74"[408] often caused disaffection at home and abroad, though he argued that they had paid off, as witnessed by Germany's superior inflation and growth numbers. Helmut Schmidt, finance minister at the time of the oil crisis and soon to be chancellor, advocated austerity, quoting Churchill that there would be "sweat and tears"[409] (leaving out the "blood") in adjusting to the new world of expensive energy. Chancellor Brandt did not like Schmidt's radical tone, though, complaining that such talk could wreck a speedy recovery. The minister, while remaining quiet in public, wrote a private letter to Henry Kissinger, proposing to create a forum of diplomats and experts on energy and economics from the main industrial countries. The aim would be to develop a common Western policy toward OPEC. Kissinger was not receptive to the idea, as tensions had arisen between Washington and Bonn which had been picked up by the media. It surfaced that the United States had been shipping materiel from its arsenal in Bremerhaven to Israel during the Yom Kippur war, without informing the German government. After the spat had died down, Kissinger changed tack and took the initiative to arrange an energy conference in Washington in February 1974.

Taking a different route

France, Italy, and the United Kingdom followed a very different course than Japan and Germany in reacting to the oil crisis. Although also highly dependent on energy imports, the leaders in Paris (Georges Pompidou), Rome (first Mariano Rumor, then Aldo Moro, who was brutally murdered in 1978 by terrorists) and London (Edward Heath, succeeded by Harold Wilson in early 1974) decided to "accept the oil deficit" and spread out adjustment over a longer period. A similar path was followed by France and Italy, who still showed some economic growth in the months following the oil crisis but thereafter experienced sharp increases in both unemployment and the general price level. For the time being, inflation was ignored in France, where monetary policy was conducted by a weak central bank that did not enjoy the degree of independence from the government accorded to its German sibling. Though the French were proud of the fact that their economic growth had kept pace with that of Germany during the 1960s and early 1970s, the country of Marianne was much more prone to inflation. A root cause was the existence of strong and strike-ready labor unions whose excessive wage demands were a main cause of the franc's chronic weakness. Such a link between aggressive labor union demands and a weak currency was even greater in Great Britain and Italy, leading to chronic pressure on the exchange rate of the pound and the lira.

As the oil price shock rekindled unrest in currency markets, compounded by uncertainty about President Pompidou's health—he was gravely ill by early 1974—Giscard d'Estaing and the French prime minister, Jacques Chaban-Delmas, opted for riding out the storm without imposing severe austerity at the outset. It did not hurt Giscard's chances in the election following the French president's death in May that he had not followed the German approach. Feeling justified in its chosen path, France turned out to be the only large industrial country to escape a fall of overall production—though barely in 1975—after the energy emergency. Italy was not so lucky; though it had a good record of output growth, its poor inflation performance had made the lira one of Europe's weakest currencies. Delaying harsh measures, the country of Fiat and Montedison still grew by a surprising 3.9% in 1974 but suffered from a 17.7% inflation rate and a large trade deficit. The collapse came the next year, the economy shrinking by 3.5% without a reduction in inflation: a prime example of a serious dose of stagflation.

Their worst hour

A most dramatic confluence of events occurred in Great Britain during the oil shock and its aftermath. Ever since the end of World War II, the British economy had been a laggard among European countries. Low productivity stemming from lack of innovation and repetitive strikes—the writer Anthony Burgess called Britain TUC-land in his novel *1985*, a spoof on the acronym of a powerful and strike-prone labor union—coupled with dangerously high inflation, had made the pound a weak currency in need of regular propping up.[410] When the Conservative Party, led by Edward Heath, came to power in 1970, full of good intentions, it intended to transform the economy.

The new prime minister was a talented musician and a world-class yachtsman but ultimately a failure as a politician. Sometimes described as Britain's "worst prime minister,"[411] Heath had been unlucky in inheriting a sluggish and inflationary economy. Initially, the new government tried to wring out inflation which proved to be devilishly hard, as the British labor unions were constantly pushing for large wage increases in excess of increases in productivity. And as hefty pay rises were pricing labor out of the market, unemployment shot up, exceeding the politically sensitive level of 1 million. Not having the iron will that Margaret Thatcher would later display, Heath made a policy U-turn in 1972, stimulating the economy in a "dash for growth." At the same time, he tried to tame union demands by imposing wage caps, infuriating British workers.

To make things worse, the mighty mineworkers union in mid-1973 retaliated against the pay caps by calling on its members to "work to rule," better known as "go slow." This tactic worked insofar as declining stocks of coal—on which Britain was deeply dependent—put pressure on the government. And with the price of coal rising, to the chagrin of the public, Heath felt compelled to take action. After talks with the mine workers failed, the government decreed a "Three-Day Work Order," in a desperate attempt at conserving energy consumption. Businesses were allowed to consume electricity only 3 consecutive days a week, and working hours were reduced. Normal life was severely disrupted, production was shrinking alarmingly, darkness reigned during the long winter nights, and large numbers of disaffected workers were roaming the streets.

Already losing popularity before enforcing the 3-day week—the Tories did not do well in the general election of February 1974. Harold Wilson, leading his fourth cabinet, returned to Downing Street 10 even though the Labour Party ruled as a minority government until October of that year. A degree of normality was restored in March 1974 when Wilson lifted the 3-day work order, although electricity conservation measures remained in place. Heath, known as irascible, rude, disdainful of others after attaining his party's leadership, returned to the benches of parliament, frequently disagreeing vehemently with Ms. Thatcher after she came to lead the government. Disillusioned, Heath could nevertheless look back on his major achievement, getting Britain to join the European Economic Community.

Galloping inflation

Pipe-smoking "man of the people" Harold Wilson took over from Heath at the time of the biggest economic and social crisis in Britain since World War II. The economy shrank by 1.5% in both 1974 and 1975, with unemployment—almost halved under Tory leadership—growing rapidly and inflation getting out of control. Having reached 15% in the first crisis year, it soared to an astonishing 28% in 1975, much of it homemade. Many people had a hard time keeping up with exploding prices, spending their income as fast as they could before the cost of food, clothing, appliances, a pint of ale, and other consumer goods was adjusted upward again. Wilson, a classic socialist, worked hard at improving Britain's social safety net, pumping money into the economy by hiking social spending by 9% in real terms a year, hugely increasing state pensions and indexing them, and implementing a series of other costly measures. Social reform was the British prime minister's top priority, not fighting inflation—a task he happily left to the Bank of England, headed by Gordon Richardson, who was powerless in a situation in which social spending was exploding. Wilson, a pragmatist who did not push for nationalization of the steel industry and mines, mostly ignoring dogmatic party members, from time to time nevertheless railed against the capitalist system. Sometimes scurrilously referred to as "Scilly" (pronounced "silly") Harold by his adversaries, since he often vacationed on the Scilly Islands, situated southwest of the British mainland, unexpectedly resigned in 1976, citing physical and mental exhaustion. The first signs of early onset Alzheimer's disease may also have been a factor.

Nixon impresses

With a large part of the world struggling with the fallout of the oil crisis, most political leaders concluded that they would be better off working together against the OPEC monolith. In line with Helmut Schmidt's earlier suggestion, but without referring to it, Henry Kissinger organized an international energy conference, held in Washington from February 11 to 13, 1974. The sage American secretary of state, looking at the big picture, saw the tumultuous developments on the oil market as a dangerous political threat to the industrial world. Kissinger wanted to assemble a like-minded group of oil importers—13 countries attended the conference—to act as a counterweight to the Arab members of OPEC. President Nixon underlined the importance the United States attached to the conference by receiving the participants for dinner at the White House. OECD secretary general Van Lennep related that the president's improvised but focused speech "impressed all of us,"[412] illustrating Nixon's capacity for shunting aside Watergate worries when addressing a friendly audience. But even though the American president had been "impressive," the conference did not achieve its goals and was seen by many as a failure.

At the gathering, the abrasive French minister of foreign affairs, Michel Jobert, speaking in Gaullist fashion at the behest of President Pompidou, was so preoccupied with France's position in the world that he paid scant attention to the dire economic situation. And he did his utmost to torpedo attempts to cooperate on energy matters, driven by a refusal to "gang up" against OPEC under American leadership. Kissinger was furious and other leaders irritated, regretting that the well-respected and moderate French minister of finance—Giscard d'Estaing—had to play second fiddle to his aggressive colleague Jobert at the meeting. The Frenchman got his way by vetoing the creation of an International Energy Agency (IEA) whose members were to work together on ensuring that energy supplies were sufficient. The IEA was eventually established but it took until 1990 before France joined up. A few months after the flare-up at the energy conference, Kissinger seeking revenge, approached Arthur Burns to ask him whether the Fed could cause economic trouble for France. The central bank chairman responded that he would think it over but angrily wrote in his diary that the secretary of state's request was "outrageous" and that "H. sometimes strikes me as a madman; a genius yes; but he has a lust for power—a good pupil of Nixon's and Haldeman's, or perhaps one of their teachers?"[413]

6. A Middle Eastern odyssey[414]

As Johannes Witteveen was packing his bags for his fundraising voyage in early 1974, the economic and political landscape looked forbidding. The world was rapidly heading for a deep recession, while inflationary winds were still blowing strongly. Watergate was almost paralyzing American politics, and tensions in the Middle East as well as between oil

Johannes Witteveen, managing director of the International Monetary Fund, 1973–1978 (International Monetary Fund photo archives.)

exporters and oil importers were at a dangerously high level. The IMF chief's mission to channel money from where it was abundant to countries that were in danger of not being able to pay their energy bills came just at the right time. Although the United States remained skeptical for political reasons, it was no longer blocking the new initiative.

Witteveen had been successful in gradually mitigating some of the American objections to an IMF oil facility. He explained that for developing countries, most of them hit hard by higher oil prices, there were no alternatives to financing their deficits to receiving loans from the IMF, or directly from OPEC members. If they could not borrow, poor countries would be forced to drastically cut back their oil imports and suffer from recession or worse, higher unemployment and lower living standards. And to ease the United States' concern that developing countries would not pay back the IMF, Witteveen presented the U.S. Treasury with studies of developing countries that had experienced large trade deficits, including Brazil, Colombia, Indonesia, Korea, Peru, Turkey, and Yugoslavia, showing that they had all paid back their loans from the IMF within a few years. Once Washington understood that oil-importing developing countries viewed OPEC's actions as directed not at them, but at oil-guzzling industrial countries that had been paying too little for an essential product, it softened its position. "The moves of OPEC gave to officials of other Third World Countries a vision of a fundamental shift in the balance of power away from industrial nations . . ."[415] This meant that not supporting recycling oil money through the IMF, vigorously advocated by developing countries, would cost the United States political capital.

Persian petrodollars

The flamboyant, high-living shah of Iran, realizing that OPEC's oil bonanza could cause resentment and hurt the world economy and entertaining a personal desire to play the role of benevolent statesman, made it known that he was willing to make a contribution to the proposed oil facility. He sent an invitation to the IMF managing director in February 1974 to visit his country. Robert McNamara, then president of the World Bank, also showed up, asking for money for his organization. The Iranian leader, who knew how to throw a party, entertained his guests from Washington at a fashionable nightclub in Teheran, where well-to do Iranians and their ladies were also present and music was playing loudly, "not the sort of place that Witteveen normally frequented."[416] Witteveen's personal assistant and confidant, Andrew Crockett, slipped away from the merriment to telephone Frank Southard, the IMF's straight-laced number two, to inform him of the results of the discussions. Southard, hearing music and loud voices in the background, asked Crockett what the music was for, to which the young man—thinking fast—calmly replied: "No music here, Frank. I am in my hotel room. The problem must be on your side."[417] But Crockett could report that the meetings had gone well and that the shah had pledged to provide the IMF with loans for the oil facility of $700 million for 1974 and $500 million for the following year. After this encouraging start to his fundraising, Witteveen was treated to a visit to the ancient cities of Shiraz and Isfahan, the birthplaces of a few Persian mythical poets whose work the Sufi-adhering IMF chief had read. The high point of the trip was an excursion to the magnificent ancient ruins of Persepolis, where the exuberant inhabitant of the Peacock Throne had commemorated the 2,500th anniversary of the Persian monarchy in grand style in 1971. Fewer than 5 years after Witteveen's visit, the shah and his family fled their country, overthrown in a revolution that turned Iran into an Islamic theocracy.

Arabian days

Continuing his grand tour, the head of the IMF flew to Geneva in Switzerland to meet with Sheik Zaki Saad, a high Saudi official who was to be the conduit for arranging a contribution to the oil facility from oil rich Saudi Arabia. Saad's English was hard to follow, and since the always polite Witteveen did not want to let on that he could not follow his host's flowery language, the meeting was not a success. Although not sure what the Saudi position was, he continued on to Jeddah in Saudi Arabia where the accommodations were poor, Witteveen and Crockett having to share a bed in their hotel. The next day King Faisal bin Abdul Aziz Al Saud received the determined IMF head in his grand palace, rolling out the red carpet for him. To Witteveen, the royal audience was a strange experience, taking place in a large hall furnished only with chairs placed along the walls. Sitting against the wall with the very formal King, the IMF money collector had difficulty establishing contact with the head of the house of Saud, but after a while the monarch—who had been briefed by his officials—ordered his ministers to discuss Witteveen's request with the IMF representatives. The outcome was successful, Saudi Arabia pledging a contribution of $1.2 billion to the oil facility.

Kuwait, a small desert emirate wedged between Saudi Arabia and Iraq, was next on the list of potential contributors. At first the Kuwaiti minister of finance was skeptical, asking why his country should help the United States by lending to the oil fund. After Witteveen explained that the Americans were actually not enthusiastic, regarding the new facility as supporting OPEC policies, Kuwait contributed $500 million, a large sum for such a small country. Traveling on to the United Arab Emirates, the IMF convinced their leaders to put $120 billion into the kitty. Algeria was the next destination. The north African former French colony was a modest exporter of oil, and Witteveen's primary goal was to gain political support for his initiative, expecting only a modest contribution for his oil fund. But despite a cordial reception, no money was forthcoming, the Algerians explaining that they had taken up large dollar credits in 1973 that they preferred to repay with their newfound wealth as soon as possible, considering that they carried an interest rate of 13%. At the end of his Algerian sojourn, Witteveen was treated to an elaborate dinner by President Houari Boumeddiene at a charming old Mediterranean-style villa. Experiencing slight culture shock when using his fingers to pick pieces of meat from a whole roasted lamb while standing, the by now tired head of the IMF was assured by the Algerian leader of his political support for an oil facility. Political support was also forthcoming from tiny but influential Lebanon, but—again—no money.

More fundraising

Following up on his successful Middle East foray, the IMF chief visited Venezuela, a major oil exporter and one of the few OPEC members outside the Arab region. Again Witteveen returned to Washington with good news: The South American country had promised to lend $550 million in 1974 to the oil facility, and $250 million the following year. Another $120 million was added when the IMF's number two, the affable American Bill Dale, traveled to Nigeria. Not yet satisfied, Witteveen tried to also obtain funding for the oil facility from Western countries. This, he felt, would "help increase understanding with oil producing nations which would be useful in the difficult financing situation which lay ahead."[418] OPEC members were all for contributions by industrial countries to demonstrate that their financial support of the new facility was not "a penalty for increasing oil prices."[419] Canada, self-sufficient in energy, soon pledged $300 million. But on a visit to Europe from May 28 to 31, 1974, the energetic fundraiser, calling on ministers of finance and central bank governors in Belgium, France, Germany, Italy, and the Netherlands, faced resistance. Witteveen was especially keen on obtaining money from Germany, expecting that the Netherlands and Belgium would soon follow. The answer he received in Bonn, where the request was dealt with by Helmut Schmidt and checked with Willy Brandt (in the final days of his chancellorship), was a polite no. The

German political leaders said that they did not see any reason why they should help solve a problem others had created. And, they said, they were also anticipating further demands for financial help from other European countries, though this reason did not sound very convincing.

Only toward the end of 1974 did Witteveen obtain a European pledge, and it came from his own country, an exporter of natural gas but an importer of oil. The Dutch had not been ready to contribute to the oil facility in May on the grounds that the Netherlands was already generously providing aid to developing countries—more as a share of national income than Germany—and that the United States was not on board. But taking a second look at the deteriorating global situation in October 1974, and not wishing to rebuff a distinguished compatriot, the government in the Hague agreed to put up $180 million immediately and $250 million in 1975. And when it was decided to reopen the oil fund in 1975, other European countries no longer wished to appear stingy, contributing $1.8 billion, of which 40% came from Germany. In the end, the IMF collected $8.3 billion ($20 billion in present-day dollars) to lend to cash-strapped oil importers, a substantial sum in the days before massive amounts of capital could be moved at the press of a computer button. But it was not enough to cover higher oil bills for most industrial countries. Although Witteveen would have liked to have a bigger oil fund, he was unable to solicit more money, OPEC countries preferring to lend directly to friendly (Islamic) nations and to earn higher returns by placing their petrodollars with banks and by purchasing foreign real estate.

The United States, not interested in contributing to an IMF-run facility, was making its own plans for official recycling of petrodollars. The Nixon administration did not trust the IMF, where the Europeans had a large say, preferring to work through the OECD, whose members were almost exclusively industrial or otherwise developed countries. The ever-active Henry Kissinger got into the act and, together with William Simon, who had succeeded George Shultz as treasury secretary in April, 1974, proposed a financial support fund of $25 billion—much bigger than the IMF oil facility—exclusively for use by industrial countries. As oil money was expected to flow largely to financial centers such as New York, the new fund could recycle money to OECD countries who might otherwise take protectionist measures when they were rapidly losing reserves. Not everyone was happy to see the IMF sidelined, especially the outspoken British minister of finance, Denis Healy, but the dissenters went along after undergoing American "massaging." In an ironic twist the "Kissinger Facility" that had been agreed on by OECD members after much hard work never saw the light. As happened with the League of Nations in 1929 and the Havana Charter—an international trade pact—in 1947, the U.S. Congress refused to ratify an initiative of the American government. Although the IMF was relieved by the unusual denouement, Kissinger and Van Lennep suffered bruised egos.

A raft of borrowers

Borrowing from the oil facility brought relief to a raft of developing countries—45 in all—as well as eight countries classified as "other developed," such as Spain and New Zealand, and two large rich ones, Great Britain and Italy, which obtained a third of the available money. The oil facility, as envisaged by Witteveen, was not intended for well-off countries, but as borrowing from the IMF was cheaper than from commercial banks, the British and Italians applied. And because London and Rome, both large oil importers, were supposedly following sound economic policies under regular credit programs with the IMF, there were no objections to their use of the oil facility. Other users of the facility, ranging from large developing countries such as India to tiny Western Samoa (borrowing a mere $500,000), were only obliged to pledge that they would not lower their imports by imposing trade measures harmful to others, such as higher tariffs, quotas, and administrative obstacles. Other conditions—often politically painful and time-consuming to negotiate—routinely part of a credit agreement with the IMF, were skipped so that no extra time was lost in getting the money to hard-up countries. The central aim was after all to help out oil importers in time to avoid drastic cutbacks in their imports, which would only contribute to the world recession.

Trade pledge

While the final details of the oil facility—officially launched on June 13, 1974—were being worked out, the industrial countries, meeting at the OECD in Paris, took a momentous step in agreeing to a general trade pledge. This was a formal declaration that the participants would steer away from erecting new trade barriers, going a step further than the IMF requirement under the oil facility by closing some loopholes that could be exploited by uncooperative nations. The United States gave the pledge its full support, in sharp contrast to its actions 3 years earlier when it imposed an import surcharge. The awful lesson of the 1930s that escalating trade measures led to disaster had now been fully taken on board. And the recycling of petrodollars from OPEC to industrial oil importers through the banking system was starting to help avert economic mayhem in the countries producing and consuming a large chunk of the world's goods. But in mid-1974, the crisis was far from over, and what was to be by far the deepest recession since World War II was only beginning to become visible as Western economies were stagnating and unemployment rising. But at the IMF and in many industrial countries the main worry was still "virulent and widespread inflation."[420] Uncertainty was everywhere, reflected in the currency markets by large swings in the dollar. American tourists in Europe had to check day by day what anything cost when converted into dollars. Worse, they sometimes ran into problems when hotels and restaurants insisted on payment in francs or other European currencies.

Keeping their shirts on

In the weeks immediately following the oil price explosion, there had been a strong demand for dollars, the markets seeing energy-scarce Europe and Japan as more vulnerable than the United States. By mid-January 1974, the rate of the once almighty German mark rate was 23% lower against the dollar than at its peak in July 1973. But a mere month later, the dollar sank again as profit-hungry American banks—freed from controls on foreign lending at the end of January—started lending furiously to foreign governments struggling to finance their oil deficits. The currency markets continued on a roller coaster ride, nervously reacting to every hint of intervention, to new economic data, and to bank failures. In the United States, a badly managed middle-sized bank, Franklin National, imploded, and in Germany, a well-known private bank, Herstatt, closed its doors. Uncertainty generated by the Watergate drama added to the toxic mix. And as the wild currency gyrations troubled central banks, foreign exchange dealers were having a ball. "Skilled foreign exchange traders earn their salaries and bonuses by correctly anticipating short-term rate movements. In the jargon of the trade, betting on long-run fundamentals is an excellent way of losing one's shirt."[421]

Attempts to return to fixed currency rates were clearly doomed to virtually instant failure. But the unruly behavior of the foreign exchange markets made clear that a system—or nonsystem, as many preferred to call it—of floating exchange rates was not all that its supporters, such as Milton Friedman, had expected. Serious work on reforming the international system had already begun in the fall of 1972 when a special high-level committee (the Committee of Twenty), chaired by Ali Wardhana, minister of finance of Indonesia, and by Jeremy Morse of the Bank of England at the deputy level, was established to thrash out a new viable system. United States officials, initially content to work within the

Group of Ten, had become disenchanted with that forum, seeing it as a "nine against one club."[422] Washington now wanted to include the developing countries, hoping that an alliance between the American side and the developing nations could be established. But this was a miscalculation; the poor countries sided mainly with the Europeans, who were more generous in providing foreign aid. And when it became clear that the differences among the 20 hard-working representatives could not be bridged, the exercise was effectively ended in early 1974. At that point, Paul Volcker hopefully suggested that "[t]he structure of the Fund [is] adaptable to any system, and the Fund itself might become more important in the absence of complete reform than otherwise."[423] Though true, some action had to be taken to dampen the huge fluctuations in currency rates that created havoc, not only bothering tourists but also, much more important, damaging world trade. When exchange rates are fixed, exporters and importers of everything from cars to soybeans, from copper to machinery and the manifold other products that are traded across borders, can be sure how much they will receive or have to pay measured in their own currencies. But wild swings in currency rates can lead to painful losses for companies who receive less or have to pay more than anticipated for the goods traded. The disincentive for participating on a large scale in cross-border trade is obvious. With this in mind, it gradually dawned on the monetary community that neither fixed exchange rates nor fully floating rates was the solution, but that doing nothing to achieve greater stability was not an option.

7. Down to the wire

By the middle of 1974, three forces were working toward a global economic, financial, and—in what was particularly dangerous—political meltdown. A worldwide recession fueled by the oil shock was under way, causing an already nervous public to worry even more about their jobs, and promising to get worse before it became better. On top of that, stubborn high inflation was making decisions on whether to stimulate the economy extraordinarily difficult. In April 1974, Nixon, under the influence of some of his advisors, was displaying increasing concern over the economy, referring to bad news on housing and interest rates. A month later, Arthur Burns, in a meeting with the president and his close advisors, stressed the need to reduce inflation and to bring the budget under control. Torn between conflicting views, Nixon, at another meeting with Burns and economic policymakers on June 24, expressed his skepticism about economics and economists. "He wanted . . . to explore ways of dealing with inflation, but he felt . . . that old ways [did] not seem to work."[424] Burns wrote in his diary that he argued that "the economy was not being starved of money and credit"[425] and that they were actually growing too fast. Also supporting cutting government expenditure, the Fed chairman was upset when budget director Roy Ash took a diametrical opposite position, ruling out balancing or even reducing the budget deficit "for purely political reasons."

In this climate of high uncertainty about the right course of economic policies, renewed tensions in the currency markets further muddied the waters. And unexpected bank failures added to the misery. But Watergate potentially posed the greatest danger, as some drastic or even deranged action by the embattled and increasingly unstable American president could not be ruled out. The Watergate mess had now dragged on for 2 years, and there was a sense in the air that the end game was near.

Republican defection

It had been a cruel spring for Nixon, and he must have had little eye for Washington's delightful profusion of daffodils, cherry blossoms, and tulips. Digging himself deeper in his hole by his stubborn refusal to cooperate with the Watergate investigators, he was losing support among the "silent majority" that had overwhelmingly voted for him in November 1972. Just as bad was the defection of some influential Republican politicians from the Nixon camp. Senator James Buckley of New York, brother of the influential and widely read conservative commentator William F. Buckley, unexpectedly hit out at the president, remarking that "a perception of corruption [has] effectively destroyed the President's ability to speak from a position of moral leadership." The senator's attack was not without self-interest, as he pointed out the obvious: By staying in office, Nixon would ruin his party's chances in the November mid-term election. Buckley concluded that Nixon should resign in "an extraordinary act of statesmanship and courage."[426] A scowling president, visibly controlling his anger, responded to questions from journalists about Buckley's disloyalty that he had no intention of abandoning his post and once again reminded his restless audience that a president could only be impeached under the U.S. Constitution for treason, bribery, or other high crimes or misdemeanors. Although Nixon from time to time needed a day or two to recover from the stress of news briefings, he was up and about early the next day visiting the Johnson Space Center in Houston, flashing his famous V-sign and working the crowds in his awkward way.

Although such intermezzos helped take his mind off Watergate, even if only for a few hours, on his return to the White House, Nixon was handed a subpoena from the terrierlike Special Prosecutor Leon Jaworski, ironically a Texas friend of John Connally, asking for more tapes and documents. The president, taken aback, flatly refused. Nixon's strategy became one of stonewalling and trying to divert attention away from Watergate by appearing forceful and in command, dealing with issues ranging from education to agriculture, speaking at fundraisers and attending Vietnam Veterans Day ceremonies. But soon, in late March 1974, Nixon received another slap in the face as more Republican politicians were distancing themselves from him; almost all Republican senators hoping to be re-elected in November did not want him to campaign for them, fearing that it would be "the kiss of death." And a former cabinet member expressed the sentiment of many others when he said that Nixon "couldn't run for dogcatcher without it turning into a referendum on Watergate."[427] And so it went on and on.

Another damning putdown came from no less a person than the new vice president, Gerald Ford, who opined that "the political lesson of Watergate is this. Never again must America allow an arrogant, elite guard of political adolescents to . . . dictate the terms of a national election."[428] On top of that, the president's most loyal cabinet member, George Shultz, announced that he would be leaving in May. The quiet-spoken treasury secretary was exhausted after having served Nixon for almost 6 years and, like Paul Volcker, who also soon left, was disappointed in the leader of his country and appalled by the Watergate imbroglio. Nixon now had to work with a skeleton cabinet and a much reduced White House staff. Kissinger was still there, and although he had a complicated relationship with Nixon, the president would more and more turn to his secretary of state for moral support. Of the old White House gang—Philip Roth wrote a satirical novel in 1971 called *Our Gang* whose central character is "Trick E. Dixon"—only Ron Ziegler and speechwriters Pat Buchanan and Ray Price were left, William Safire also having packed his bags.[429] And after the resignation of his personal lawyer, Leonard Garment, Nixon brought in an aggressive, though not very loyal, Boston lawyer, James St. Clair, who toward the final days of the of the Watergate drama became preoccupied with saving his own skin.

The road to impeachment

During his long career, Nixon had made many enemies—although they were not always out to get him as he often claimed—and some of them were now playing classic American hardball politics. In its impeachment inquiry, the House Judiciary Committee, whose chairman, the Democrat Peter Rodino, was not free of partisanship, was examining domestic surveillance and wiretapping and other "intelligence activities," campaign dirty tricks, partisan misuse of government agencies, the president's personal finances, the secret bombing of Cambodia, and the impoundment of congressionally voted funds. Included in the shopping list were acts that were not obviously grounds for impeachment, such as dirty tricks and misuse of government agencies, both of which had a long history in American politics. "All sides were now dipping their hands in the blood of a national tragedy."[430]

Nixon's stonewalling and dodging tactics were only leading to a further escalation of the crisis. If he refused to respond to Rodino's subpoenas for the tapes, he would be accused of contempt of Congress and could be impeached on those grounds alone. But "Nixon's instinct was to tell them all to go to hell."[431] His top aide, Alexander Haig and his lawyers thought differently, while some prominent Republicans also criticized their leader. Barber Connable, a respected representative from New York—a future president of the World Bank—remarked: "Now that the President has been forced to take off his clothes in public . . . the question of additional tapes can be handled like a game of Russian roulette."[432] An excellent poker player, who had made a nice bundle while serving in the Pacific during the World War, Nixon was not averse to bluffing and gambling, and heeding the advice offered, he decided to provide transcripts of some of the tapes but not part with them.

Soon the White House was filled with the sound of furious typing as Nixon's personal secretary, Rosemary Woods, who was suspected of

President Nixon presenting edited transcripts of White House tape recordings, April 29, 1974. (U.S. National Archives and Records Administration.)

having erased 18½ minutes from one of the tapes, and 15 other secretaries transcribed the tapes that had been demanded. Closely reading 1,200 pages of verbatim transcripts, the man whose fate hinged on the material busily rubbed out parts he did not wish to release, including coarse language. This would turn out to be a serious mistake, as was Nixon's claim that he was handing over all relevant material when he announced the release of the transcripts on national television on April 29, 1974. The harassed president had worked for days on the text of the tapes to fashion it in a way that was unlikely to incriminate him or, as the saying went, "reveal the smoking gun." "How Nixon thought he could get away with all this is a mystery."[433] He had shown lapses of judgment before, but this time his excisions were thought to be highly suspicious and therefore severely damaging. What he also had not anticipated was that leaving out his frequently uttered profanities would cause shock and merriment. Elegantly designated "expletive deleted," the public was not only curious of what the actual swear words were, but also got the impression that the American president was as foul-mouthed as a drunken sailor.

Even more damaging to Nixon was that people who were not so much bothered by a leader who swore under pressure were appalled by the sleazy, conniving, cold-hearted, and paranoid atmosphere at the White House revealed by the tapes. For days on end, Nixon-haters, but also less partisan members of the public, eagerly reached for their newspapers in the morning to peruse sections of the tapes and marvel and snigger at the flood of excised "expletives." "Expletive deleted" became part of the American vocabulary just as "I am not a crook" had before it. But levity aside, sentiment held that the president was not truthful when he accused John Dean of lying in claiming that he (Nixon) first learned about the coverup in September 1972, a mere 2 months after the break-in. Nixon stuck to his line that he only became aware of a coverup on March 21, 1973, as Dean made his pitch about "a cancer in the White House."

Looking for the smoking gun

The next act in the Nixon drama followed a few days later. Jaworski had also grown fed-up and was now trying to blackmail the president. Threatening to go public with the news that Nixon had been named an unindicted co-conspirator by the Watergate grand jury, the special prosecutor insisted on receiving White House material, but told Alexander Haig that he that he would ask for only 18 of the 64 tapes he had demanded earlier. When Haig suggested that he had a sense that he and the president were being blackmailed, Jaworski coolly replied: "all I can tell you is, there's blackmail, and there's blackmail."[434] The implication was that there are situations where a victim can refuse to comply and when he cannot. But as usual, Nixon did not budge, knowing from listening several times to the tape of his conversation with Haldeman on June 23, 1972—a mere 6 days after the break-in—that its contents spelled disaster. He would, he decided, not part with that tape, not even allowing his lawyers to listen to it. Now confiding in Ziegler in the absence of other members of the old "gang," Nixon exclaimed: "Perhaps this is Armageddon, but I would rather leave fighting for a principle."[435]

By now—May 1974—the president was showing clear physical signs of stress and spent more time in his hideout in the Executive Office Building, where he could work and think better than in the Oval Office. And in the evening, he regularly sailed along the Potomac River on the splendid presidential yacht *Sequoia* with his wife—the longsuffering Pat—and their daughters, or with his close friend Bebe Rebozo. Relaxing as such trips usually were, the conversation now constantly focused on what was to be done, the family and the enigmatic Cuban American businessman insisting that Nixon not resign. But the accumulated stress was soon to take its physical toll on top of its mental damage as the man who hardly ever suffered from illness was beginning to be bothered by a swollen leg.

As the legal wrangling continued over Nixon's refusal to turn over the actual tapes, the Supreme Court loomed in the distance. After all sorts of legal acrobatics, Special Prosecutor Jaworski petitioned the highest court in the country to take immediate jurisdiction, trying to finally end the unedifying spectacle of a wily but wounded animal pursued by a pack of wolves. The Supreme Court, agreeing to take the case and promising a decision in *United States v. Nixon* before its summer recess, gave the president 2 months to work on a convincing defense. Buoyed by the opinion of political analyst Theodore White and backed by the everpresent John Connally, Nixon believed that he could still survive as it looked—it was early June—as if the Senate would let him off the hook by 5 or 6 votes and the House would probably not impeach him. And although he had promised to abide by a definitive ruling by the Supreme Court, he had not defined "definitive." Perhaps he could claim that a 5–4 ruling was not definitive.

Travel escapism

The president seized the respite the Supreme Court timetable allowed him to travel abroad to places where he would be popular and could demonstrate what a great and indispensable leader he was, in contrast to the not very impressive Gerald Ford. Nixon had cleverly chosen to tour the Middle East, where Kissinger had finally, after an incredible period of shuttle diplomacy, engineered a withdrawal of both Israeli and Syrian forces at the end of May. Nixon had also been involved by working over Golda Meir, the tough as nails Israeli prime minister, to compromise on the terms of the troop withdrawal. On his arrival in Cairo on June 12, 1974, with his secretary of state—who did not enjoy playing second fiddle—in tow, the American president was greeted as the great peacemaker. He was immediately whisked away and driven in an open car with President Anwar Sadat through throngs of cheering Egyptians. Having recently been diagnosed with phlebitis in his left leg, a potentially lethal swelling of a vein, Nixon defied doctor's orders and stood all the time in the ride to the presidential palace. He was now walking with a limp, his left leg badly swollen. To those in the know, the great peacemaker risked a fatal embolism, in which a blood clot could form in his leg and travel to his lungs. Yet Nixon pushed on, meeting with King Faisal of Saudi Arabia in Jeddah (Witteveen had passed there 2 months earlier) and President Hafez Assad of Syria, who in the past had used very strong anti-American language but who was now prepared to reestablish diplomatic relations with the United States.

The next stop was Israel. Golda Meir had just been deposed as prime minister and had handed over to Yitzak Rabin, a former general and war hero who would years later be assassinated by a right-wing fanatic. Not everyone in the Rabin cabinet was satisfied by the Nixon/Kissinger peace process, and despite the generous American support during the Yom Kippur war, the reception in Jerusalem was unexpectedly reserved. But if he had thought the Israelis were ungrateful, the American commander-in-chief did not show it.

A pain in the leg

On returning to Washington on June 19, 1974, the legal challenges and media bashing were right there to welcome Nixon. Not that it was unexpected, but he reflected on the contrast between the momentous advance of peace in the Middle East and the Watergate tussle, which he felt to be almost trivial in the greater scope of things. That many foreign leaders privately agreed with him was of no significance in the American political cauldron. More bad news followed: Leaks from the House Judicial Committee revealed substantial discrepancies between the transcripts and the actual language on the tapes, a discovery followed by subpoenas for more tapes. And undermining his attempt to look fit and unworried, his most outspoken adversary in the visual media, prominent journalist Dan Rather of CBS, trumpeted the news that Nixon was afflicted with phlebitis. A frenzy of publicity followed, rife with speculation that the president was suicidal. After all, Nixon was to leave for Moscow a few days later while suffering from a serious medical condition. That did not seem like the behavior of a stable person avoiding unnecessary risks.

The Moscow summit with Leonid Brezhnev was not a success. Before his departure, Nixon, weakened by his Watergate ordeal, had to suffer the indignity of his secretary of defense, James Schlesinger, and the top military brass, including Admiral Elmo Zumwalt, brazenly opposing his attempt to reach an arms reduction treaty with the Soviets. Flying first to Brussels, Nixon visited NATO headquarters for the treaty's 25th birthday party. Although European leaders treated the American president with respect, it was mingled with "the solicitude shown to terminally ill patients." Nixon himself "had something of the air of a political prisoner on parole, delighted to be in the sunshine again but knowing that he must soon return to sterner reality."[436]

In the Russian capital, Brezhnev, though he did not understand the fuss about Watergate—in the Soviet Union, enemies of the leader were dealt with most severely—sensed Nixon's weakness at home, making the Soviet leader reluctant to reach any agreement with the other superpower. Not quite knowing what to do with his American guest, he dragged him to his dacha overlooking the Black Sea in Yalta. Brezhnev showed his chummy side while walking with Nixon along the shore, but conceded nothing. The summit ended on July 2, 1974, and a far from fit and depressed president flew back to the United States on Air Force One. Throughout the discussions, Nixon's "face appeared heavy and mask-like."[437] Moreover, his "attention seemed to wander at times and he appeared distraught."[438] On Independence Day 1974, tired and brooding, Nixon spent time with his family in his southern abode in Key Biscayne, Florida. A decision by the Supreme Court was now only a month away.

8. The recession bites

As the summer of 1974 arrived, the global economy was floundering. Although the oil shortage in the United States disappeared after the oil embargo was lifted, the economy was shrinking and unemployment rising fast: Still at an acceptable level of 5% in May, it stood at 7.2% in December and would continue to increase in 1975. But with inflation roaring ahead at a 12% clip, apparently unaffected by what was happening in the real economy, economic policy stayed focused on fighting inflation. Nixon's new conservative treasury secretary, Bill Simon, was fixated on bringing down the budget deficit by cutting government spending by $10 billion, even as tax revenues were unexpectedly rising with rapid inflation, higher nominal incomes pushing wage earners into higher tax brackets. Simon believed in economic "old-time religion," the opposite of the classic Keynesian response to a recession. Heavy criticism from Democrats, as well as from within the administration, followed. Roy Ash, director of the Office of Management and Budget, a former president of Litton Industries and a big contributor to the Nixon campaign, blasted Simon's approach.

Ash and Simon were enemies, the budget director having attacked the former energy czar's handling of the oil crisis. The two adversaries had also been locked in an unseemly battle for the departing George Shultz's job: "Ash's ambition was so intense that he turned rivals into victims."[439] The spat escalated when the budget director went public with his attack on Simon's budget policy, saying, "Simply baying at the moon won't do the job."[440] Nixon, who had chosen Simon as his new treasury secretary because the man from Wall Street was liked by Congress, agreed to split the difference by announcing $5 billion in cuts. The Keynesian approach would have been to lower taxes as the recession started to bite, and Democratic politicians were clamoring for a $6 billion tax cut. But this went against the "old-time religion" most Republicans believed in. The president's fate being in the hands of Congress and desperately trying to avoid impeachment, he was on his best behavior toward Republicans and conservative Democrats.

The Fed blindsided

At the time the Federal Reserve was established (1913), Congress mandated the Federal Reserve "to coin money and regulate the value thereof"[441]—in other words, to control inflation. And in 1974 its chairman, Arthur Burns, was determined to do so while striving to avoid recessions. This was before Congress, by passing the Humphrey-Hawkins Act of 1978, introduced a dual mandate to both "promote full employment . . . and reasonable price stability."[442] Burns, not yet bound by the obligation to explain to the House and Senate Banking Committees what the Fed was doing, considered inflation a menace that would eventually hurt economic growth. To some, this was also "old-time religion." And by not taking into account the negative effects of the oil shock on output growth, the Fed chairman believed, as did the White House, that 1974 would be free of recession. He aimed for monetary growth of 5.25% at the beginning of the year, moderately tight in view of the untamed price increases. Burns and his staff turned out to suffer from a recognition lag, not realizing that a serious recession was developing. They acknowledged the contribution the quadrupling of oil prices was making to the inflation numbers but underestimated what it would do to economic growth and unemployment—the "tax" part of the oil shock. Soon interest rates began to rise, the prime rate—the rate banks charge their best corporate customers—reaching 10.25% in April, shocking to some, but in reality not all that much in light of the high rate of inflation.

Franklin goes belly up

The Fed eased its policy somewhat after Franklin National Bank, the twentieth-largest bank in the United States, got into trouble in May 1974, spreading fear that many others would be sucked in if Franklin went under. Central banks act as "lenders of last resort" to bail out banks that cannot meet their immediate obligations but are solvent. The Fed, in timely fashion, lent Franklin over $1 billion to avoid a panic in the money market. But that was not the end of the story. As large losses from currency speculation and bad loans came to light, Franklin had to close its doors on October 8, 1974, after a run on the bank. It was the biggest bank failure in the United States since the 1930s.

Investigating the roots of Franklin's mismanagement was like opening up a sewer. Only 2 years earlier, Michele Sindona, a banker with close connections to the Italian Mafia, had purchased a majority share in the Long Island bank, allowing him to launder money to aid the Sicilian drug cartel—and allegedly also the Vatican Bank. Sindona, the stereotype of a con man, had developed ties to the Republican Party and—according to rumor—the Nixon administration. The mysterious Italian-American used his contacts to ensure that bank regulators would not prevent him from obtaining control over Franklin because of his dubious credentials.

As vice chairman of Franklin, Sindona was in a position to speculate heavily in foreign currencies without being challenged from within the bank. He was not very good at it, and he tried to cover his losses by defrauding the already shaky bank of $30 million. Having been declared insolvent, Franklin was liquidated under the guidance of an Italian lawyer, Giorgio Ambrosoli, who uncovered Sindona's misdeeds. Based on information provided by the liquidator, Sindona was arrested and convicted. In July 1979 poor Ambrosoli paid with his life for his honesty, gunned down by a Mafia assassin hired by Sindona. A few years after his conviction, the criminal banker was extradited to Italy where he was sent to prison for life but after serving less than 2 years died of cyanide poisoning under mysterious circumstances.[443]

The Fed tightens

It was good fortune that the demise of Franklin National Bank did not lead to a chain of failures by other banks, but it did act as a warning shot to regulators to be more alert in the future and to avoid political interference. As the shock of the Franklin mess faded away, the Fed returned to tightening monetary policy, pushing up the prime rate to 12%. The critics of the Fed were now out in force, pointing to a severe downturn in housing starts and other signs of economic weakness. Prominent economists such as Arthur Okun, who had been chairman of the council of economic advisors to President Johnson, blamed the Fed for deviating from its allegedly monetarist bent. Okun would have expected the money supply to grow at the same pace as inflation, but at the prevailing rate of 6% and price increases of above 10%, the result was a decline in real money growth of 4%. This, economists in the Keynesian camp warned, was stifling the economy, and although pumping up the money supply could lead to even higher inflation, they "were willing to pay the price."[444]

But William Poole (later to become president of the Federal Reserve Bank of St. Louis) rejected this view, warning that going the Keynesian route would not do much for unemployment but worsen the inflation–wage spiral. And because the public would not stand for further price explosions, the Fed would have to step on the brakes, bringing about another recession. Therefore, argued Poole, the choice was "not between inflation and unemployment but between unemployment now and unemployment later."[445] Paul Volcker was not part of this debate, but judging by his record as a fierce inflation fighter during his time as chairman of the Federal Reserve from 1979 to 1987, he would have been closer to Poole than to the Keynesians.

Nixon, never keen on spending time on economic policy, and depending heavily during the last years of his presidency on the wisdom of George Shultz and Herb Stein, his chief economic advisor, suddenly took an active interest in the "dismal" science in July 1974. He had traveled abroad with a swollen leg and had gotten no political mileage out of it. More exhausting trips were ruled out. But although it was not his favorite subject, focusing on economic issues—and there were serious issues—could from time to time keep him from brooding over Watergate and escape from the funereal atmosphere in the White House.

Inflation as diversion

Nixon's main economic concern—to the extent that he was able to focus on anything else than Watergate—remained inflation. Mustering what little energy he had left, he held a cabinet meeting with the inflation problem as the only item, following up with gatherings with businessmen and economists. He also met with his special economic advisor, Kenneth Rush—in part hired to keep the peace between Ash and Simon—and Herb Stein to discuss whether the Fed should start loosening the monetary reigns. Around this time, Arthur Burns was picking up clear signs of a recession but was not ready to pump more money into the system since inflation gave no sign of abating. This was in line with what the president's advisors told him, and this is what Nixon wanted to say in a supposedly major speech on the economy on July 25 in Los Angeles. The audience of 1,700 businessmen greeted Nixon with applause, but they got very little in return. The president's televised speech was mainly a rehash of old ideas, hammering on the need to stem inflation, the root of which was people living beyond their means. Except for the promise of a "sweeping review" of government regulation—always popular with businessmen—he had nothing concrete to offer. But even if Nixon's words on the economy would have been momentous, the public's interest would have been minimal at this stage of the Watergate saga.

The recession goes global

Elsewhere in the world, the economic upheaval caused by the oil shock started earlier than in the United States, and most European countries were soon struggling with a rapidly worsening recession, sometimes made worse by strikes, as in the United Kingdom. The downturn in one country was hurting its trading partners even if protectionist measures were few. And as the great majority of industrial and developing countries were simultaneously faced with a sharp drop in household consumption—especially durable goods such as cars, televisions, and washing machines—and corporate investment was stagnating, the recession became global. But most economic numbers lag behind actual developments, and such crucial information as the change in national production was released with a delay of a few months in the early 1970s, making it was very hard for central banks and governments to track what was going on in real time. Herb Stein's explanation that "we did not at all foresee that the unemployment rate was going rise to [a high number]"[446] was as true for European countries and Japan as for the United States.

While letting the dollar, the German mark, the pound, and other regularly traded currencies float had prevented the oil shock from wreaking financial havoc, large movements in currency rates—the dollar jumping around from an appreciation of 30%, then falling by 17%, rising by 10% and dropping again by 10% during 1974—was also complicating the lives of harassed central bankers. Some countries responded by heavily buying and selling dollars to track the greenback. This was a controversial practice that John Connally had dubbed "dirty floating" as compared to "clean" floating." But it had not deterred Canada and Japan from getting their hands "dirty," the Canadian Finance Minister, John Turner, claiming, "Two dirties make a clean."[447] Clearly, although floating was inevitable and comprehensive reform of the monetary system out of reach, some guiding principles were needed to avoid currency wars.

Fortunately—in sharp contrast to the United States—political stability had been maintained in Europe, and new dependable leaders had been elected. In May 1974, Helmut Schmidt was anointed chancellor of Germany and Valéry Giscard d'Estaing elected as the French president that same month. In addition, Harold Wilson's fourth incarnation as prime minister of Britain brought a modicum of calm to Albion. The exception was Prime Minister Kakuei Tanaka of Japan, who was still in office in the summer of 1974 but who resigned in November after revelations of dubious business practices and sex scandals; he would be convicted in 1976 of accepting kickbacks from Lockheed Corporation. But such goings on in faraway Japan was not very newsworthy in the West. In the summer 1974, the only thing that mattered was the fate of Richard Nixon.

9. Nixon's last stand

The Washington the summer of 1974 was hotter than usual, and blackouts and brownouts were frequent, with air conditioners going full blast in between. Pollution—cars were still massively spewing toxins in the air—created a hazy cloud over the city as sweaty pedestrians sought refuge in air-conditioned shops and cafes. The American president, staying cool in the White House but hounded by demonstrators and losing supporters as regularly as clockwork, geared up for what he knew was the final battle in a siege that had now lasted more than 2 years. In early July, he still believed that he had a chance to survive as long as he kept the June 23, 1972, tape out of the hands of his persecutors. Besides Nixon, only Haldeman knew what was on it, and he could be trusted to keep quiet, although he would later, in an unsuccessful attempt at blackmailing the president, ask for a pardon.

The high drama continued as Senator Sam Ervin presented the report of his senatorial committee. The conclusions were damning, but the senator fell into the trap of exaggeration, stating that Nixon had perpetrated such "wrongdoing that it called the legitimacy of the 1972 presidential election into question."[448] The White House simply ignored Ervin's publicity-seeking. But Nixon knew full well that heavier guns would be fired at him. He was now spending a large part of his day doing "the arithmetic of the impeachment vote."[449] When Gerald Ford met the president on July 13 in San Clemente, where Nixon was escaping the nation's capital's summer and political heat, he observed that the exhausted president "wasn't as strong either mentally or physical as he had been before"[450] and was full of resentment and bitterness about how unfairly he was being treated by Congress and the media.

Nixon was also spouting fire, complaining a few days later that his detractors had treated him with "savagery—well, we call it savagery—we will call it viciousness, sometimes libelous . . ."[451] Come July 19, 1974, John Doar, special counsel to the House Judiciary Committee, recommended impeachment on the grounds of the "enormous crimes"[452] Nixon had committed. This was hyperbole, especially considering that the content of the June 23, 1972, tape was not yet known. With impeachment around the corner, Nixon felt obliged to react this time, instructing Ron Ziegler to strike back during a press briefing. This the press secretary did with aplomb, accusing Doar of acting in a "partisan, duplicitous, false way" and stating that Chairman Rodino had presented a "false picture of fairness." It all was a sad and shameful show, "unutterably humiliating to almost all Americans that the leadership of government was now dangling by a thin . . . thread."[453]

Acts of desperation

Nixon was now showing clear sign of severe stress after the series of setbacks he had undergone. And in a paranoid state, he told Kissinger that his opponents wanted to kill their president, adding "I may physically die."[454] He was also becoming desperately worried about his political future. In this state of mind, the nation's leader, losing support among Republicans at an alarming rate, called George Wallace, the ultra-conservative governor of Alabama and third candidate in the 1972 election, to help him contain the flood of defections by Southern politicians. It was painful enough that Nixon was now asking a third-rate politician to save him, but downright embarrassing when Wallace told him that he could no longer support him but that he would pray for the president. Nixon, utterly dejected, simply told Haig: "there goes the presidency."[455]

On July 24, the Supreme Court broke the suspense, Chief Justice Warren Burger declaring that Nixon's claim of executive privilege did not apply in criminal cases. The verdict was delivered by a vote of 8–0, William Rehnquist (a future chief justice) having recused himself as a former employee of the Justice Department. The stunned president had no choice but to turn over the tapes Jaworski had demanded, among them the compromising June 23, 1972, conversation with Haldeman. With the Supreme Court handing down a unanimous verdict, Nixon's hopes of claiming the decision was not "decisive"—he had hoped for 5 for and 3 or 4 against—went up in smoke. America's maligned leader was now fighting for his life. He first considered handing over edited transcripts of the tapes but was soon dissuaded from taking that route. After all the manipulations with the tapes and transcripts, Tricky Dick had lost all credibility.

For the first time ever, Nixon asked someone else—his overworked lawyer Frank Buzhardt, soon to suffer a heart attack—to listen to the June 23 tape. Deeply shocked, the loyal counsel had to conclude after running the tape twice that it was highly incriminating. In other words, this was the "smoking gun." It was hard not to conclude that the president's instruction to Haldeman on June 23, 1972, to get the CIA tell the FBI to stop investigating the Watergate break-in was a clear case of obstruction of justice. Still hoping against his better judgment that he might be able to escape, Nixon asked his other lawyer, James St. Clair, and his chief of staff, Al Haig, to listen to the June 23 tape; he had just released 20 tapes to Judge Sirica, but was still holding on to the most incriminating one. St. Clair and Haig both shared the opinion that it contained the "smoking gun," the now nervous lawyer insisting that it be released forthwith out of fear that he, too, could be accused of obstruction of justice.

The House Judiciary Committee was finalizing its work, starting with its impeachment debate on July 25, 1974, in the packed Rayburn Building on Capitol Hill. The atmosphere was electric as the various members of the committee took the floor. In a televised debate, there was a tendency to play to the gallery. Besides denouncing Nixon on valid grounds, some speakers could not refrain from striking a sanctimonious tone. But as the majority of the more sober members of the committee also voted for impeachment, the die was cast. To Haig and Kissinger—if not to the president—the verdict could mean only one thing: Nixon could not survive any longer. Rumors were now swirling around, including reports of an imminent kamikaze attack on the Capitol by Nixon loyalists in the military. Other sources suggested that a coup was in the offing, executed by Marine units or the 82nd Airborne Division. The atmosphere in Washington had become as unhealthy as the pollution that plagued it each summer. In an attempt to warn his boss about the impending doom, his chief of staff told the beleaguered statesman, looking more haggard every day, that when the content of the June 23, 1972, tape became public—and leaks could be expected—"the staff won't hold and public opinion won't hold either."[456] But still Nixon was not prepared to resign.

Giving up the smoking gun

The only persons not pressing the 61-year-old president, nursing a dangerously swollen leg and in mental anguish, to retire were his family and the everpresent Bebe Rebozo. Nixon was still wavering, constantly weighing his options and changing his mind daily. On August 1, he told Haig that he would resign but reversed course in the evening while sailing on the Potomac, promising Rebozo that he would give it one more try. But on August 3, he showed his family the "smoking gun" tape and said that he would resign. His family, led by his feisty daughter Julie, demurred and talked him out of it. Nixon now took the line that he would not resign on Monday August 5, but he would release the June 23 tape, which his daughters and their partners judged to be open to differing interpretations, and attach a written explanation. Flying to Camp David and retiring to the Aspen Lodge, the president started working on what he wanted to put in his explanatory statement. And he developed a new strategy: He did not rule out resigning, but he first wanted to see what the reactions were after he handed over the red-hot tape together with his statement. Perhaps he could still get away with it, avoiding impeachment and surviving except for being censured by Congress. But Nixon's statement was clumsy and unconvincing. The first draft also contained obvious lies which his remaining inner circle did not accept, insisting on corrections that would also let them off the hook.

The statement was full of *mea culpa*: He, Nixon, had made mistakes, but "the basic truth remains that when all the facts were brought to my attention, I insisted on a full investigation and prosecution of those guilty." He continued: "I am firmly convinced that the record, in its entirety, does not justify the extreme step of impeachment and removal of a president."[457] And his severely stressed press spokesman kept repeating that the president would not resign. To briefly escape the media frenzy, the Nixon family again cruised on the Potomac aboard the *Sequoia* in the evening, but the trip was anything but restful, media types and gawkers packing the bridges to take it all in. To daughter Julie, it felt like a "death watch."[458] Back in the White House, Nixon learned that the reaction to his statement was devastating. All Republican members of the Judiciary Committee were now deserting him, stating in turn that they would vote for impeachment. Gerald Ford, prompted by the latest development and finally knowing what was on the June 23 tape, declared that he had concluded "that the public interest is no longer served by repetition of my previously held belief that . . . the President is not guilty of an impeachable offense."[459] Other comments ranged from "insincere" to "tawdry" and "a bunch of lies." Outside the White House, the "Jail to the Chief" signs were again proliferating.

How to end it

Nixon had been thinking hard about his options for quite a while. Members of his family, and some of his advisors were worried that Nixon might commit suicide. When firing the "Germans" in April 1973, he had told Haldeman that he felt terrible and that he "had prayed that [he] wouldn't wake up in the morning."[460] But having used the same sob story when informing Erlichman of his fate, he had clearly not been serious, but rather feeding his penchant for melodrama. Nixon's mood was different when he remarked to Haig in early August 1974: "[Y]ou soldiers have the best way of dealing with a situation like this. You just leave a man alone in a room with a loaded pistol,"[461] adding that he didn't have a pistol. Shocked, his chief of staff immediately ordered Nixon's doctors "that all pills be denied the President."[462] But the president, a deeply religious man, did not believe in suicide and did not ask for a gun.

Resignation was an obvious option but went against every fiber in Nixon's body, as he often stated. He was not a quitter but a tough fighter, as everybody could read in *Six Crises*. He could continue to fight impeachment tooth and nail, but after release of the June 23, 1972, tape and the almost violent reaction to his accompanying statement, that escape route was now closed. And being subjected to the humiliating impeachment process and putting his family through more agony was not an option for the proud man Nixon was. What about pardoning himself, which—according to some advisors—was legally possible? That also was not what a proud man would do and would strongly suggest guilt. Would Ford, on taking over as president, pardon him? He could not bank on it, and if he instructed Haig to ask outright for a pardon, the morally upright Ford might well "bristle, grow indignant, get angry, throw Haig out of his office, and set his feet in cement against a pardon."[463]

Nixon had now endured more than 2 years of hell and was suffering from phlebitis, which became worse rather than better—the illness would a few months later almost kill him—and was increasingly displaying erratic behavior. He was exhausted and slept poorly, often rambling and not thinking straight. But he was also bitter, angry, and disgusted with his detractors. All options he had considered that were not criminal acts were either closed, too risky, or too demeaning. In this state of mind and in anger, possibly fueled by heavy drinking—he had "a very limited tolerance for alcohol"[464] when he was stressed—he could be tempted to go out with a bang rather than the whimper of resignation. In describing Watergate in 1979 as one of the "most dangerous periods in American history,"[465] Haig—who was intimately involved in the events of August 1974—hinted that extreme outcomes of Nixon's endgame had been a distinct possibility but declined to go into details.

Still enjoying considerable support from the military, the president could try to enlist the units most loyal to him to stage a coup. But the chances of it succeeding without bloodshed could not be high. Moreover, if it was established that Nixon was somehow involved in an attempted coup, he would surely sooner or later end up in jail. Although Haig's mention of the existence of great danger in August 1974 may have implied the possibility of the military seizing power, it could well have been based on Nixon's well-known "itchy trigger finger."

Vietnam on his mind

Nixon had achieved many things during his presidency, but it was still bothering him that he had not been able to finish the job in Vietnam. The so-called peace Kissinger had brokered in Paris with Le Duc Tho had proved to be a paper tiger. The North Vietnamese, who had not stuck to their part of the bargain—and obviously had never intended to—were now getting ready to overrun South Vietnam. After having pulled out all its troops from Vietnam under the terms of the peace accord in return for a promise by the Communist side to cease hostilities, the United States had no means to withstand any aggression from the North Vietnamese Army and the Vietcong except for bombing the North. But this was no longer possible, Congress having reacted to Nixon's massive bombing of Hanoi in December 1972 by halting all funding for military action in Vietnam. The president remained deeply suspicious of Hanoi's plans—and with good reason—but was powerless to stop it from bringing the weak South Vietnamese Army to its knees and reunifying the country under the red flag. A mere 9 months later, this exact scenario would play out in Saigon.

There were still many Americans who found the prospect of the United States losing a war for the first time in history abhorrent. What had been achieved was not "peace with honor" but a pull-out with no hard guarantees that General Giap, the cunning strategist of the North, would not attack again. It must have crossed Nixon's mind that teaching the Communist elite a final lesson would be to destroy Hanoi. In an interview in 1981, he stated that he had made two mistakes during his presidency. The first one was not being tough enough with the North Vietnamese. But "the major mistake I made . . . was not doing early in 1969 what I did in May 3 of 1972 and on December 15, 1972, and that was to bomb and mine North Vietnam." Had he done so, he claimed, "We would have ended the war in Vietnam in 1969 rather than in 1973."[466]

Nixon also had an itchy nuclear finger. In 1954, only 41 years old and already vice president, he had tried to convince his commander-in-chief, Dwight Eisenhower, to intervene in Vietnam, where the colonial power—France—was losing the war against the Vietminh, led by Ho Chi Minh. The deciding battle was being fought at Dien Bien Phu, and Nixon wanted the United States to rescue the French, using atomic bombs if necessary. But Eisenhower wanted none of it, and the French army was thoroughly defeated. A few years on, Nixon threatened Communist China with American force if it did not halt its incessant shelling of two tiny islands—Quemoy and Matsu—held by the American-supported Nationalists. Seizing on his opponent's hawkish utterances, John F. Kennedy depicted Nixon as "trigger-happy"[467] during their famous televised presidential election debate in 1960.

There was no "new Nixon" when it came to military matters. In 1985 he revealed in an interview that he had come close to dropping nuclear bombs on Vietnam on several occasions. He had also considered a nuclear strike in 1970, when it looked as if the Soviet Union might "jump the Chinese,"[468] and again the next year as India and Pakistan were slugging it out and he feared Chinese intervention, but also in October 1973 when the Soviets threatened to get involved in the Yom Kippur war. And there was his close political advisor John Connally, whom he trusted more than Henry Kissinger and whose chilling views on Vietnam he did not hide. In his memoirs, the impulsive politician recalls that in early 1968 President Lyndon Johnson—by then hopelessly mired in Vietnam—asked him what he, Connally, would do to win the war. He did not hesitate, saying: "I would give Hanoi seventy-two hours to announce that they were withdrawing from the field and terminating their invasion of South Vietnam. If they had not done so at the end of seventy-two hours, I would destroy Hanoi."[469] Johnson replied: "We've been bombing Hanoi. . . . It doesn't even slow down the flow of supplies."[470] Connally explained: "I'm talking about using nuclear bombs.

I'm talking about destroying Hanoi."[471] As secretary of the treasury, the brusque Texan continued to bandy around his extreme message and may have encouraged Nixon—with whom he stayed in regular contact after he had left Washington—to wipe out Hanoi as a final act of defiance.

Could Nixon in the state of severe mental anguish and deep anger he was experiencing in early August 1974 have given the order to launch nuclear weapons? His track record of nearly reaching for the "red button" makes it plausible. And as commander-in-chief, his orders would have to be obeyed, the recipients not having the authority to refuse on the grounds that the president was mentally unstable. He could simply give instructions that American B-52 bombers take off from U-Tapau in Thailand and drop their lethal load on nearby Hanoi. The two-man rule requiring that a launch order by the president be confirmed by the secretary of defense did not yet exist. The risk of an unstable commander-in-chief going it alone was therefore not contained. Would there be retaliation from North Vietnam's closest ally, the Soviet Union? That was certainly to be expected, but Nixon might have thought Moscow would likely choose targets such as Guam and Midway, small enough to avoid triggering a total nuclear showdown. Nixon would be impeached anyway and could claim stress-induced temporary insanity to avoid adding to the charges. Others could worry about the political meltdown and Kissinger could do damage control.

Had Nixon in utter desperation taken the nuclear route, it would at a minimum plunge the world back into the depths of the Cold War, a risk that Kissinger did not want to take. The Harvard professor was on record that in 1968 he had judged Nixon to be "dangerous, capable of unleashing a nuclear war,"[472] although he insisted that he had changed his mind after Nixon had tapped him to be his national security advisor. Now, 6 years later, after first imploring the president to resign in the national interest, Kissinger teamed up with Haig, instructing the armed forces through Secretary of Defense James Schlesinger "that no military orders from the president of any national security importance were to be acted upon unless countersigned by one of them."[473] Vice-President Ford also sent out a message to the military: "I know that I can count on the unswerving loyalty and dedication to duty that have always characterized the men and women of the department of defense."[474] And with this action, the possibility of Nixon's "mad" option was also blocked. In 1981, General Haig, in a Senate hearing on his confirmation as secretary of state, took credit for his role in ensuring an orderly transition of power in a dangerous situation, but again without providing details.

The final push

Nixon's behavior at a cabinet meeting he had called on August 6 was erratic: He claimed that he still had options and that he should not resign, that being "be a regrettable departure from American historical principles."[475] Ford, with the presidency within his reach, became impatient and interrupted the president, emphasizing that he would not have made statements in support of Nixon had he known then what had surfaced about Watergate the previous day. The besieged president then bizarrely started a discussion on inflation but was made to understand that this was not the time for such a digression. He got up and left the room without a word. Later in the day, Nixon was still frantically doing political arithmetic and once again wanted to hear from Barry Goldwater where he stood. Haig made the call and got an earful, the senator saying he could not stand the president's lies anymore and that there was no point in continuing. In even more blunt language, the Arizona senator told fellow Republicans that "Nixon should get his ass out of the White House—today!"[476] From California, future president Ronald Reagan also got in on the act, supporting resignation.

Finally, fully convinced that all options except resigning were closed off, the 37th president of the United States gave up. Summoning Ford to the Oval Office on the morning of Thursday, August 8, Nixon told Ford he had decided to resign. "The President's face was ashen, but his voice was controlled and measured."[477] Having finally concluded what he should do probably helped a great deal smoothing Nixon's exit. His decision to leave was quite possibly based on the dual expectations that Special Prosecutor Leon Jaworski would let him off the hook if he resigned and that Gerald Ford would pardon him. On August 8, rumors about Nixon's throwing in the towel were swirling around in Washington, some wags telling friends, "there is a Ford in your future," quoting a once-popular commercial. That evening, the president seemed reasonably in control of himself, though emotional as he announced his decision to a television audience of tens of millions of viewers. Reactions ranged from sadness and shame to relief and "just desserts." At noon on August 9, 1974, Nixon handed over the presidency to Gerald Ford and bizarrely flashed his trademark V sign with his buttoned up jacket—as always—awkwardly stretched across his abdomen before being whisked away by helicopter from the South Lawn of the White House. A dangerous period in American history had come to an end, a potential catastrophe was avoided, and a "long national nightmare"[478] ended.

Part IV
Ruin Or Revival?

1. Searching for stability

After several years of mounting suspense, the wrenching Watergate crisis had finally been put to rest, avoiding a potentially chaotic and dangerous political situation with possible global ramifications. And the departure of Nixon and the xenophobic elements in his administration created space for improvement in international financial cooperation. But economic threats remained: stubborn and worsening stagflation and a lack of guidance of the international monetary system. And Gerald Ford faced the delicate legacy of Watergate: What to do with his predecessor? Moving swiftly, the "accidental president" pardoned Richard Nixon barely a month after taking the helm as America's supreme leader. The full and complete pardon elicited furious reactions. Bernstein and Woodward, the young journalists who had played a crucial role in Nixon's downfall, saw the pardon as a "betrayal," a "secret and dirty" act.[479] Ford's press secretary, Jerry terHorst, promptly resigned in disgust. Speculation about a deal between Nixon and Ford was rife, but the new president steadfastly insisted that there had been none. For months indignation about the pardon was vented, and it may have cost Gerald Ford the presidential election against Jimmy Carter in 1976. What the pardon did achieve was to remove the possible embarrassment that a Nixon trial and conviction would have caused—Judge Sirica revealed that he would have sent Nixon to prison—possibly encouraging America's Cold War adversaries to exploit Washington's perceived weakness. Henry Kissinger, who strongly held this view, had no doubt pointed out the risk to Ford.

The economy tanks

In late summer 1974, it became clear that the American economy was tanking; it continued to sink deeper during the following year. "[T] he "U.S. economy could not have been worse for Ford in his first full year in office."[480] The freshly elected president, in an attempt to ensure continuity, had initially kept on the whole of Nixon's cabinet, which proved to be unhelpful in halting the economic decline. The only new face among Ford's main advisors was Alan Greenspan, a number cruncher who had run a successful consulting firm and who had been appointed by Nixon in his final days as his chief economic advisor. William Simon, despite his far from stellar performance, stayed on as treasury secretary and did not display much insight or initiative either on the domestic or the international economic front. And with the departure of Paul Volcker from the Treasury, relations between the United States and the IMF deteriorated to their nadir. Witteveen relates how he endeavored to establish better relations with the U.S. administration and also met with internationally minded Congressman, a diplomatic offensive that gradually paid off.

It had become customary in the United States to express economic conditions in a *misery index* by adding the percentage of unemployment to that of the rate of inflation. At the end of 1974, the index stood at 15.2 points—unemployment having reached 5.8% and inflation running at 9.4%—an increase of 7 points compared to the first year of the Nixon administration. Worse was to come in early 1975, the index shooting up to 17.6%, unemployment having jumped to 8%, but as the year proceeded, lower inflation brought some relief.

The degree of economic misery was comparable in many other parts of the world, and the volume of world trade—usually growing faster than global output—shrank by 4.5% in 1975, the worst result in peacetime

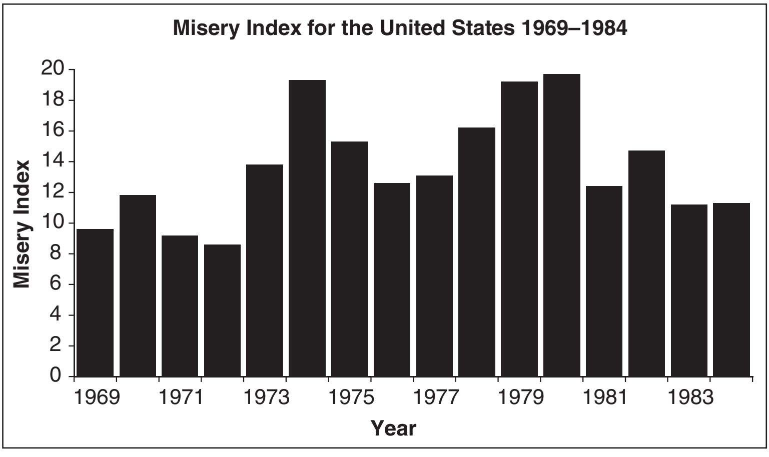

Figure 4.1 U.S. Misery Index, 1969–1984.

since the Great Depression. And it did not help that although the oil crisis had made floating exchange rates inevitable, currencies continued to show sharp fluctuations, increasing economic uncertainty. Without a responsible global response to combat the deep recession, stubbornly high inflation coupled with excessive uncertainty about the level of the dollar, the world economy was heading toward a meltdown.

Whip inflation now

Early in his tenure, Ford's economic team convinced him to concentrate on fighting the inflation dragon. The chosen approach was to convince the public at the grassroots level to beat inflation by voluntarily adjusting their behavior. According to the president, "If both the government and the people tightened their belts voluntarily and spent less than they had before, that would reduce demand, and the inflation rate would start going down."[481] The most visible—and derided—part of this simplistic attempt was a massive issuance of WIN (Whip Inflation Now) buttons, supposedly helpful in swaying the public to change their ways. Greenspan, who was new to the White House and who had not been involved in the WIN project, thought it reflected "unbelievable stupidity."[482]

Being a pragmatist, Ford first contemplated a tax increase on the advice of his treasury secretary, then reversed course in January 1975, deciding to lower the income tax and at the same time impose a windfall levy on oil refineries. Secretary Simon and his ultraconservative brethren were deeply unhappy, also because the president had been listening to the advice of Greenspan and William Seidman—brought in to head the newly created Economic Policy Board—to initially concentrate on easing the recession. But Greenspan and his supporters were not giving up in the battle against inflation; they merely wanted a pause to avoid a downward economic spiral. And vastly improved relations between the White House and the Federal Reserve allowed for close coordination between fiscal and monetary policy. Chairman Arthur Burns, who had kept interest rates elevated during most of 1974, eased up somewhat in early 1975 but refused to fully open the monetary spigot that many in Congress were aggressively calling for.

Late winter and early spring of 1975 were crucial months not only for the United States economy, but also for the entire capitalist world. "During the first half of 1975, unemployment and slack in utilization of productive capacity in the large industrial countries reached levels not witnessed for several decades,"[483] wrote the IMF in its annual report for 1975. In the 1½ years after the oil crisis of late 1973, the economies of industrial countries shrank by almost 2% after having grown on average by 4.6% between 1962 and 1972. The worst affected were wage earners, experiencing lower standards of living and suffering from a widespread job losses. By mid-1975, the fall in national production in the United States since the quadrupling of oil prices had reached 3.8%, more than in any other industrial nation. France, escaping serious interruption in oil supplies, fared best, managing to avoid shrinkage, but would in future years lag behind. Ominously, as badly as the real economy was faring, inflation in industrial countries did not—as was normal during recessions—come down, averaging 10%.

Cooperation to the rescue

Unlike the 1930s, when a lack of international cooperation led to the catastrophe of a worldwide depression, the realization 40 years later that another economic meltdown could only be avoided by nations working together was the crucial difference between the two periods. Just as importantly, the American president and the head of the American central bank developed "the closest relationship between a president and a Fed chairman in history."[484] In 1975, Burns had no less than 48 meetings with Ford, and for the 2½ years of the president's tenure, 69 times, a uniquely high number. In Europe, too, coordination improved markedly. With the impulsive Karl Schiller gone as minister of finance of Germany, succeeded by Helmut Schmidt, who appointed the steady Hans Apel in 1974 in his place, the German government and the Bundebank worked better together than before. And at the highest level, the relationship between Chancellor Schmidt and President Giscard d'Estaing of France, both anointed in spring 1974, was as close as was conceivable between the leaders of two former enemies. Although coordination of policies in Western Europe was never easy, the example of the French–German tandem stimulated other Common Market countries to work closer together, although plans for a European monetary union went nowhere at that point.

Green shoots

By the middle of 1975 early signs of economic recovery—so-called green shoots—had become visible in the United States, prompting a shift toward a tougher stance on inflation. Expansionary budget policy was halted, no longer providing stimulus to the economy, while the Fed was easing monetary conditions. Such a policy shift taken in great harmony owed much to the personalities involved. The president's chief economic advisor, Alan Greenspan, enjoyed an excellent rapport with Ford, both believing that "what the economy most needed was a return of confidence and cool."[485] And monetary guru Arthur Burns became close with Ford: "The contrast with Nixon could not have been greater."[486] As

Burns was to comment later, "Ford was the only president who really understood me."[487] Ford, unlike Nixon and presidents before him, did not try to interfere with the Fed, having grasped after the WIN button debacle that the central bank had to have a free hand in conducting monetary policy.

Cooperation among American policymakers had been crucial in avoiding the ruin of a downward spiral of the economy, which, considering its size—around a quarter of global output was produced in the United States—would have dragged other countries with it and provoked trade and currency wars. In Europe, improved cooperation between governments and central banks, as well as better relationships between government leaders, also produced favorable results. But the Continent lagged somewhat behind, the green shoots of recovery showing up later than in the United States. In Japan, where policy cooperation was not an issue thanks to the central bank's lack of independence, did better than most, its exports roaring back in the summer and fall of 1975. But the sense of relief that went with a return to growth was tinged with concern about the most stubborn inflation in modern times in industrial countries. Part of it represented the aftermath of the oil shock, but the main culprit was an inflation psychology that had taken hold. Wage earners and businesses had come to fully expect price increases year after year—which, if continued at 10% a year, would lead to a doubling of the price level in 10 years—and had adjusted their behavior accordingly. Wage increases remained high, and corporations were passing on their higher costs to consumers. Inflation had become chronic and was in danger of morphing into a ruinous state of hyperinflation.

Central banks, but also most governments, concluded that because incomes policy—price and wage controls—did not work, there was no choice but to tighten monetary policy to break inflation expectations. History had shown that rapid inflation tends to feed on itself—the experience of Weimar Germany in the 1920s being the most spectacular example—to the point of endangering the fabric of society. To slay the inflation monster would require great determination and endurance from central banks, and not many countries could boast their chief money masters to be in that class. Germany was among those who qualified, with Karl Klasen followed by Otmar Emminger, whose facial features could with some imagination be compared to that of a hawk. After the redoubtable William McChesney Martin, the United States' monetary helmsman, Arthur Burns, enjoyed only partial success. In Italy, Guido Carli was impressive but had little to no support from his profligate government. Among the smaller countries, the Dutchman Jelle

Zijlstra and the Swiss Fritz Leutwiler, both sharing the German monetary philosophy, were also seen as hard money men.

Policymakers and academics who believed in monetary discipline understood that until newfound growth was accompanied by low inflation, a return of the days of milk and honey of the 1950s and most of the following decade would not be possible. It was simply an economic and political necessity to bring down the misery index—which during one point in 1975 shot up to almost 20%. President Ford did not have luck on his side. Despite a mostly above-satisfactory performance by the American economy in the first half of 1976—national income growing at a rate of 6%—unemployment stubbornly remained at 8%. The lack of new jobs diminished Gerald Ford's chances to win the November 1976 presidential election against James (Jimmy) Carter, former Democratic governor of Georgia.

Avoiding a currency war

Following a peaceful resolution of the Watergate drama, the return to economic growth in the summer of 1975 and an easing of oil prices had avoided another serious meltdown. Yet all was still not well; the scourge of inflation could not be left untreated lest inflation psychology led to a social breakdown. And the international monetary system had become rudderless after the collapse of the Bretton Woods system, posing the risk of a currency war. With the exception of ivory tower economists like Milton Friedman, who thought that fully floating rates would take care of the adjustment process, monetary experts agreed that something had to be done to either fix the system or at least agree on some principles that would be mindful that the existence of widespread floating could create havoc reminiscent of the 1930s.

Within the G-10, the discussion on international monetary reform had stalled. The United States was dead set against anything resembling a system of fixed exchange rates and rejected a role for gold such as that touted by France. The Americans, represented by Simon and Volcker, made clear that they no longer wanted to have their country's hands tied by some mechanism or rule that would force adjustment on it by others in order to rein in its balance of payments deficits, whereas the continental European countries were clamoring for a way to force countries with large deficits, meaning the United States, to bring them down. In more diplomatic terms, the debate was about whether the onus should be on deficit countries or surplus countries to adjust their economic policies. The United States—then the major surplus country—had come full circle since Bretton Woods, where White, much to Keynes's displeasure—had insisted on having deficit countries doing the heavy lifting. Now, 20 years later, the European surplus countries countered that since they were following disciplined policies, it was not up to them to change course. But American officials were allergic to anything that was designed to "discipline" their country. The resulting impasse and attendant acrimonious debates were terminated in early 1974 when the C-20 ministers decided that going on would be a waste of time.

Dead end

Although only a palliative, the IMF staff, under the guidance of the heavily accented Scot Marcus Fleming, had in the meantime produced a set of guidelines for floating exchange rates. The idea was to reduce extreme swings in currency rates by allowing central banks to buy and sell foreign currencies—and so influence the exchange rate—under certain circumstances. But most members of the IMF Executive Board, especially the assertive American director, Sam Cross, worked hard to water down the guidelines, which went through eight drafts. The board met more than a dozen times on the subject, and members became weary and restless listening to what is euphemistically known as the "oratorical style" of some speakers. But throughout the seemingly endless discussions, Witteveen, chairing the meetings, "suppressed signs of frustration and listened with (almost) inexhaustible politeness. At the end of each debate, despite the divergent and sometimes irrelevant opinions expressed, he was able to find elements of insight in all speeches and weave a consistent story of what he suggested could contribute to a consensus. The directors, impressed (and a little proud) to hear how coherent and valuable their interventions had been, felt flattered to be contributing to that consensus."[488]

The IMF board finally agreed on a weak text in June 1974, but efforts to implement the guidelines came to naught, and the project was ignominiously dropped the next year. At that stage, work was already under way to design new binding rules for a modest reform of the monetary system. The fund's managing director, fighting for his organization's position as the center of the system, declared, "[W]e would be wise to adopt an amendment of our Articles of Agreement that would allow the exchange system to develop in the manner best suited to evolving circumstances."[489] In other words, saddling the system with strong and binding rules was to be avoided.

Ceasefire

The United States' negative attitude toward the IMF was gradually changing within the overall more positive stance toward monetary cooperation of the Ford administration. International discussions in the G-10 and elsewhere on amending the Fund's statutes, though drawn out over several years, had a different tone than during the Nixon/Connally years. But there were still bouts of acrimony, mostly featuring traditional economic adversaries: the United States and France. The American view, pushed hard by Volcker and Simon, was that floating exchange rates should be fully accepted and no longer branded as "illegal." Predictably, the French insisted on returning to a system of fixed rates. In the meantime, the American insistence on removing gold from the system—"demonetizing" the yellow metal—was gathering steam with the full support of Johannes Witteveen, who favored a central role for the struggling SDR.

Washington's aim was largely achieved despite heavy counterattacks by France's minister of finance, Jean-Pierre Fourcade, who had succeeded Giscard d'Estaing upon his elevation to the presidency. A final breakthrough on the gold question came when the ministers and governors of the five largest shareholders of the IMF reached an informal agreement while pleasantly cruising the Potomac River on the presidential yacht *Sequoia*, on which Nixon had once brooded about how to escape impeachment. After selling the deal on gold to other countries, the rules were permanently changed. There would no longer be an official gold price. Central banks and the IMF were allowed to sell gold to the market. The requirement for fund members to pay 25% of their contributions in gold was dropped. But an energetic attempt by Witteveen to establish a gold substitution account, allowing central banks to convert their "excess" gold into dollars through the intermediation of the Fund, did not gain traction. And because old habits die hard, and although the role of gold was substantially reduced, most central banks and treasuries were not ready to part with what they considered an important part of the national wealth and a war chest, despite gold's diminished monetary role.

Floating circumscribed

Witteveen reverted to his tactic of patience and flattery to move along the drawn-out discussions on whether countries should be fully free to adopt a floating exchange rate. Much of the hard work was done by the fund's executive board, where the eloquent American and French directors, Sam Cross and Jacques Wahl, were pitted against each other. The increasingly proactive developing countries tended to side with the French position to end the "experiment" of floating and return to a par value system, while Canada and the United Kingdom stayed close to the American position. For Germany, the issue was vexing, and although it had learned to live with floating, it was reluctant to oppose France and endanger European solidarity. At the highest level, the irascibility of French finance minister Fourcade made it very hard to make progress, and in private Witteveen expressed his frustration with the Frenchman's behavior.[490] When the umpteenth compromise draft of a new article in the IMF statutes on floating was examined by financial leaders in Paris on June 10 and 11, 1975, the by now isolated French still opposed "legalizing" floating rates. And the United States remained reluctant to accept any mention of a return to fixed exchange rates.

But things were looking up when at the usual dinner of members of the IMF's ministerial committee it appeared that an American–French *rapprochement* was in the works, as Fourcade had tentatively agreed to a formulation that he—working in his nonnative English—took to mean that the central objective would be to attain "a system of stable exchange rates." The next morning, a very unhappy French Minister realized his mistake when he read the written text of the agreement, which referred to "a stable system of exchange rates,"[491] a much looser formulation, basically allowing floating. Angry and frustrated, "Fourcade tossed aside the . . . draft . . . as a 'caricature of the par value system,'"[492] and the agreed formula was discarded.

Sensing the need to end the impasse and avoiding the risk of a political blowup—the exchange rate regime had been tightly linked to French foreign policy since De Gaulle—Witteveen flew to Paris in July 1975. Knowing that Fourcade would be absent and that his deputy, Jacques de Larosière, entertained more moderate views than his minister, he hoped to make some headway. The savvy Frenchman helpfully explained that his country's seemingly immutable position was a bargaining chip to get the American side to relent a little in opposing all intervention in currency markets. A few months later, Fourcade—still in a pugilistic mood—squared off against his American counterpart, William Simon, forcefully repeating his earlier position and the former Wall Street bond dealer doing the same. By now the finance ministers of the three other big countries—Germany, Japan, and the United Kingdom—were getting impatient with the constant Franco-American dust-up, telling their excitable colleagues that they would go along with any language that was acceptable to both. But "[i]n giving *carte blanche* they . . . did not expect the U.S. and French authorities to settle their differences."[493] Soon they would be pleasantly surprised.

American–French breakthrough

The new wave of international cooperation, fostered by Ford, Schmidt, and Giscard, created a climate in which forging compromises became more acceptable to national legislative bodies and other interested parties. The days of John Connally lay firmly in the past. Making the best use of the new diplomatic atmosphere, the freshly appointed American undersecretary for monetary affairs, Edwin Yeo III, and his French counterpart, Jacques De Larosière, began an intensive series of secret meetings. After traveling to Paris 17 times in 3 months, Yeo—who probably liked the city on the Seine more than the Frenchman liked Washington—and his pragmatic colleague were able to thrash out a clever compromise on which President Giscard was willing to sign off. The main French concession was to recognize that countries should be free to choose floating rates, while Yeo could accept a reference to a possible future par value system in the amended IMF statutes, which would also require member nations of the IMF to allow close monitoring—"firm surveillance"—of their economic policies.

Closing the deal

The French president, sensing that the momentum had to be kept up and that the time was ripe to formalize the agreement reached at the expert level, wanted to invite his colleagues Ford, Schmidt, Wilson, Moro, and Miki (the Japanese prime minister), to a confidential summit meeting. But the American administration was quite skeptical of Giscard's initiative. George Shultz, no longer a cabinet member, but available as a highly skilled negotiator, was asked by Ford to meet with Giscard and Helmut Schmidt, as well as with Harold Wilson, the British prime minister, to sound them out. Marking progress, a dinner was arranged at Marly, a residence near Versailles reserved for French presidents. In a congenial atmosphere, the discussion focused on the monetary system and proved to be a turning point for the position of the United States. Shultz, the informal ambassador, marveled at how such a high-level dinner could take place "without the event being reported or perhaps even known by the world press."[494]

After the positive atmosphere at Marly, Giscard went ahead and arranged a confidential meeting among the world's high and mighty to close the deal that De Larosière and Yeo had prepared. This time the venue was the Chateau de Rambouillet, tucked away in a forest a short distance south of Paris. Being the second presidential residence, the chateau is well appointed, though more of a country mansion, quite different from the splendid Elysee Palace in the heart of Paris. Its great advantage as a meeting place was that it was far away from the hustle and bustle of the French capital and the prying eyes and ears of journalists. Moreover, it was the residence Giscard preferred by far. In his memoirs, he waxed lyrical about the beauty of the surroundings, located at the edge of the magnificent forest where Charlemagne had once liked to hunt. It had been love at first sight for Giscard when he set eyes on Rambouillet at the invitation of General de Gaulle for a hunting outing in the early 1960s.

On the occasion of the summit meeting, held on the weekend of November 14 and 15, 1975, the guests were delighted by the setting and worked productively on a number of issues. The French president liked to consider the assembled statesmen "our little group" who decided issues of global importance. This stung smaller industrial countries like the Netherlands and Belgium, who expressed unhappiness at not having been invited. But it became clear that the days of the G-10 as the center of international discussions were over. Canada was also not invited to Rambouillet, but was later added—at the insistence of the United States—to what became known as the Group of Seven (G-7).

Lifting the veil

The agenda for the Rambouillet summit covered a wide range of subjects among which monetary reform was viewed as vital. The informal American–French agreement on exchange rates had been kept secret, including from the other four invitees—quite an achievement in itself—and when the French president announced over a sumptuous dinner that a bilateral accord had been reached, the reaction was one of great surprise. Such a show of international cooperation was hailed as a refreshing departure from recent clashes. Closer cooperation was further affirmed as the six government leaders also pledged that treasuries and central banks would regularly be in touch on exchange rate developments and work together to "counter disorderly market conditions or erratic fluctuations [of currency rates.]"[495]

The embryonic meeting of the G-7 was a great success and raised President Ford's international profile, having displayed a good grasp of the discussions on economic policy and a positive attitude toward international cooperation. But crafting the exact language of the new article on exchange rates of the IMF statutes was less harmonious. At a meeting of the G-10 in Paris in December—the G-10 would survive for many years more but progressively lose influence—the IMF staff, represented by its general counsel, Joseph Gold, and its chief economist, Jacques Polak, raised objections to the draft produced by the Yeo-De Larosière duo. It did not help that the top brass of the fund had been given copies of the draft text on exchange rates only 3 weeks after its endorsement by the Rambouillet Six. "As a result of their criticisms—both of a legal and economic nature—Messrs. Gold and Polak were highly unpopular with the deputies of the Group of Ten . . . and were attacked for obstructing the long-awaited political resolution of the problem of exchange arrangement."[496] Meeting in Washington soon after the contretemps at the G-10 gathering, Polak was excluded from the redrafting group of Yeo and De Larosière even as Joseph Gold, the usually congenial British lawyer, was invited to participate. More annoyance was generated when the IMF general counsel presented a long list of changes, but eventually, after Gold had left the meeting for an hour in an agitated state, the redrafting was finished late in the night. The matter was smoothed over when the G-10 ministers met on December 19 and Gold was thanked, with tongue in cheek, by the American and French ministers, Simon and Fourcade, for contributing to an "important improvement in the text."

Meeting in Jamaica in January 1976, the oddly named Interim Committee of Ministers and Governors of the 20 countries and groups represented on the IMF's executive board gave their blessing to the changes

British prime minister Harold Wilson and U.S. president Gerald Ford at the Rambouillet Conference, November 17, 1975. (Courtesy Gerald R. Ford Library.)

proposed in the Fund's statutes. The new Article IV essentially maintained what the Americans and French had worked out, emphasizing collaboration with the IMF by its members to promote orderly conditions on currency markets and work toward a stable system of exchange rates (the wording that had so bothered Fourcade before). An important element that had been pushed by the United States was the injunction to abstain from *manipulating* exchange rates. The intention was to prevent countries from gaining an unfair competitive advantage by maintaining an undervalued exchange rate. Types of manipulation were listed including large scale purchases of dollars (interventions) by central banks and measures to limit capital flowing into countries. And to monitor compliance, the IMF would exercise "firm surveillance" over exchange rates. But surveillance never turned out to be so tough that any country was ever identified as a manipulator.

Major reform or fiasco?

The Jamaica agreement was greeted with fanfare and relief by the IMF and its largest shareholders. A role for the fund for been preserved and a damaging political irritant removed. A stronger dollar, buoyed by the vigorous recovery of the American economy, contributed to the atmosphere of self-congratulation. U.S. treasury secretary Simon even compared the outcome to the success of the Bretton Woods. But not everybody shared this highly optimistic vision, some monetary experts expressing doubts about the importance of the Jamaica agreement and referring to the new language of the statutes as comprising a "nonsystem." Hard rules for managing exchange rates were absent, and the official use of gold was not fully eliminated.

Among the critics was Alexandre Kafka, the respected Brazilian executive director at the IMF, who referred to the result as "reform without reconstruction."[497] Robert Triffin, a longstanding advocate of comprehensive reform, was also disappointed, suggesting that the exercise had been a fiasco. Doubts about the implementation of the new rules were also harbored in private by IMF chief Witteveen, who worried that the "very sensitive area" of exchange rates would be difficult for the fund to influence—as turned out to be the case. It showed, Witteveen comments in his memoirs, "how powerless governments were to solve this fundamental problem of the monetary system."[498] It was clearly no time to return to anything that resembled the Bretton Woods system. The dollar was now firmly in place as the only reserve currency of any importance, and the SDR was gradually withering away, playing only a marginal role.

Like so many well-thought-out initiatives, it seemed to be going the way of Esperanto.[499]

2. Stimulate or deflate?

By early 1976, fears of a world economic meltdown had ebbed and the exchange rate conundrum was for the time being set aside. The summer and fall of 1975 had brought good news as the economies of the United States and other large countries, with the notable exception of the United Kingdom and Italy, had come roaring back, a trend that continued in 1976 and early 1977. The American economy, usually the first to pull out of a deep recession, was growing at a pace of 7% a year, with Japan's close behind. The German and French economies also started to recover well in early 1976, but with Germany enjoying a much lower rate of inflation. The IMF commented in September 1977 that "the countries that have been most successful in bringing down inflation—including the United States, the Federal Republic of Germany, and Japan—are now in a relatively good economic position."[500] As the recovery took hold, policies shifted to fighting persistent inflation to remove the damaging uncertainty caused by rapid price increases that could stifle future growth. Germany was the star pupil, having brought down inflation to 3%, with the United States in second place at a rate of 5.3% in 1976. And both countries had made it very clear that fiscal and monetary policy were to be tighter than before in the hope of keeping price increases manageable.

Ford and Burns were managing the American economy in a well coordinated and harmonious way, but Democrats in Congress were concerned that the Fed was too tough in reigning in inflation. A group of house representatives led by Henry Reuss and by the charismatic Senator William Proxmire were trying very hard to "democratize" the central bank, a euphemism for reducing its independence. Burns now had to appear regularly before Congress, and his verbal sparring with the politicians became known as the "best theater in Washington."[501] But the self confidant Fed chairman usually got the upper hand, frustrating the members of Congress to no end.

Elsewhere in the world, monetary policy was also tightened and progress made in fighting inflation, now public enemy number one in northern Europe and Japan. Not so in Italy and the United Kingdom, where a combination of political instability and expansive policies, too long maintained, led to disconcertingly high inflation. The British became the inflation champions for an industrial country in 1975, prices rising by a shocking 28%—close to what could be considered out-of-control inflation—and Italy claimed the title in 1976, with 18%. In both cases sluggish economic growth contributed to a severe sense of malaise. As both countries were also having balance of payments and exchange rate problems, they had no choice but to turn to the IMF for financial support.

Britain waives the rules

What followed was a drama worthy of Shakespeare or Italian opera. The British Isles possessed the fourth-largest economy in the world; Italy, the sixth. Neither country had needed the IMF before, and both were extremely reluctant to take the usual bitter fund medicine. Moreover, these were countries with a long history of finance, their banks having lent to other countries all over the world. Now they were in the uncomfortable position of asking for money instead of lending it. As they were big enough to cause serious damage to the global economy if one of them, or worse both, were to fall into a deep depression or default on their foreign loans, they believed they had enough clout to negotiate soft policy conditions with the IMF. For Britain, the existence of a holdover from the heyday of the British Empire, the pound sterling area, was a complicating factor. And in Italy, a weak minority government did not dare reverse its overly expansionist policies.

On several occasions, the Bank of England had asked friendly central banks to tide it over when its foreign reserves were falling because of withdrawals from pound sterling balances held in London. And in March 1976, when Nigeria was converting part of its pound sterling deposits into dollars just as the British central bank lowered its lending rate, the pound plunged. This was probably not a coincidence, as "some figures within the U.K. Treasury were looking for a way of raising international competitiveness through a devaluation of sterling by around 5 percent,"[502] no matter what the new IMF rules said about manipulating the exchange rate. Markets, suspecting that Britain was pushing the pound lower, reacted strongly, forcing the Bank of England to turn again to supportive central banks for a bridge loan of $5.3 billion to be repaid in 6 months. As central banks can only supply each other with short-term financing, the natural exit from the bridge was the IMF. The previous year, Britain had already obtained in excess of $2 billion from the fund with very few policy strings—know as conditionalities—attached. But at the insistence of the United States, and with agreement from most other G-10 countries, any fresh IMF money could this time only be obtained with strict conditionality. The British leadership was not amused by the prospect of going cap in hand to Washington and being told to do unpleasant things.

Policy dilemmas had long plagued the British economy. Attempts to stimulate economic growth and reduce unemployment had led to high inflation, followed by two large devaluations under the Bretton Woods system. And after the pound was floated, many bouts of depreciation of the British currency occurred. The problem was already acknowledged by Harold Wilson when he became prime minister in 1964, deciding "irrevocably" not to devalue, having in mind that "[t]he financial world at home and abroad was aware that the . . . decision to devalue in 1949 [by 30%] had been taken by the Labour Party government. There would have been many who would have concluded that the Labour government, facing difficulties, always took the easy way out by devaluing the pound. Speculation would be aroused every time Britain ran into even minor difficulties—or even without them."[503] But a mere 3 years later, the rate of the pound sterling was adjusted downward by 14.3%. The Bank of England's modest dollar reserves added to Britain's vulnerability, although it could delay the inevitable by encouraging an increase in pound sterling balances by raising interest rates or by borrowing from foreign commercial banks. Pound sterling balances were a legacy of the role of the pound as a reserve currency—important at the time of the gold exchange standard—but any increase in them was essentially a form of creating debt. And borrowing dollars from banks, made easy at first because of oil money recycling, was becoming more expensive as Britain's creditworthiness was no longer unquestionable.

Merry-go-round economics

The result of this complex mix was a series of "stop and go" policies, expansion leading to inflation, large trade deficits, and capital flight followed by tight budgets and credit crunches, pushing up unemployment. These economic merry-go-rounds, frequent strikes, and political uncertainty gave rise to talk that the United Kingdom was becoming ungovernable—even suggestions that a military coup was in the offing were aired. Against this most uncomfortable background, the experienced politician James Callaghan—chancellor of the exchequer at the time of the 1967 devaluation—took over from Harold Wilson as prime minister in April 1976. A moderate socialist, the new British leader was already 64 years old when he moved to Downing Street no. 10. He kept robust and bushy-browed Denis Healy as his chancellor. Not only did the pair face formidable challenges abroad, but they also had to deal with an unruly left wing within the Labour Party, led by long-haired, acerbic Michael Foot, the stereotype of a socialist activist.

Although mild budget cuts introduced by Healy in 1975 enjoyed some initial success, more permanent confidence in the British economy and the exchange rate remained elusive. As demanded by the central banks that had provided the bridge loan to their British sister institution, secret discussions between UK officials and the IMF staff began in August 1976. They were to be concluded in December when the bridge loan had to be paid back, the IMF taking over from there. But the British were dragging their feet, claiming they could not provide the necessary economic forecasts by late October as the fund team had requested. Around the time of the 1976 IMF annual meeting in Manila, the pound sterling swooned, dropping from an already sharply depreciated rate of $1.79 against the dollar in July—40% lower on a trade-weighted basis than at the time of the Smithsonian agreement—to $1.63 on September 28. Healy, waiting at Heathrow airport to board a plane to Manila, hurried back to the UK Treasury and immediately announced that Britain was applying for a large credit from the IMF.

The IMF goes undercover

Negotiations started in earnest in London the following November. The atmosphere in London was tense. To reduce encounters between the fund staff and reporters, UK officials registered the staff in a hotel under assumed names. Although the intention was innocent enough, reporters later interpreted it as a desire by fund staff to enter London unseen to secretly dispense their bitter medicine. Although the IMF team, fully supported by their managing director, was indeed talking tough, their British counterparts were proving to be even tougher during the drawn out negotiations. Right off the bat, Healy announced that the United Kingdom wanted to borrow $3.9 billion, the maximum under then-prevailing IMF rules, and stated that he believed the measures already taken were sufficient to obtain the money. Witteveen, judging the chancellor's words to be "a rather brazen claim,"[504] remarked during a press conference at the IMF annual meeting that a staff mission would visit London to thoroughly examine British policy. To make sure the message was clear, he added that negotiations with the United Kingdom would be conducted in the same manner as with other members of the IMF.

When the IMF team, led by Alan Whittome, a former high official of the Bank of England, revealed that it considered a reduction of 3 billion pounds in government expenditure necessary, Healy rejected the idea out of hand. The main problem stemmed from dissension within the Labour Party, where the dogmatic Keynesian faction insisted on expansionary policies targeted at lowering unemployment and maintaining a high level of social spending. And to cope with the high balance of payments deficit that would inevitably follow, the party's radical left wing favored erecting import barriers. Even within the more moderate British cabinet, there were also suggestions to use the threat of protectionism as blackmail against the IMF. The prime minister at that stage did not want to go this dangerous route but remained silent on the talks with the IMF, which were conducted by his chancellor. As intense as the pressure in the British cabinet and socialist establishment was on Healy, he exercised the same degree of pressure on fund negotiator Whittome. Early in the debates, which took place at the level below that of Minister Healy, the IMF team was stymied by the refusal—per the instructions of the British officials—to discuss any changes at all in policies.

Trench warfare

When Whittome informed Witteveen of the trench warfare between the fund and British officials, he was instructed to return to Washington. This helped as Healy now allowed his officials to discuss policy adjustment, but progress on actual changes was minimal. The whole of Britain was following the saga with its possible catastrophic political consequences for the Labour government, with reporters constantly hounding the negotiators. Healy's next move was to have his representative at the IMF, William (Bill) Ryrie, approach his American and German colleagues—considered hardliners—to be more forthcoming, claiming that Britain's policies were sound and that it simply needed IMF money to get it through a bad patch. Ryrie's *demarche* was unsuccessful, and when Britain in secret requested German deputy minister of finance Karl Otto Pöhl (in 1977 to head the German central bank) to use some of the Bundesbank's ample reserves for a balance of payments loan, he abruptly refused. American support for the IMF's position was also firm, Arthur Burns exhorting Witteveen to "[k] eep to the rule of law"[505]—in other words, not deviate from regular IMF conditionality under any circumstances. The fund chief, while not believing the rule of law was at stake here, considered it essential to let the IMF negotiate as objectively as possible and not determine policy conditions under political pressure. But this was not how the British politicians saw it, Healy continuing to use every trick in his toolbox to soften conditions.

In December 1976, with the deadline of repayment of the central bank bridge loan close, the British cabinet readied itself to reach a final decision on what changes in economic and financial policies it could accept. The IMF negotiators did not know what Healy would be proposing, and Callaghan had all the time refrained from revealing what he deemed to be the best option. Being in the dark and fearing an outcome that would be damaging not only for Britain, but also for the world economy, such as erecting a fortress with trade tariff and quota walls, the IMF and the United States agreed that a critical moment had arrived.

The alarming possibility of the meltdown of a major economy prompted the United States to try to force Britain to agree to a program with the IMF based on truly sound policies. President Ford, now in his final days in office, had been warned about the situation and asked IMF chief Witteveen to immediately travel to London "as a personal favor"[506] to speak with the British prime minister. Witteveen thought the request "strange" but agreed to try to get the negotiations back on track. Boarding a plane the same evening, aware of the tremendous publicity the IMF had to cope with, Witteveen was surprised that when he crossed the tarmac at Heathrow the next morning, the few journalists around did not recognize him. This was unusual, as the IMF staff team in London had been exposed to journalists taking pictures of the hotel windows behind which they suspected the negotiators to be. And the fund's chief negotiator, Alan Whittome, was followed by a media helicopter while being driven to the UK Treasury. But this time the lanky Dutchman succeeded in reaching Downing Street without any attention being paid to him. The journalists must have kicked themselves when they found out what they had missed.

GATT and all that

When the IMF managing director sat down with Prime Minister Callaghan and Chancellor Healy in Callaghan's gloomy but attractively furnished residence on December 1, 1976, he noticed a copy of the charter of the GATT (General Agreement on Tariffs and Trade), the rule book on international trade, carefully placed on the table. After an exchange of the usual pleasantries, Callaghan straightaway pointed to the trade charter, saying that it showed that a country with serious balance of payments problems could impose import restrictions. Continuing, he threatened to introduce such measures if there was no agreement with Witteveen. Healy pitched in with the same message. Not giving in to blackmail, the threatened IMF chief observed that Britain was of course free to do what it wanted, but that it was the fund's task to try to bring balance to the UK economy. Not a word was spoken about protectionist actions any longer, the discussion moving on to domestic policies. Witteveen, in professorial mode, then lectured his British hosts on the importance of bringing about a shift in activity from the bloated public sector to private enterprise and that this would require creating room for exports and private investment. The meeting was then adjourned as the crucial meeting of the British cabinet to decide which way to go was to take place. Over lunch, the IMF head and Healy further discussed the terms that the IMF wanted to see in the standby agreement.

At 3 P.M., Witteveen was back in the prime minister's office for the make-or-break session. Explaining what the IMF thought necessary to return the British economy to health, he insisted on cutting public expenditure, but somewhat less than what the fund negotiators had asked for initially. Callaghan answered: "I accept Healy's proposals, but will not go further."[507] Under the IMF program, the British government would therefore introduce budget savings of 1 billion pounds in 1977 and 1.5 billion pounds the following year, implying a reduction of the budget deficit from 9% of GDP to 5%.

Leaving Downing Street with Witteveen, Healy was very relieved, remarking: "This is the first time that I hear from Jim that he is willing to accept something."[508] The cabinet had been split and Callaghan, who had remained sitting on the fence, had not authorized his finance minister to reach a solution, waiting until the very end to cut the knot. News of the breakthrough was well received, the pound sterling exchange rate recovering swiftly as capital was returning to London. Around the same time the vexing problem of the pound sterling balances was contained through an agreement of a credit facility of $3 billion arranged by friendly central banks. Britain could draw on the loan to make it possible to reduce the 7 billion pounds sterling held by foreign central banks. The arrangement worked, and the role of sterling as a reserve currency and potential threat to the exchange rate of the pound was reduced to a modest level.

Opera buffa

Although the path to agreement with Italy was smoother and less confrontational than the turbulent route of the negotiations with the United Kingdom, the end result was not as satisfactory. A country with a recurring need for financing its trade deficits, Italy had in the past often relied on capital inflows and borrowing abroad. But in early 1974, hit by the oil crisis and plagued by a lack of confidence in the lira, officials in Rome started discussions with the IMF staff on a standby credit. The fund initially did not want to push the Italians hard, agreeing with them that a strict deflationary program would not be desirable. This forthcoming attitude made for rapid progress toward an agreement at the technocratic level, but within the Italian coalition government, discord about the not very intrusive terms demanded by the fund led to its collapse. Fortunately for politically unstable Italy, the new and competent minister of finance, Emilio Colombo, succeeded without much delay to obtain a credit of $1.2 billion. The program allowed Italy to run a balance of payments deficit equal to its oil deficit, but the IMF required Italy to reduce the non-oil part of its payments deficit. Although the agreement was approved by the IMF executive board, one doubt too many remained about the strength of the program. The respected 72-year-old Dutch director, Pieter Lieftinck, was the most outspoken, expressing doubt at the Italian government's ability to halt the prevailing wage-price spiral. Italian labor unions were notoriously intransigent, and their far-left-leaning leaders were quick to organize strikes whenever their indexed wages were threatened.

History repeated itself: After reaching calmer waters for a brief period, Italy ran into serious difficulties again. The global recession had hit the Italian economy very hard, the economy shrinking by 6% in the third quarter of 1975 from its peak before the oil shock. Embarking on a major program of kickstarting the economy, Italy soon experienced a large gap in its trade balance as capital was fleeing. As a consequence, the central bank's dollar reserves declined to a mere $1.3 billion.

No holiday

Alan Whittome, head of the European Department in the IMF, and also the chief negotiator on the British program, flew to the Italian capital in March 1976 for exploratory discussions with the Italian Treasury and the Banca d'Italia. This was to be no Roman holiday for the fund team; it no longer made sense to agree to soft conditions if a more permanent improvement of the economy was to be achieved. One of the biggest obstacles to making the Italian economy healthier was an elaborate scheme of wage indexation, known as the *scala mobile*, defended tooth and nail by the labor unions. Price increases, however high, were promptly compensated, making it hard for Italian goods to compete on world markets. The position of IMF management was that this time, seeing that Italy's problems were "made in Italy," the usual tighter budget and monetary policies must be accompanied by some loosening of the indexation scheme. No major problems were encountered in negotiations on how much to bring down the budget deficit and slow down the growth of credit, but the government—a minority coalition that now included the strong Communist Party—made no headway in paring back the intricate wage scale, which the IMF insisted should happen before a standby credit would be granted.

Displaying a talent similar to that of the British government in trying to soften IMF conditions, Italian prime minister Guilio Andreotti (many years later acquitted of charges of collaborating with the Mafia) tried to pull a fast one in October 1976. The wily Italian politician, intent on speeding up the process, jumped the gun, publicly announcing that the IMF would on the basis of an agreed economic program release $540 million to Rome, which would unlock an additional $1.2 billion loan from the European community.

Meanwhile, Italian officials explored the possibilities of softening the IMF terms with their German colleagues but were rebuffed. Prime Minister Andreotti himself met with Managing Director Witteveen in December, following up with a visit to President Ford and Secretary of State Kissinger to discuss the fund's stance. His message was that he hoped that Witteveen would understand that Italy "cannot be asked to do the impossible," adding with a dramatic flourish that if "Italy were to collapse, Italy would not be the only loser."[509] But Witteveen, without pressure from the United States which—as was the case with Britain—wanted to see a strong Italian policy package, and the IMF Chief kept insisting on adjustment to the indexation scheme, at minimum "a guarantee of non belligerence on the part of labor unions."[510] The fund was now in the awkward position of "negotiating invisibly with the labor unions over the head of the Italian government."[511]

The denouement occurred on March 29, 1977 when another Italian finance minister, Gaetano Stammati—the political musical chairs having continued in Rome—visited the IMF managing director in Washington. The weak Italian government had not succeeded, after long deliberations, in squeezing significant concessions from the unions. The new negotiator, probably sensing that the fund was ready to compromise, presented what his prime minister had been able to modify in the *scala mobile*. After a long session, Witteveen called for a break to allow the Italians to inform Rome that he was not yet fully satisfied and that a bit more was needed. The answer came back that what the IMF was asking for the impossible, prompting Witteveen to reply that he did not want to be dogmatic but that the effect on the index had to be greater. Stammati returned to Rome for further consultations and called Washington on March 31 to say that the unions had moved a bit, allowing the fund managing director to accept the compromise. Although the result fell short of what the IMF thought had been necessary, it did achieve a breakthrough of sorts, the fund having been able to nibble off part of an institution considered sacrosanct by the unions, communists, and other left-wing politicians. Stability was restored for some time in Italy, but Fillipo Maria Pandolfi—yet another minister of finance—stated in September 1978 that what his country really needed was "a radical change . . . to correct slowly but steadily the structural conditions of the economy."[512] Unfortunately these wise words would fall on deaf ears for decades.

3. Talking down the dollar

By 1977 the world was in much better shape than during the ominous days of previous years. Wage earners, professionals, and pensioners were becoming more optimistic again and spending money on big-ticket items such as cars and electronics. Cities were better maintained, and travel by road and air was picking up rapidly. Watergate was becoming more of a source of entertainment—the Oscar winning film *All the President's Men*, starring Robert Redford as Bob Woodward and Dustin Hoffman as Carl Bernstein, was viewed by millions—than a reminder of a dark and dangerous period in the United States' history. An economic meltdown after the oil crisis had been avoided, and the British Isles and Italy had been saved from themselves, as well as from causing serious collateral damage. The world economy was enjoying a strong recovery, the rich industrial countries growing close to 7% during the first part of 1976 before slowing down to around 3%. The developing countries showed similar results, reversing the trend of rising poverty. Inflation had come down to 5.5% in the United States, still high by historical standards but a big improvement since the aftermath of the oil shock. And much closer international cooperation had made it possible to reach a meeting of minds, if not complete agreement, between the United States and Europe on the position of gold and the dollar, as well as on how to deal with floating exchange rates, removing yet another threat to international trade and payments. But in the United States and in Europe, the number of people out of work was stuck at a high level. As a general rule, a fall in unemployment lags strong economic growth by many months. And because jobs are largely what the public cares about, they paid little or no heed to the favorable real GDP numbers which are an abstraction for most consumers.

Carter takes over

With Jimmy Carter winning the election, partly because voters were still worried about the economy, and because the new president was keen on putting more people to work, the first priority of the inexperienced new administration was designing a stimulus program. Carter's team of economic advisors was led by a famous Keynesian, Lawrence Klein of the University of Pennsylvania, a strong proponent of the use of large mathematical forecasting models. "I think economics didn't grab his interest,"[513] said Stuart Eizenstat, a prominent member of the White House staff at the time, of the president, who was not schooled in the subject. The former Georgia governor, "briefed endlessly,"[514] went along with the objective to bring down the unemployment level—then still 8%—to a mere 4–4.5%. Neither Carter nor his Keynesian advisors realized that such a target was overambitious and would lead to a resurrection of the inflation spook. But Congress had just passed the Humphrey–Hawkins Bill, aimed at broadening and make more binding the government's role in ensuring economic prosperity. The act, reflecting liberal Democrat Keynesian instincts, and displaying "a disturbing lack of concern for the danger of inflation,"[515] defined full employment as 3% unemployment for *adult* workers. The nuance that the percentage of all persons without jobs is always higher than for adults was not widely understood. Klein, a future winner of the Nobel Prize in economics, who did recognize the naïveté of the goal of 3% joblessness, had before passage of the bill described it as a possible "albatross," but hoped that amendments "would make this a good bill."[516] In reality, the amended bill was not very different from the draft and provided many headaches for the president and the Federal Reserve in the fight against inflation.

Professor Klein, perhaps sensing that Carter's economic team and his closest advisors included a number of Georgia amateurs, declined to become the president's chief economic advisor. Instead, Charles Schultze, a respected economist with government experience, left the prestigious Brookings Institution to take the job. The crucial position of secretary of the treasury went to Michael Blumenthal, who grew up in Shanghai after his family had fled Nazi Germany. Blumenthal had studied economics at Princeton and become CEO of Bendix Corporation by way of working at the State Department during the Kennedy and Johnson administrations. Bert Lance, a close friend of Carter, had less impressive credentials. Something of a *parvenu*, Lance did not last long in his position as director of the budget office "due to controversy over past banking practices."[517] He was replaced by a more competent Georgian, James McIntyre. Lacking a chief of staff in the beginning at the express wishes of the incoming president, the internal organization of the White House was complex and bureaucratic, made worse by the former governor's penchant for details. His Economic Policy Group was not working well, and its "recommendations were often nothing more than the collection of different agency recommendations, without adequate synthesis."[518] Moreover, "relations between Carter and [Fed chairman] Burns got off to a bad start."[519]

Burns was upset about remarks by Carter during the campaign hinting at an excessive independence of the central bank. The conservative

Fed chairman also disagreed with the president's planned stimulus plan, believing that the economy's slower growth rate was caused by uncertainty generated by the severe stagflation of previous years. He worried—something heads of central banks are paid for—that high inflation could soon return when the budget floodgates were opened. Under those conditions, corporations would be reluctant to invest. The priority should therefore not be stimulating an economy that was not doing so badly, but nipping resurgent inflation in the bud, Burns emphasized.

Keynes returns

Carter, strongly committed to bringing down unemployment, soon announced the stimulus program that had already been worked out by his transition team in the president's tiny hometown of Plains, Georgia. The combination of tax cuts and increases in government spending—the budget deficit set a new record at $66 billion—was a major injection for the American economy. But in a climate of ongoing uncertainty among households and companies, the results were mixed. The demand for goods was rising but had little effect on the rate of joblessness. There were also early signs that inflation was picking up again. It was not a surprise that the United States was leading the way in switching to expansionary policies: European policymakers—except for those in Britain and Italy—are usually more concerned about inflation than American governments are.

Carter's economic advisors, observing that growth in Germany was slowing down and that prices there were rising at a rate of only 3%, the lowest among the G-7 countries, suggested that Germany and Japan—also showing some slowdown—should share the burden of expansion with the United States. Vice President Walter (Fritz) Mondale was soon dispatched to Bonn and Tokyo to plead the American case for a joint effort to boost the world's three largest economies. Richard Cooper, a brilliant 42-year-old international economist and undersecretary of state for economic affairs, and the bearded, enthusiastic Fred Bergsten, already secretary of the treasury for international economic affairs at the age of 35, went along. Their message proved to be a tough sell.

Schmidt balks

Before meeting with Helmut Schmidt, the Americans had learned that—as reported in the *New York Times* on January 24, 1977—the moody chancellor had warned that officials from the Carter administration who were suggesting that Germany should participate in a stimulus exercise could "better shut their mouths."[520] Knowing what was coming, the American delegation politely listened as the German chancellor pointed to his country's record on unemployment and inflation, gruffly telling his visitors that he could do without lessons on how to run the German economy. Going on, Schmidt expressed his appreciation for the inflation-fighting credentials of Bill Simon, the conservative treasury secretary under President Ford. Mondale shot back: "[W]ithout him we wouldn't have won the election."[521] Expressing his concern that a joint stimulus effort would undo the progress that had been made in bringing down inflation, the chancellor asked what the Americans thought would be the effect of their plan on inflation. When Bergsten answered that prices were expected to rise by only an extra 0.3%, Schmidt could not believe his ears. And he resented having two young inexperienced officials—as he saw them—"lecturing" him. As to be expected, he rejected what he described as "a concerted Keynesian policy of deficit spending"[522] that would result in worldwide inflation. The German leader also did not have a high opinion of President Carter as a person after having met him on several occasions, judging him "moralistic, idealistic and irresolute."[523] Poor chemistry between world leaders did not augur well for the kind of international cooperation that had flourished under Ford.

In Tokyo, the Mondale mission fared better, although the polite Japanese were not falling over themselves to embrace the American proposal. They "reluctantly joined in because of U.S. coercion,"[524] as well as American complaints about manipulating their exchange rate. The Bank of Japan had been busily buying dollars and succeeded in keeping the rate of the yen low. This smacked of intervention that went beyond preventing disorderly market conditions as an attempt to preserve Japan's competitive position. "Bergsten was authorized by the president and the secretary of the treasury to admonish the Japanese in the strongest terms to refrain from such intervention. . . The Japanese were taken aback,"[525] perhaps not only because of the unwelcome message, but also because in Japanese culture, very direct warnings, especially when issued by much younger foreigners, are not received well. Still, the short-run aim of the American offensive—a higher rate of the yen—was achieved.

Misreading markets

Paul Volcker, who in 1975 had been appointed president of the Federal Reserve Bank of New York, appreciated the strong academic background of Carter's economic team but thought that there was "a possible question about their qualifications: a relative absence of the particular sensitivities that become ingrained in those who have been actively involved in financial markets."[526] This shortcoming became apparent when officials implementing the administration's expansionary policies misread the foreign currency markets. The Carter economic team understood that their program could affect exchange rates and initially welcomed a depreciating dollar as a tool to push other large countries to stimulate their economies. But what they did not realize is that markets can react strongly if they detect policy shortcomings, such as neglect of the outlook for inflation and deliberate attempts to influence currency rates. And when the dollar weakened in the course of 1977, the U.S. Treasury did not react, happy that the move was helpful in bringing down the large American trade deficit. Moreover, Washington, preoccupied by what became known as the locomotive strategy, was pushing hard in international meetings for the "big three" countries to stimulate their economies and pull along others.

A sputtering locomotive

The G-7 met in London in May 1977, with Jimmy Carter making his entry in the world of summitry. The results were not overwhelming, Germany not wanting to commit to targets for economic growth, but merely to communicate forecasts, and Japanese prime minister Fukuda only willing to vaguely commit to a growth rate of 6.7%. The German chancellor's resistance to the locomotive strategy was ingrained. "Helmut Schmidt might have been the leader of the Social Democratic Party on Germany's Left, but he was first of all a German, and for him stability counted above all."[527] Eventually, after strong pressure from the United States with the backing of the IMF, Germany came around and expressed support for the locomotive approach, though halfheartedly.

Pushing his own agenda at the London summit, the chancellor, supported by the other Europeans, criticized the United States for its wasteful use of energy. American policy had been to control the price of oil, keeping it far below the world price, while in other industrial countries market determined prices had helped to conserve energy. Still shielding the public from higher oil prices several years after the oil crisis, while politically expedient, was not a good strategy. It stimulated demand for oil in the world's largest user of the black liquid and discouraged domestic energy production as artificially low prices made stepping up pumping and exploration less attractive. The lessons of the devastating effects of the first oil crisis had been largely ignored by American politicians inclined toward short-termism. But President Carter was sensitive to the complaints and made an international commitment to ease energy controls, despite warnings from his political advisors that such a step would be "electoral suicide."[528] While welcoming the American president's gesture, the Europeans and Japanese were becoming worried about the by now steep fall of the greenback and the concomitant strengthening of their own currencies.

In the Land of the Rising Sun, the rapidly growing trade surplus was pushing up the yen to levels that its policymakers considered excessive. Japan now had to make the agonizing choice between simply letting its currency become even more expensive—a kind of super yen—or intervening heavily to halt its relentless rise, risking strong protests from Washington. But local politics carried the day as exporters lobbied hard against further appreciation of their currency, and the central bank responded by buying as much as $6 billion in 1977. At this stage, European countries too started to express anger at Japan's currency manipulation. And at meetings of the G-7, the IMF, and the OECD, "everybody complained about Japan's performance as if the Japanese economy was a cancer in the world economy,"[529] lamented Tooyo Gyohten. Life became very uncomfortable for the delegations from Tokyo at these gatherings. The "triple S" of Japanese officials (smiling, secretive, and sometimes sleeping) was definitely a thing of the past, the Western media joining the Japan-bashing.

A costly lesson

Germany's trade surplus of $25 billion was practically as large as that of Japan, and markets were pushing up the mark as well. Wanting to halt its rise and prop up the dollar, the German central bank intervened in excess of $3 billion in 1977, also triggering criticism from the other side of the Atlantic. Still the greenback had not stabilized and its fall accelerated after U.S. treasury secretary Blumenthal engaged in what was considered as "talking down the dollar,"[530] suggesting on various occasions that a certain depreciation of the dollar might be welcome. The surplus countries were aghast—there was talk of "aggressive neglect"[531]—and challenged Blumenthal, who vehemently denied any willfulness about his public remarks. Many did not believe him, including Otmar Emminger, who had become head of the Bundesbank in mid-1977. In his memoirs the German central banker described the American administration's "open mouth policy" as an attempt to get its locomotive strategy on track, suspecting that "a very cunning expert in the Carter Administration had contrived that a rapidly sinking dollar could make things so unpleasant for the Germans that they would protect themselves willy-nilly by taking the desired expansionary measures."[532]

The diving dollar

Blumenthal took away a lesson many politicians have had to learn the hard way: simply talking about the level of exchange rates can move markets. But the lesson came too late, and a new and dangerous dollar crisis was in the making, creating an atmosphere of tension and outright acrimony among the transatlantic partners. In Japan, always afraid of stepping on American toes and suffering the consequences, reactions were more muted. The United States' active negotiators, Cooper and Bergsten, visited Tokyo again in September 1977 and insisted on Japan's increasing its imports—which were repressed by a raft of trade restrictions—from America. A few weeks later, at the IMF, Denis Healy, who had toyed with the idea of introducing import restrictions in Britain the previous year, singled out Japan, accusing it "of distorting the equilibrium of the entire world economy."[533] Even while the yen continued to strengthen, though dampened by the Bank of Japan's regularly buying dollars against yen, Washington stepped up the pressure. Finally daring to push back a little, Japanese officials suggested that the United States should take measures to control its inflation and curb its oil imports, a message German officials had already delivered to little effect.

Against the background of a lack of cooperation between surplus and deficit countries, the dollar crisis broke out in full force in October 1977. The immediate event that gave rise to a flight out of the greenback came from an unexpected source. Britain, having purchased the stupendous

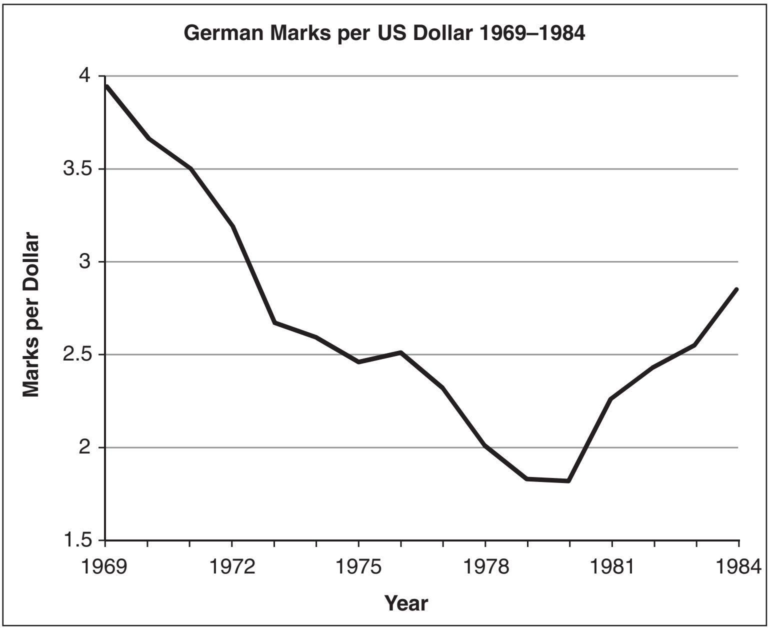

Figure 4.2 German Marks per U.S. Dollar, 1969–1984.

amount of $15 billion to replenish its eroded reserves, suddenly ceased its dollar purchases. Having relieved pressure on the dollar up to October, the sudden absence of the Bank of England as a buyer of greenbacks caught the market by surprise. Panicky reactions followed soon, with dollars being dumped for marks and yen. Massive central bank interventions—in the 6 months between October 1977 and March 1978, a record amount of $30 billion was absorbed in the reserves of surplus countries—did not prevent the strong currencies from climbing higher against the dollar. And the absence of signs that the United States was concerned about the nosedive of its currency added to the chaos. Tales of stressed currency traders needing medical attention abounded.

A first timid reaction came from President Carter on December 21, 1977. After first playing the blame game by attributing the huge American trade deficit on rising oil imports and slow economic growth in Germany and Japan, he announced a plan for improving the United States' balance of payments. Reversing his administration's tack, he now attempted talking up the dollar, declaring that the government had the obligation to protect the integrity of the dollar. Congress had also woken up to the danger of the dollar dropping like a stone and passed the International Emergency Economic Power Act, authorizing the president to introduce far reaching controls and direct trade measures in an international economic emergency. In explaining the measure, a government spokesman disingenuously remarked that the emergency act would not be activated "as long as no flight out of the dollar by American citizens was discerned."[534] He had not understood that American banks and businesses were also dumping dollars.

Arthur Burns, already anxious at an earlier stage of the currency problems, supported the dollar by convincing his fellow governors at the Fed board—with a narrow majority—to raise the discount rate from 6% to 6.5%. A brief return of calm in the currency markets was soon followed by renewed panic, especially when the dollar slid beneath the psychologically important threshold of 2 German marks. Huge amounts of money also flowed toward the currency markets of smaller European countries, the Swiss franc being the main recipient. Fritz Leutwiler, the respected head of the Swiss national bank—normally a supporter of open markets—did not want to stand idly by while his currency went through the roof. He convinced the Helvetian government to impose strong measures, including prohibiting foreigners from buying Swiss securities, to avoid a dollar flood. But when voices in Germany began advocating taking similar drastic measures, Bundesbank governor Otmar Emminger told the media that he was not thinking of such steps at all.

Called in by an angry Helmut Schmidt, who held a newspaper report of his remarks "under [his] nose,"[535] the central banker was warned that he was overstepping his authority and that deciding on direct controls was a matter for the government. Emminger calmly explained that had he answered the journalist's question by telling him that he first had to check with the government in Bonn, hundreds of millions of dollars would have flooded Germany on that day.

Trying to calm the waters

After intensive deliberations between the United States and Germany—an early sign of improved international cooperation—the two countries made a common announcement on March 13, 1978, declaring that they were determined to counter disorderly foreign exchange markets. This was to be achieved by increasing the credit line between the Fed and the Bundesbank and by using SDRs to obtain German marks with which the Fed could intervene. Coordinated intervention is a more effective tool to calm market jitters than a policy of going it alone, and with its own stock of marks—though smallish—the United States could now signal its seriousness about defending the dollar. And this commitment was reinforced when the U.S. Treasury issued $15 billion Carter bonds—securities denominated in German marks, providing more ammunition for intervention. But the effects of the announcement were short-lived, and currency traders and investors were once again rattled in July. This time, the trouble started within the European currency bloc (the snake) when, after buying $5 billion worth of other European currencies, Germany threw in the towel and revalued its currency against the French franc. Once currency traders had tasted blood, they started looking for other places to quench their thirst, the dollar being the obvious candidate.

The waters had also been muddied by the outcome of the Bonn summit of June 1978—coming 10 years after the disastrous conference on currencies in the same city—and markets were not impressed with the results. Schmidt had come round to the locomotive strategy after a threat from U.S. treasury secretary Blumenthal that the United States was against a summit in Germany unless Schmidt did his part and committed to a growth target. Wanting to be seen as the great statesman conducting a successful summit with the world's political grandees, the German chancellor acquiesced. And when the growth targets for the world's three economic powerhouses were met, the summit participants hailed its success. To others the only real achievement was President Carter's promise to lift all controls on oil prices in his energy-guzzling country and raise them to the world price level over time.

Anthony Solomon, the capable and decisive monetary undersecretary at the U.S. Treasury, looking back on the summit, concluded that "there is a good argument that the major lost opportunity of the Bonn summit agreement was that not enough pressure was put on the United States to face squarely its inflation problem and take stronger measures early enough to bring inflation under control." And had there been more specific pledges by the United States, "[t]he result would have been to have speeded up the adjustment of U.S. inflation, and perhaps to have avoided some of the disturbances that subsequently plagued the financial markets."[536] There is little doubt that Paul Volcker, in his 10th-floor office in the heavily fortified building of the New York Fed, agreed wholeheartedly.

Passing the baton

In June 1978, Johannes Witteveen resigned as managing director of the IMF. In the nearly 5 years that he headed the growing international organization, he took several far-reaching initiatives. Besides introducing the oil facility, he succeeded in establishing a followup arrangement with strong policy conditions, known as the Witteveen facility. He furthermore successfully negotiated large credits for Britain and Italy. Witteveen also established good relations with the major financial leaders of the world and was respected in the developing countries who had often felt ignored by the West. In his patient and diplomatic way, the "professor" achieved much more than his predecessors. Although Witteveen could have stayed on if he wished, he preferred to return to the Netherlands for family reasons, his wife wishing to return and one of their children suffering from a serious illness.

The search for a successor did not take long. Jacques de Larosière de Champfeu, a 49-year-old French aristocrat and director of the French Treasury, was a natural choice. The slight, prematurely gray career civil servant with his intense gaze spoke excellent English and got along well with the Americans. He had worked closely with Edwin Yeo III on compromise language for the amendment of the IMF statutes after the breakdown of the Bretton Woods system, earning the respect of the international financial community. De Larosière was a tough workaholic who spent long hours chairing meetings of the Fund's executive board and—unlike his predecessors—would also often be present at meetings when very small member countries, such as the Comoros Islands, were being discussed. Soon after he moved into the spacious office of the managing director, with its conveniently abutting small meeting room and its attractive view of the American capital, the plucky Frenchman was faced with a new round of crises.

Inflation infection

Realizing that virtually nothing that his administration had announced in terms of economic policy had worked, Carter decided that it was time for much more forceful action. Inflation had been accelerating of late, and there were signs that there was less idle capacity in the economy than thought earlier—a frequent bias among quasi-religious followers of Keynes. Commenting on the state of the American economy of mid-1978, the IMF cautiously stated, "[T]here is . . . a possibility that demand in the United States may be pressing more closely against capacity than would be suggested by conventional measures of slack in the economy."[537] At that point, unemployment had fallen to 5.8% and prices were rising at a rate of over 7%.

On October 24, 1977, the president, who had recently appointed Alfred Kahn—a Groucho Marx lookalike who had successfully negotiated deregulation of the airline industry—as his special inflation advisor, addressed the American people on national television to announce a new anti-inflation initiative. His economic team had come around to the view that their strong Keynesian expansionary policies were no longer providing the right medicine. The main element of solving the inflation conundrum, Carter announced in his speech, was to bring back incomes policy, despite its poor track record. Wage and price guidelines were to be formally implemented; voluntary compliance would no longer do, the Carter team believed, to bring the accelerating inflation rate down to 7% in 1979. The president also pledged to reduce the budget deficit to at least $30 billion, less than half of what it had been when he took office. And to sugarcoat the pill, there would be a tax rebate for workers who had observed the wage standards when inflation exceeded 7%. But, worried that the proposal would be too costly, Congress buried the proposal.

Carter in limbo

"It is impossible not to like Jimmy Carter," wrote Margaret Thatcher in her autobiography, at the same time mentioning that the American president had "an unsure handle on economics . . . and was inclined to drift into futile *ad hoc* interventionism when problems arose."[538] Carter—by 1979 broadly perceived as weak and vacillating—made little impression with his speeches on the American economy on foreign financial players as well as on Wall Street. The sentiment was amplified by the president's unexpected selection of William Miller, who had been president of Textron Corporation, an aerospace company, to be the new chairman of the Federal Reserve. Miller, a smallish gentlemanly figure with neatly combed white hair, was not an ideal choice, and his lack of experience in financial matters would prove to be a drawback. Markets are generally impressed by heads of central banks with strong personalities and a good grounding of the business they are in, while appointees from outside the financial world seldom inspire confidence. The new Fed chief was soon experiencing difficulties, having to deal with the sliding dollar and stubborn inflation. Miller also did not enjoy much authority at the board of governors of the Fed. Trying to impose a non-smoking policy at meetings did not work, and his attempt to shorten the sometimes long-winded orations of his colleagues by placing egg timers on the Board room table that went off after 3 minutes was "dismissed as an ill-conceived practical joke."[539] But the new man in the chair was as concerned as his predecessor about the weakness of the greenback, staying in daily contact with his German counterpart, Otmar Emminger.

The German central bank governor warned Miller, "[S]een from Europe and especially from Germany the core problem is the rate of inflation in the United States. 7 to 8% inflation [in the United States] against 3 to 4% in a raft of European countries is over time not compatible with the position of the dollar in the world."[540] What was needed, the fierce German emphasized, was not just currency intervention but strong policies to improve the fundamentals of the American economy. Miller agreed, observing that there was no point in excessive intervention to reward speculators, signaling that he was ready to take strong action.

A strong package

Soon after Carter's poorly received inflation speech, the Federal Reserve had to sell 2 billion German marks to avoid a dollar collapse. To support its intervention and halt the massive flight out of the dollar, the Fed increased its discount rate to a record 9.5% and doubled its credit lines with major central banks. The Treasury issued $10 billion Carter bonds, and—in an unusual move—the United States tapped its immediately available contribution in the IMF. It also sold $2 billion of SDRs and increased its gold sales program, which had been launched earlier. The financial package, announced on November 1, 1978, totaled $30 billion, a then-unprecedented magnitude.

Chairman Miller described the emergency measures to Emminger as a "risk-program,"[541] implying that the American side was prepared to take the risk of a weakening of the economy. That risk would soon materialize. But for the moment the reactions to the package were unanimously positive, and the dollar immediately appreciated by 6%. Treasury monetary point man Anthony Solomon wanted to avoid the impression that the Americans had returned to a fixed rate system, as the French would have liked, explaining that the United States continued to support

U.S. president Jimmy Carter, German chancellor Helmut Schmidt, French president Valéry Giscard d'Estaing, and British prime minister James Callaghan on the island of Guadeloupe, January 5, 1979. (U.S. National Archives and Records Administration.)

floating exchange rates. Recent interventions, he continued, were aimed to correct disorderly market conditions caused by a "doom and gloom psychology."[542] His diagnosis was correct insofar as the often emotional mood of financial markets is an important factor in the movement of currencies, often overlooked by academic economists. Years later, this would change with the spectacular rise of behavioral economics, as illustrated by the award of the Nobel Prize in economics in 2002 to Daniel Kahneman, a psychologist by training.

A welcome pause on currency markets took hold in early 1979, but some apprehension remained as inflation in the United States speeded up again, heading for double digits. Accelerating price increases and the unprecedented slide of the dollar did not sit well with oil-exporting countries. Most OPEC members had by now—sooner than expected—spent much of their oil revenues and were looking for new cash injections. Spurred on by rising expectations and often lacking self-restraint, the newly rich were frequently spending their money unwisely, importing luxury goods that were not contributing to improving their economies. And even the large oil exporters, considered to be "low absorbers," had largely wiped out their trade surplus, in 1978 falling to $6 billion from $26 billion the previous year. OPEC countries were determined to restore the price of oil in real terms, as well as the fallen purchasing power of the dollar in which they were paid. At the same time, many rich countries, foremost among them the United States, had been lulled into complacency about energy supplies and prices, and conservation efforts in North America were pitiful.

Second oil crisis

Revolution broke out in Iran in late 1978—the shah left "on vacation," never to return—bringing chaos in its wake and severely disrupting oil production. The effects were immediately felt on the world market, with the price of oil rising sharply. OPEC pounced on the possibilities that falling oil supplies offered and started raising prices further in the spring of 1979. Eventually, the price of black gold doubled during what became known as the second oil shock. Panicky reactions followed, and long lines at gas stations were back again in the United States. But policymakers in many countries—having learned some painful lessons—reacted differently this time around, stepping up effective conservation efforts and allowing domestic oil prices to be determined by the world market. Although the renewed energy emergency initiated a new round of stagflation, the dollar strengthened, serving as a "safe haven" for investors and speculators. Not having to worry about the dollar for the time being, the American president focused on dealing with the new oil crisis. An honest man, he did not promise the American people a "Manhattan energy project," as Nixon had done. But in a speech on energy conservation on July 15, 1979, Carter stressed the gravity of the situation while sitting by a wood fire in a cardigan in FDR style. Calling the oil crisis "the moral equivalent of war,"[543] the fireside chat was dubbed the "malaise" speech, typifying the president's somber outlook. The only measure of importance announced was that oil prices would finally be decontrolled, a necessary but politically highly unpopular action. The symbolic installation of solar panels on the roof of the White House was not widely followed by the American public.

Moving into campaign mode, the presidential election in November 1980 drawing nearer, the man from Georgia saw his popularity falling rapidly as the economic misery index kept climbing. The guilty party remained inflation, which was becoming a nightmare for Carter and his economic team. Having lost credibility as an inflation fighter, the president started to cast around for someone who could recapture the confidence of both markets and the American public. The one figure who stood out as a strict money man was Paul Volcker, president of the Federal Reserve Bank of New York since 1975, who was not afraid to speak his first-rate mind. Tall Paul regularly clashed with William Miller at meetings of the Federal Open Market Committee, at which the members of the board of governors in Washington, together with a number of presidents of regional Federal Reserve banks (on a rotation basis), decide the course of monetary policy. And after the beleaguered resident of the White House decided to shake up his cabinet, retiring five members, including Michael Blumenthal, Volcker moved to center stage in August 1979.

Bringing in Volcker

Carter had decided to replace the outgoing secretary of the treasury with William Miller, where the former corporate CEO felt more at home. It was agreed in the White House inner circle that it was time to place a forceful person, thoroughly experienced in money matters, at the helm of the Fed. Despite taking a big cut in salary and, being a family man, not happy having to live in Washington, away from his family in New York, Volcker very much wanted the job. Folding his long frame into a chair next to the president, who had never heard of Volcker, sitting in the Oval Office for the most important examination of his life, the candidate explained how much he valued the independence of the central bank, noting that he was in favor of a tougher monetary policy. He then pointed to Miller, who was also present, and said that he wanted "a tighter policy than him"[544]—afterward worrying that the diplomatic gaffe might have spoiled his chances. That evening, Carter wrote in his diary about the candidate: "He was enormous in size, stubborn, opinionated, committed to controlling inflation and preserving the value of the dollar, intelligent, highly trained, very experienced."[545] He was also surprised that Volcker turned out to be a Democrat. Despite trepidations harbored by the president's advisors that choosing an independent and outspoken person at the helm of the Fed would basically eliminate the White House's influence on monetary policy, the chain-smoking giant got the job. The money master, trusted at home and abroad, soon moved into the marble building on Constitution Avenue, receiving a warm welcome from the media.

Europe: health and sickness

Elsewhere the second oil shock also caused pain and added to the already strong inflationary pressures. The picture in Europe was mixed, with Germany performing best on energy conservation and inflation—keeping its rate of increase below 4%—thanks to its habitually tight monetary policy and its modest budget deficits. Like his predecessors, Bundesbank president Otmar Emminger was an inflation hawk but displayed some flexibility. Early in his career he had applied for a position at the Reichsbank—the German central bank during the Nazi period—but had been rudely turned down since his ideas were not in step with the prevailing doctrine. But in 1950 he was invited to join what had become the German Bundesbank, where he soon climbed the ranks and made a name for himself in the international financial community. Emminger was totally absorbed in his work, and when his neighbor at the table at an official dinner apologized for talking about monetary policy at length, his typical reaction was: "You can talk shop with me the whole evening."[546] His deputy and successor in 1979, the always tanned and gregarious but tough negotiator Karl Otto Pöhl, carried on the Bundesbank tradition of fierce independence and total commitment to price stability. From time to time, this philosophy caused clashes with German politicians, as well as those in the United States, Britain, and France. In most instances, the men from Frankfurt won the tussle if it did not end in a stand-off. Defeat was unthinkable.

In France, the situation was more complex: Efforts to reduce oil imports were extensive and included accelerating the French nuclear energy project, but unemployment remained high, and inflation was stuck at around 10%. Heroic efforts—in the French sense—by Prime Minister Raymond Barre, with the full backing of the French president, to keep government expenditure in check were only a partial success. The French economy was very rigid, competition was frowned on, and wage indexation considered untouchable, militant labor unions defending the nefarious practice tooth and nail. Georges Marchais, the aggressive leader of the then still strong Communist Party, declared in August 1979: "I am always ready to make a pact with the devil to cause the policies of Giscard-Barre to fail."[547] Two years later, after Giscard lost the presidential election to the Socialist Party leader, Francois Mitterrand, the Communist Party became part of the new government coalition. After a disastrous start as president, Mitterrand had to make a U-turn in his economic policies to regain a degree of confidence in his government.

The British economy remained weak, and with inflation at 15%, the island nation looked set for another stretch of misery. The only point of light was that North Sea oil was coming on stream. But a dramatic turnaround—after first going through a recession—was in the offing as the Conservative Party, led by Margaret Thatcher, won the election in 1979. Breaking the excessive power of the labor unions and deregulating the economy the new prime minister succeeded in bringing her country back to the ranks of the capitals whose voices are heard in the international arena. Not so in Italy, Europe's other straggler. Its weak political system and lack of structural reform meant relegation to the second tier, despite being a member of the G-7. Having reverted to the old strategy of pumping up the economy when it could not afford it, Italy's trade balance deteriorated sharply and inflation reached 16% in 1979, cresting at a shocking 20% the next year. The country that had invented banking was gradually taking over the mantle of sick man of Europe from Britain.

Rising star

By contrast, Japan was a rising star—economically more than politically—enjoying respectable export-led growth, diminishing oil imports and inflation of less than 3% in 1979 and keeping it at that level in the following years. Japan, still burdened by its past, relished its ascendancy, and at the G-7 summit in Tokyo in late June 1979, it pulled out all stops, including a lavish dinner hosted by the emperor. The meeting dealt exclusively with ways to settle the world oil market, which was roiled by strong gyrations. The conclave focused on agreeing on ceilings for oil imports of the major energy importers. Positions were divided, but not in the usual way. On this occasion, the United States and France formed an alliance, insisting on strict import ceilings, while Germany and Japan wanted to protect their energy imports. Otto von Lamsdorff, the aristocratic German minister of economy, caused irritation by his long-winded defense of the German position, which ironically clashed with earlier complaints from his chancellor about the lack of oil conservation by the United States. After a while, Helmut Schmidt cut off his minister to allow the debate to flow again. Britain, benefiting from its oil reserves in the North Sea, stayed out of the fray. But its representative attracted much attention as the new prime minister, Margaret Thatcher, made her first appearance at an international meeting. This was the last time the "Iron Lady" remained on the sidelines at a summit meeting. After difficult negotiations, the seven leaders arrived at an agreement on ceilings for importing oil.

The highlight of the gathering was dinner at the Imperial Palace at the invitation of Emperor Hirohito. French president Giscard d'Estaing was seated to the immediate right of the host due to his seniority. Making conversation was not easy, as the emperor, dressed in traditional Japanese garb, did not express himself in modern Japanese, but in an ancient version of the language incomprehensible even to his contemporaries, so that the Japanese present at the dinner also needed a translator. Giscard mentioned in his memoirs that after exchanging pleasantries, he posed an unusual question to Hirohito, whose murky wartime record had long been a point of contention. "The American authorities ended the imperial cult in 1945. How does it feel when you have been proclaimed god during a part of your life and then suddenly you cease to be a deity?"[548] asked the French president. The Japanese emperor listened to the translation of the question with a kind and indifferent smile, answering softly: "One gets used to it."[549]

4. The dragonslayer

The American financial package of November 1978 was a success, the dollar no longer sliding as if on a steep ski slope, and confidence was returning to currency markets. But the battle was not won yet; the sudden new oil shock—this time a doubling of the price of the black liquid—roiled the markets, the greenback sliding down again in June 1979. The American currency was now vastly undershooting, prompting policymakers in Washington to sell large amounts of the German marks they had obtained in November. Across the Atlantic, the central bank in Frankfurt joined up by selling marks against dollars, but only sparingly. The Bundesbank had recently introduced a target for the growth of the money supply in its fight against inflation and was loath to overshoot its goal, because dollar purchases increased the money supply. (When a central bank buys dollars from residents, the seller obtains domestic currency, which bumps up the money supply.) Interventions in currency markets by the Fed were at this time five times as high as those of the German central bank, a discrepancy that irked the United States.

Trying to settle the matter, the Americans asked for a meeting with Schmidt in late September 1979. On their way to the IMF annual meeting in Belgrade, the American delegation made a stopover in Hamburg, the hometown of Helmut Schmidt. After Air Force 1 had landed, the U.S. delegation, headed by Treasury Secretary Miller and Volcker, this time as chairman of the Fed, sped to their working lunch with the German chancellor. Also present were the steady Hans Matthöfer, German finance minister since the previous year, and Otmar Emminger. The Americans put their cards on the table, demanding more active and better coordinated support from Germany in defending the dollar, and putting pressure on Emminger to step up his interventions. The Germans at first reacted defensively, aware of press comments that they were in favor of a cheap dollar since that would reduce their oil bill (oil being traded in dollars). But when Miller and Volcker proposed that the parties agree on an absolute floor for the rate of the greenback to be jointly defended with equal currency interventions by both sides, Schmidt demurred. A similar suggestion had been made by Volcker a year earlier, but now that he headed the board of governors of the Fed, the proposal carried more weight. "Not acceptable," came the curt reply from Emminger, with the argument that the Bundesbank could not again miss its money supply growth target. Chancellor Schmidt supported his central bank chief's position, slyly adding that he did not stand behind the Bundesbank's policy 100% and would have preferred a somewhat less restrictive policy. But, continued Schmidt, "One cannot through foreign exchange intervention fight a politically determined mistrust of the dollar."[550]

Following up, Emminger, referring to the large difference in interest rates between the United States and Germany, asked whether the Fed's monetary policy could not be directed more to supporting the weak dollar. Volcker replied: “Are you perhaps of the opinion that the American interest rates are not high enough?”[551] “Yes,” replied the German inflation fighter, mentioning that prominent American bankers had told him that high interest rates did not bother them as long as they knew they could easily refinance themselves, simply passing on those high interest rates to their clients. And, lectured Emminger, what mattered in the present inflationary climate was not so much interest rates as the money supply. To the surprise of those present, Volcker agreed: “Yes, what really counts is the money supply.”[552]

The meeting ended with the German side sticking to its guns, not wanting to commit to open-ended intervention. The joint statement issued merely read “Both sides agreed [that] exchange rate stability . . . and a strong dollar are in the interest of both countries.”[553] Upon leaving Hamburg, Charles Schultze, President Carter’s chief economic advisor, also present at the conclave, remarked cynically that Schmidt had been “at his egotistical worst.” Volcker almost agreed: “He was at his egotistical best.”[554] Schmidt’s estimation of the American central bank chief seems to have been higher than Tall Paul’s feelings about the chancellor, writing in his memoirs: “Volcker was the only one [among American senior officials]whose arguments were not only based on the foreseeable consequences of [American policies] for the United States, but also for the world economy.”[555]

Volcker’s coup

Volcker, who had already been working with his associates on a radical plan to change the way monetary policy was to be conducted, left midway during the Belgrade IMF meeting in early October 1979 for Washington to complete the work. Eager reporters who were looking for a scoop suggested that the central bank chief had left in a hurry because of some emergency. To their disappointment, nothing spectacular turned up. But a little over a week later, the media would be informed of the surprising new approach to monetary policy. Stripped of its technicalities, the essence of the Fed’s move was to place much more emphasis on the money supply than it did under Burns, and change its operational method to achieve this. No longer would the central bank focus on directly moving interest rates but instead work on easing or tightening the liquid reserves of the banking system. Banks’ willingness to lend to businesses and households depends a great deal on how large their reserves are, and once the money borrowed is spent, it mostly ends up in the checking accounts of other businesses. And because checking account balances are money—just like banknotes—the total money supply is changed when the Fed acts to increase or decrease bank's reserves. Although the black magic of money creation is not easily understood, it does not take a PhD to realize that there is a link between how much money there is and how fast prices go up: Too much money chasing too few goods drives up inflation.

Playing the political card

The new policy was not only based on economic arguments, but at least as much reflected Volcker's political skills. Volcker sensed that at a time when Congress was breathing down his neck, focusing almost exclusively on the money supply instead of on interest rates was going to give the Fed more room to squeeze out inflation. Under the Fed's new approach, interest rates—on which politicians and the public focused their attention, angered when they went up—would become a byproduct of the Fed's policies. Charles Schultze, Carter's main economic advisor, recognized the public relations aspect of what Volcker was doing, describing it as "a political cover," saying that the Fed's leaders were not monetarists, but that the new procedure "allowed them to do what they could never have done if it looked as if they were the ones raising interest rates."[556] But Volcker insisted throughout that the decision to target the money supply instead of the level of interest rates was not based on public relations considerations.

The historical change at the Fed was announced on Saturday October 6, 1979 in the evening. The 50 or so reporters herded into the Federal Reserve Board's inner sanctum were none too pleased to see their weekend interrupted and had some difficulty following the more technical elements of the presentation. Reactions to the startling move by the Fed were mixed, some critics being outright hostile. The *New York Times* on October 14 branded Volcker "a gambler," adding, "He is betting high with a poor hand."[557] But the reactions from Europe were overwhelmingly positive. There the news was interpreted as a signal of a tougher stance on inflation, immediately boosting the value of the dollar.

Although the Fed enjoyed a great deal of independence, Volcker knew that it was prudent for a major overhaul of its practices be communicated to the White House before it was announced. It had taken quite some convincing to get the Keynesians at the White House on board. But once put in place, the government did not express any misgivings about the Fed's new approach. This did not prevent the monetary high priest from regularly having to defend his policy innovation against the foes of monetarism. Denying that he had converted to a new religion, Volcker acknowledged that other than monetary factors can also play a role in causing inflation. But in everyday practice, the going was rough from the very start, inflation staying high—expectations had not yet been turned around, and inflation psychology ran deep in the United States. Fears that the Fed would plunge the economy in a recession were rampant, triggering accusations of misguided and cruel practices, including playing high-stakes poker with the economy and sadistically hurting everybody in sight. And conditions would become worse for a long time before they became better. Inflation refused to come down and unemployment moved up, the misery index climbing to 17% in 1981. The economy dipped in and out of recession, output declining by 0.4% in 1980, painting a picture of economic policy impotence.

Tough love

Sticking to strictly controlling the money supply led to phenomenally high interest rates, short-term rates reaching 20% and 10-year governments bonds—which were supposed to come down as inflation expectations receded—yielding up to 14%. The effects of the record high cost of money was not restricted to the United States but affected the whole world economy, which once again found itself in the throes of stagflation. But not everyone believed that the policymakers at the Fed—and central bankers in general—were a bunch of sadists. Commenting on the very high level of interest rates in mid-1981, the IMF explained that they "resulted from the interaction of firmer monetary restraint . . . with the momentum of the ongoing inflation after a long period of generally inadequate fiscal restraint. Although there are sound . . . reasons to anticipate a substantial decline in nominal interest rates when inflationary expectations subside, the absence of a reliable basis for gauging the timing of any such change in expectations has tended to maintain uncertainty for the prospects for interest rates." Translating from the Fundese, the message was: "You have to continue to stick to tight money for the time being, and results will eventually follow."[558]

Carter bows out

As with President Ford, the high misery index during the Carter years played an important role in the November 1980 presidential election. Ronald Reagan, the incumbent's challenger, directly addressing the American public during a televised debate, famously asked: "Are you better off today than you were 4 years ago?" Carter was unable to come up with an equally strong one-liner. While almost always underlining the Fed's independence when queried by the media on the damage high interest rates were doing, Carter attacked Volcker's "strictly monetarist approach" as "ill advised"[559] shortly before the election. After his bitter defeat, the Georgian blamed his loss squarely on Volcker's monetary policy. But Stuart Eizenstat, Carter's influential domestic advisor, later reflected: "Our biggest mistake was . . . misjudging the strength of inflationary forces in 1977 and having an economic policy which overstimulated the economy."[560]

Volcker continued his unpopular policy after Reagan became president. Although inflation at the time of the new president's inauguration was still running at 12%, conditions on international currency markets had vastly improved since Volcker had announced his drastic policy switch a little over a year earlier. The dollar had come out of its swoon, climbing close to the psychologically important level of 2 German marks per greenback, and the gold price—often considered a barometer for confidence—was coming down rapidly as fears of inflation were diminishing. Beryl Sprinkel, the new U.S. monetary point man, soon seized the opportunity to announce that there would be no more interventions to influence the dollar exchange rate.[561] This position—fully in line with the new administration's preference for free markets—meant that a new period of benign neglect of the currency rate was beginning, but this time with a strong dollar, not one that needed propping up. This was fine with the Fed; monetary policy could now be fully focused again on the domestic economy. But with short-term interest rates again reaching 21%, output remaining flat, and unemployment at 7.5%, the Fed's image among members of Congress and the American public was at a painful low.

Dealing with Reaganomics

President Reagan could not have been happy with his economic inheritance, but as an incurable optimist, he declared it "Morning in America." Volcker could not yet show much for his efforts, and it was not surprising that his relationship with the new president was remote. Their difference in personalities—Volcker cerebral, Reagan operating on gut feeling—also did not invite frequent contact. And "[the] president had little interest in economics or economists and had little stomach for one on one meetings with [Volcker]."[562] The Fed chairman divulged later, "Once in a while, I was asked to see him [Reagan]. He would drift off into some Irish jokes."[563] Although, like the intuitive president, most of his economic advisors supported an anti-inflation stance, they "were a rather odd mix of hard-boiled monetarists and what came to be popularized as 'supply siders,' mixed in with a few pragmatists . . ."[564] Relations with Treasury Secretary Donald Regan were often strained, the former Wall Street executive regularly hinting that the Fed's independence was too great. Volcker greatly irked Regan by explaining that trying to defeat inflation by keeping a reign on the money supply would be undermined by large budget deficits, suggesting that a tax increase was called for.

Already known for his temper by those compatriots whom he considered uncooperative, Regan became truly incensed when foreigners—whose countries were growing more slowly than the United States—had the gall to criticize the administration's budget policy. On one occasion, after several Europeans had complained about the American deficits, Donald Regan's "Irish blood was up . . . telling his foreign counterparts that they had it wrong and [the United States] had it right; that they should be emulating [the United States'] policies, not criticizing them."[565] Volcker wrote in 1992 that he once was walking into the meeting hall at a high-level gathering, "with Regan in full flight, almost shouting. It was immediately apparent that this was not a high point for the niceties of international diplomacy,"[566] especially since the treasury secretary was defending a bad policy. Eventually, Volcker did get his way, and a tax increase was adopted.

The final thrust

For almost 3 years, Volcker had fought against his many adversaries when in the middle of 1982 the crucial breakthrough on the inflation front took place. Double-digit inflation had been narrowly avoided in 1981, but it took another half-year before evidence that a real change in expectations could be confirmed. The dragon of inflation was finally in its death throes, but Volcker knew that he could not let up too soon lest the beast recover. Around Christmas 1982, the dragon was in an advanced state of rigor mortis. Prices in 1982 increased a little less than 4%, lower than in every year since 1972. And as 10 years of dangerously out-of-control and debilitating inflation came to an end, it heralded the beginning of a long series of years of economic stability. Economic growth also picked up in 1983, and joblessness came down, the American recovery in the United States helping other countries to pull out of recession. The Great Inflation was now a thing of the past, thanks to Volcker's determination and that of the likes of Margaret Thatcher and the equally determined German Bundesbank. It was the beginning of the Great Moderation, a most felicitous combination of low inflation and high employment that would last until the outbreak of the global financial firestorm of 2007 and 2008, pushing the world economy into the Great Recession. Had Volcker not stubbornly and aggressively fought

Paul Volcker as elderly statesman. (Courtesy Kenneth C. Zirkel.)

chronic inflation, hyperinflation could well have developed, with its attendant complete loss of confidence, eventually bringing about a collapse of the American economy, a disastrous rout of the dollar, currency, and trade wars, culminating in global depression.

Volcker titled his Per Jacobsson Lecture, delivered in Washington in September 1990, “The Triumph of Central Banking?” Monetary specialists do not dispute the question mark: Central banking is more of an art than a science, and mistakes are inevitably made. But the way that Paul Volcker managed to wring out inflation and make possible the Great Moderation is the closest to a triumph that central banks can achieve.

* * *

In 2009 Paul Volcker, already in his 80s, made a stunning comeback when President Obama appointed him his special economic advisor, having considering making him secretary of the treasury. There are no other instances of prominent crisis combatants of the 1970s being recalled to public service at the highest levels at such advanced age.

Notes

1. Volcker and Gyohten, 29.
2. Haig, 327.
3. *Washington Post*, April 25, 2012.
4. Charles de Gaulle, Conférence de Presse, Paris, February 4, 1965.
5. Shaw.
6. Keynes, *A Tract on Monetary Reform*, 17.
7. World Gold Council, September, 2011.
8. The early history of gold draws on Bernstein, *The Power of Gold* and National Mining Association, *The History of Gold*.
9. Bernstein, 121.
10. Galbraith, 188.
11. Beyen, *Het Spel en de Knikkers*, 99–101.
12. Ibid., 97.
13. Quoted in Ahamed, *Lords of Finance*, 468.
14. Morris, 392.
15. Beyen, 100.
16. Schumpeter, 393.
17. Bernstein, *The Power of Gold*, 238.
18. Bagehot, 322.
19. Mundell.
20. Lindert, "Key currencies and Gold," 24.
21. Keynes, *Indian Currency and Finance*, 157.
22. The pre-war gold standard had worked well, Mises, 449–469.
23. Cassel, *Money and Foreign Exchange after 1914*, 212, 213.
24. Keynes, *A Tract on Monetary Reform*, 176.
25. Professor Edwin Kemmerer of Princeton University: Joh. De Vries, 284.
26. Galbraith, 207.
27. Rist.
28. Central bankers engaged in unprecedented cooperation: extensively described in Ahamed, Lords of Finance.
29. "Achtung Schacht": anecdote among central bankers.
30. Beyen, 115.
31. Clarke, *Central Bank Cooperation 1924–31*, 144.
32. Wijnholds, 223.
33. *Statement* by the Bank of England, London, September 20, 1931.
34. Norman, September 21, 1931.
35. Ahamed, 431.
36. Vissering's visit to the Bank of England, Joh. De Vries, 443–449.
37. Sayers, 458–459.
38. Eichengreen, *Golden Fetters*, 294.

39. Cassel, *Report of the Gold Delegation,* 23–24.
40. Morgan, 399.
41. Keynes, "Open letter to President Roosevelt."
42. Morgan, 399.
43. Galbraith, 214.
44. Eichengreen, *Golden Fetters*, 371.
45. Bank for International Settlements, *Annual Report* 1939, 75.
46. Beyen, 83.
47. Bank for International Settlements, *Annual Report* 1941, 79.
48. Cassel, 66.
49. Transfer of Spanish gold to Russia, based on Burnett Bolloten, *The Spanish Civil War*, and Preston.
50. Bolloten, 280–281.
51. Morgan, 578.
52. Ibid., 579.
53. The Bank of England 1939–45, 1024.
54. The Czech Central Bank ordered the BIS, Beyen, 124–127.
55. The Bank of England 1939–45, 1024.
56. Looting of Dutch gold: Joh. De Vries, 350–374.
57. The Foreign and Commonwealth Office of Great Britain, 67.
58. Brief by Stuart Eizenstat on the release of the report on looted gold.
59. Joh. De Vries, 365–369.
60. Beyen, 154.
61. Moggeridge, 684.
62. James, 53.
63. Ibid., 57.
64. Krueger, 217.
65. White outsmarted Keynes: Steil, *The Battle at Bretton Woods,* 197–199.
66. Bretton Woods Conference.
67. Beyen, 162.
68. James, 48.
69. *The Education of a POW*, based on A. Bakker, *Pieter Lieftinck 1902–1989*, 81, and author's personal information.
70. James, 70.
71. Beyen, 176.
72. White has obviously been given the benefit of the doubt, based on Boughton.
73. Judt, 21.
74. The IMF was waiting on the sidelines: Horsefield, 217–219.
75. Beyen, 199.
76. James, 107.
77. Jacobsson's dealings with Germany: James, 112–115.
78. Jacques Polak biographical sketch in Polak, xiii–xxviii, and author's personal information.
79. Author interview with Andrew Crockett.
80. Triffin biographical information: largely based on Ferrant and Slooven.
81. Ibid., 63, 64.
82. Charles de Gaulle, *Discours et Messages: L'Effort*, 202.
83. Gaullist position beyond economics and an extension of French foreign policy: Szász, *Monetaire Diplomatie*, 222.

84. Charles de Gaulle, *Mémoires de l'Espoir,* 13.
85. Activities of the gold pool based on: Coombs, 42–68; Eichengreen, *Global Imbalances and the Lessons of Bretton Woods*, 35–72.
86. Coombs, 68.
87. Eichengreen, *Exorbitant Privilege*, 59.
88. Group of Ten: United States, Japan, Germany, France, Italy, Canada, The Netherlands, Belgium and Sweden with Switzerland—not an IMF member until 1992—as observer.
89. Coombs, 25.
90. Solomon, 34.
91. Valéry Giscard d'Estaing: "exorbitant privilege," Eichengreen, *Exorbitant Privilege*, 4.
92. Solomon, 62.
93. Robert Triffin wrote a letter: "Lettre de Robert Triffin à Charles de Gaulle, 22 fevrier, 1965; Lettre de Charles de Gaulle à Robert Triffin, 17 mars, 1965, reproduced in Ferrant and Sloover, 131–137.
94. Ferrant and Sloover, 54, 55.
95. President Charles de Gaulle's recent call: Yan, 24, 25.
96. Fowler.
97. Solomon, 111.
98. Machlup, "Plans for Reform of the International Monetary System," preface to 2nd edition.
99. Machlup, lower price of gold: "A Proposal to Lower the Price of Gold" in Fritz Machlup, *International Monetary Economics,* 239–244.
100. Mrs. Machlup's Wardrobe Theory: Machlup, "The Need for International Reserves."
101. Bellagio Group, *The Problem of* Choice, 1964.
102. Financing and adjustment: Kenen.
103. German economists: Otmar Issing, 1967.
104. This line of thinking: Milton Friedman, "The Case for Flexible Exchange Rates' in Friedman, *Essays in Positive Economics* 157–200.
105. Charles P. Kindleberger, *International Money*, 24.
106. Ibid., 25.
107. Ibid., 25.
108. Ibid., 25.
109. Ibid., 27.
110. Volcker, Gyohten, 57.
111. Ibid., 57.
112. Pierre-Paul Schweitzer, Closing Remarks, IMF Annual Meeting, Tokyo, 1964.
113. Biological information on Pierre-Paul Schweitzer: Margaret De Vries, *The International Monetary Fund 1972–1978*, 632–635, and author interview with Crockett.
114. Speech by Henry Fowler, Margaret De Vries, *The International Monetary Fund 1966–1971,* 131.
115. Solomon, 142.
116. Margaret De Vries, *The International Monetary Fund 1972–1978*, 187.
117. Zijlstra relates: Puchinger, 185, 186.
118. Ibid., 189.
119. Ibid., 189.

120. Coombs, 184.
121. Puchinger, 190.
122. Coombs, 184.
123. Ibid., 184.
124. Johnson on De Gaulle, Johnson, 23, 24.
125. Ambrose, *Nixon: Ruin and Recovery 1973–1990*, 562.
126. Burns and Nixon kept in touch: Kettl, 118.
127. Erlichman, *Witness to Power*, 90.
128. Woodward, 34, 35.
129. Burns, 3.
130. Garment, 187.
131. Kissinger, *Years of Upheaval*, 97.
132. Paulson, 28.
133. Garment, 299.
134. Biographical information on Volcker derived from: Neikirk; Treaster; Silber; and oral information from Robert Solomon and André Szász.
135. Burns, 62.
136. Silber, 82.
137. Arthur Burns, 2.
138. Richard M. Nixon, *Inaugural Address,* January 20, 1969.
139. Ibid.
140. Ibid.
141. IMF, *Annual Report* 1969, 3.
142. Discussions between Friedman and Nixon, Ebelstein, 185, 186.
143. Matusow, 16.
144. Ibid., 16.
145. Ibid., 18.
146. Silber, 55, 56.
147. Own Air Force plane: Treaster, 39.
148. IMF, *Annual Report* 1970, 3.
149. Coombs, 28.
150. Blessing's war-time activities: Marsh, 40–44.
151. Ibid., 44.
152. Ibid., 44.
153. Greenspan, 59.
154. Garment, 199.
155. IMF, *Annual Report* 1971, 88, 89.
156. Volcker worried about his job: Silber, 75.
157. Zijlstra, 234.
158. Kettl, 119.
159. Ibid., 118.
160. Paul Samuelson as quoted by Kettl, 119.
161. Ibid., 118.
162. Burns on incomes policy: Matusow, 70, 71.
163. Erlichman, as quoted by Kettl, 133.
164. Burns, 38.
165. Kettl, 125.
166. IMF, *Annual Report* 1971, 18.
167. Volcker, 61.

168. *Newsweek*, January 25, 1971, 27, quoted by Matusow, 93.
169. Solomon, 190.
170. Ibid., 190.
171. Kissinger, *White House Years*, 951.
172. Matusow, 97.
173. Reston, 403.
174. Ibid., 395.
175. Connally, *In History's* Shadow, 256.
176. Reston, quoted in www.treasury.gov/about/history/page/jbconnally.aspx
177. Stein, 162.
178. Burns, 38.
179. Volcker, 117.
180. Coombs, 219.
181. More ominous, Volcker, 117.
182. IMF, *Annual Report* 1971, 7.
183. Richard M. Nixon, *Address* to the Nation on Economic Policy and Productivity, June 17, 1970.
184. Houthakker quoted by Coombs, 208.
185. Witteveen, final attempt: Szász, 70, 71.
186. Coombs, 211.
187. Ibid., 211.
188. Ibid., 211.
189. Silber, 76.
190. Jelle Zijlstra in De Nederlandsche Bank, *Annual Report* 1971, 27.
191. Matusow, 142.
192. Silber, 80.
193. James, 215.
194. Silber, 65.
195. Silber, 66.
196. Solomon, 181.
197. Margaret De Vries, *The International Monetary Fund 1966–1971*, 526.
198. Ibid., 527.
199. Ibid., 527.
200. Ibid., 527.
201. Volcker, 75.
202. Matusow, 144.
203. James, 217.
204. Volcker, 75.
205. Ibid., 91, 92.
206. Coombs, 219.
207. Puchinger, 191.
208. Ibid., 191.
209. Ibid., 191.
210. Reston, 404, 405.
211. Volcker, 77.
212. Matusow, 147.
213. *Wall Street Journal*, August 5, 1971.
214. Volcker, 76.
215. James, 215.

216. Ibid., 215.
217. Matusow, 153.
218. Ibid., 153.
219. Ibid., 152.
220. Haldeman, *The Haldeman Diaries*, 346.
221. Silber, 89.
222. Ibid., 88.
223. Matusow, 154.
224. Volcker, 79.
225. Richard M. Nixon, *Address* to the Nation, August 15, 1971.
226. Ibid.
227. Ibid.
228. Ibid.
229. Ibid.
230. Ibid.
231. Perlstein, 603.
232. Newsweek, 22.
233. Silber, 92.
234. Matusow, 156.
235. Ibid., 156.
236. *New York Times*, August 16, 1971.
237. Reston, 412.
238. Silber, 92.
239. Matusow, 156.
240. Volcker and Gyohten, 93.
241. Ibid., 93.
242. *New York Times*, August 17, 1971.
243. Volcker, 81.
244. Silber, 93.
245. Fase, 304.
246. Ibid., 304.
247. Margaret De Vries, *The International Monetary Fund 1966–1971*, 541.
248. Coombs, 220.
249. Margaret De Vries, *The International Monetary Fund 1966–1971*, 537.
250. Ibid., 538.
251. Ibid., 540.
252. James, 223.
253. Volcker, 82.
254. Volcker, 83.
255. Matusow, 169.
256. Ibid., 169.
257. Solomon, 194.
258. Margaret De Vries, 546, 547.
259. James, 226.
260. Burns, 58.
261. Solomon, 196.
262. Ibid., 196.
263. Marsh, 164.
264. Ibid., 165.

265. Puchinger, 192.
266. Ibid., 194.
267. Ibid., 194.
268. Matusow, 173.
269. Ibid., 173.
270. Ibid., 173.
271. Kissinger, *White House Years*, 950.
272. Matusow, 174.
273. Haldeman, 372.
274. Solomon, 201.
275. Silber, 100.
276. Volcker, 85.
277. Silber, 100.
278. Matusow, 176.
279. Ibid., 176.
280. Margaret De Vries, 552.
281. Volcker, 87.
282. Ibid., 85.
283. Volcker and Gyohten, 95.
284. Ibid., 95.
285. Volcker, 81.
286. Ibid., 88.
287. Solomon, 205.
288. James, 237.
289. Ibid., 237.
290. Ibid., 237.
291. Volcker and Gyohten, 97.
292. Ibid., 97.
293. Solomon, 203.
294. Yan, 16, 17.
295. Volcker and Gyohten, 98.
296. Emminger, 207.
297. Matusow, 178.
298. Ibid., 178.
299. Ibid., 180.
300. Volcker and Gyohten, 98.
301. Ibid., 98.
302. Ibid., 98.
303. Volcker, 101.
304. Coombs, 222, 223.
305. Ibid., 224.
306. James, 230.
307. Matusow, 3.
308. Van Lennep, 237.
309. Haldeman, 399.
310. Ibid., 439.
311. Silber, 106.
312. Ibid., 107.
313. Kettl, 127.

314. Volcker, 113.
315. Silber, 104.
316. Conversation Haldeman-Nixon, June 23, 1972, White House Tapes, Nixon Papers N.A.
317. Matusow, 189.
318. Ibid., 210.
319. Bernstein and Woodward, *All the President's Men*, 29.
320. Ibid., 56.
321. Ibid., 57.
322. Ibid., 57.
323. *Washington Post*, October 10, 1972.
324. Ibid., 169.
325. Solomon, 228.
326. Volcker, 117.
327. Nixon, 733.
328. Ambrose, 73.
329. Ibid., 81.
330. Kutler, *The Wars of Watergate*, 261.
331. Ambrose, 190.
332. Coombs, 228.
333. Ibid., 229.
334. Schmidt, 194.
335. Coombs, 229.
336. Solomon, 232.
337. Schmidt, 193.
338. Matusow, 201.
339. *New York Times*, December 2, 1972.
340. Burns, 104, 105.
341. Ibid., 128.
342. Thatcher, 70.
343. Corcelette and Abadie, 7.
344. Ibid., 7.
345. Ibid., 105.
346. Giscard d'Estaing, *Le Pouvoir et la Vie: Choisir*, 89.
347. Shultz, 14.
348. Schmidt, 179.
349. Shultz, 12.
350. Carter, 69.
351. Ibid., 439.
352. Thatcher, 257.
353. Kutler, 320.
354. Ambrose, 136.
355. Burns, 106.
356. Ambrose, 174.
357. Ibid., 188.
358. Bernstein and Woodward, 371.
359. Ambrose, 194.
360. Ibid., 196.
361. Garment, 279.

362. Ibid., 281.
363. Ambrose, 202.
364. Ibid., 203.
365. Ibid., 208–9.
366. Matusow, 239.
367. *New York Times* February 14, 1973.
368. Ibid., April 6, 1973.
369. Johnny Cash, radio commercial, autumn 1973.
370. Matusow, 262.
371. Ibid., 262.
372. James, 245.
373. Zijlstra, 252.
374. Ibid., 252.
375. Biographical information on Witteveen's youth and early career based on Witteveen, 51–55.
376. "A Mystic at the IMF," *Time Magazine*, August 13, 1973.
377. Author interview with Witteveen.
378. James, 245.
379. Witteveen, 211.
380. Schmidt, 197.
381. Author interview with Leo van Houtven, Bethesda MD, August 6, 2013.
382. Margaret De Vries, *The International Monetary Fund 1972–1978*, 313.
383. James, 255.
384. Author interview with Leo van Houtven.
385. Volcker, 138.
386. Ibid., 138.
387. Margaret De Vries, *History of the IMF,* 305.
388. Carl Bernstein and Bob Woodward, "The 5 Wars of Watergate," *Washington Post*, June 10, 2012.
389. Ambrose, 252.
390. Richard M. Nixon, *Memoirs*, 929.
391. Morris, 251, quoting Elliot Richardson, *The Creative Balance*, Holt, Rinehart and Winston, New York, 1976.
392. Ambrose, 250.
393. Ibid., 258.
394. Nixon, 946.
395. Ambrose, 271.
396. Ibid., 290.
397. Zumwalt, 459, 460.
398. Ford, 116.
399. Bernstein and Woodward, *All the President's Men*, 336.
400. Matusow, 264.
401. Ibid., 266.
402. Ibid., 267.
403. IMF, *Annual Report*, 1974, 1.
404. Ibid., 9.
405. Matusow, 282.
406. Volcker and Gyohten, 131.
407. Marsh, 166.

408. Emminger, 275.
409. Schmidt, 201.
410. Britain TUC land in Anthony Burgess, *1985.*
411. Hannah.
412. Van Lennep, 248.
413. Burns, 124.
414. Largely based on Witteveen, 202–210, and author interview with Witteveen.
415. Margaret De Vries, 318.
416. Author interview with Andrew Crockett, San Francisco, March 20, 2012.
417. Ibid.
418. Margaret De Vries, *The International Monetary Fund 1972–1978*, 326.
419. Ibid., 326.
420. IMF, *Annual Report*, 1974.
421. Coombs, 235.
422. Shultz, 121.
423. James, 255.
424. Burns, 129.
425. Ibid., 130.
426. Ambrose, 314, 315.
427. Ibid., 319.
428. Ibid., 320.
429. Roth.
430. Black, 950.
431. Ambrose, 326.
432. Bernstein and Woodward, *The Final Days*, 154.
433. Ambrose, 328.
434. Haig, 455.
435. Ambrose, 338.
436. Kissinger, *Years of Upheaval*, 1161.
437. *New York Times*, June 27, 1994.
438. Ambrose, 373.
439. Matusow, 279.
440. Ibid., 292.
441. Silber, 142.
442. Full Employment and Growth Act, Kettl, 149, 150; Silber, 142.
443. Franklin National bankruptcy information based mainly on *Time*, October 21, 1974, and April 7, 1980; Di Fonzo, 1983.
444. Matusow, 296.
445. Ibid., 296.
446. Ibid., 298.
447. Coombs, 235.
448. Black, 965.
449. Kissinger, 1181.
450. Ford, 123.
451. Ambrose, 387.
452. Black, 966.
453. Ambrose, 390.
454. Emery, 408.
455. Haig, 471.

456. Nixon, *Memoirs*, 1057.
457. Ambrose, 413.
458. Ibid., 416.
459. Brinkley, 61.
460. Ibid., 133.
461. Haig, 496.
462. Bernstein and Woodward, *The Final Days*, 404.
463. Ambrose, 408.
464. Black, 484.
465. Kutler, 547.
466. *New York Times*, September 6, 1981.
467. Ambrose, *Nixon: The Education of a Politician 1913–1962*, 588.
468. *Time*, June 24, 1985.
469. Connally, *In History's Shadow*, 205.
470. Ibid., 205.
471. Ibid., 205.
471. Bernstein and Woodward, *The Final Days*, 187.
473. Kutlin, 546.
474. Ibid., 546.
475. Ambrose, 417.
476. Morris, 301.
477. terHorst, 185.
478. Gerald Ford, televised speech August 9, 1974, quoted in Brinkley, 63.
479. Brinkley, 68.
480. Ibid., 117.
481. Ibid., 77.
482. Greenspan, 66.
483. IMF, *Annual Report* 1975, 1.
484. Kettl, 132.
485. Greenspan, 93.
486. Kettl, 134.
487. Ibid., 132.
488. Crockett in Witteveen, 347.
489. Johannes Witteveen, Speech at the IMF Annual Meeting, September 1, 1974, quoted in Margaret De Vries.
490. Author interview with Witteveen.
491. Margaret De Vries, 740.
492. Ibid., 740.
493. Ibid., 743.
494. Shultz, 113.
495. Rambouillet meeting: mainly based on Giscard d'Estaing, *Le Pouvoir et la Vie: Choisir*, 85–87 and Schmidt, 214.
496. Margaret De Vries, 748.
497. Kafka.
498. Witteveen, 225.
499. Triffin, "Jamaica: Major Revision or Fiasco?"
500. IMF, *Annual Report*, 1977, 1.
501. Kettl, 143.
502. James, 280.

503. Lamberto Dini, “Turbulence in Foreign Exchange Markets,” in Bakker, *Essays in Honor of André Szász*, 228.
504. Witteveen, 216.
505. Ibid., 218.
506. Ibid., 218.
507. Ibid., 212.
508. Ibid., 212.
509. Andreotti, *Diari 1971–1979*, 56, quoted by Margaret De Vries, 453.
510. Ibid., 453.
511. Witteveen, 215.
512. Margaret De Vries, 459.
513. Biven, 55.
514. Ibid., 55.
515. Ibid., 33.
516. *Time,* June 28, 1976, 54.
517. Biven, 41.
518. Eizenstat, quoted in Bevin, 45.
519. Kettl, 167.
520. Biven, 99.
521. Putnam and Henning, 36.
522. Schmidt, 229.
523. Ibid., 222.
524. Biven, 103.
525. Ibid., 108.
526. Volcker, 146.
527. Volcker, 147.
528. Ibid., 148.
529. Volcker and Gyohten, 153.
530. Emminger, 374.
531. *The Economist*, August 6, 1977.
532. Emminger, 374.
533. Volcker and Gyohten, 154.
534. Emminger, 377.
535. Ibid., 379.
536. Biven, 182.
537. IMF, *Annual Report* 1978, 5.
538. Margaret Thatcher, 68.
539. Silber, 137.
540. Emminger, 381.
541. Ibid., 384.
542. Ibid., 389.
543. Bevin, 158.
544. Silber, 146.
545. Carter, 347.
546. As related to the author by an insider.
547. Giscard d’Estaing, Le Pouvoir et la Vie: Choisir, 130.
548. Ibid., 127.
549. Ibid., 128.
550. Emminger, 395.

551. Ibid., 395.
552. Ibid., 396.
553. Ibid., 396.
554. Silber, 167.
555. Schmidt, 326.
556. Meltzer, 1033, n. 32.
557. Quoted in Silber, 178.
558. IMF, *Annual Report* 1981, 1.
559. Biven, 206.
560. Ibid.
561. Destler and Henning, 20.
562. Kettl, 186.
563. Meltzer, based on interview with Volcker, 1087.
564. Volcker, 174.
565. Ibid., 183.
566. Ibid., 183.

This page intentionally left blank

Bibliography

Abrams, Burton: "How Richard Nixon Pressured Arthur Burns: Evidence from the Nixon Tapes," *Journal of Economic Perspectives*, no. 4, 2006, 177–188.

Adams Brown, William: *The International Gold Standard Reinterpreted 1914–1934*, National Bureau for Economic Research, New York, 1940.

Ahamed, Liaquat: *Lords of Finance: The Bankers Who Broke the World*, Penguin Books, London, 2009.

Ambrose, Stephen E.: *Nixon: The Education of a Politician 1913–1962*, Simon and Schuster, New York, 1987.

Ambrose, Stephen E.: *Nixon*: *The Triumph of a Politician 1962–1972*, Simon and Schuster, New York, 1989.

Ambrose, Stephen E.: *Nixon: Ruin and Recovery 1973–1990*, Simon and Schuster, New York, 1991.

Bagehot, Walter. *Lombard Street: A Description of the Money Market*, London, 1873.

Bakker, A., and M. M. P. van Lent: *Pieter Lieftinck 1902–1989*, Veen Uitgevers, Utrecht, 1989.

Bank of England: *The Bank of England 1939–45, Unpublished War History*, made public in 2013, Bank of England Archives M5/533–539.

Bank for International Settlements: *Annual Reports*, 1939, 1941, Basel.

Bellagio Group: *International Monetary Arrangements: The P*roblem *of Choice*, *Report of a Group of 32 Economists*, Princeton University Press, Princeton, NJ, 1964.

Bergsten, C. Fred: *Dilemmas of the Dollar: The Economics and Politics of United States International Monetary Policy*, Council on Foreign Affairs, 2nd edition, New York, 1996.

Bernstein, Carl, and Bob Woodward: *All the President's Men*, Simon and Schuster, New York, 1974.

Bernstein, Carl, and Bob Woodward: *The Final Days*, Simon and Schuster, New York, 1976.

Bernstein, Carl, and Bob Woodward: "The 5 Wars of Watergate," *Washington Post*, June 10, 2012.

Bernstein, Peter: *The Power of Gold: The History of an Obsession*, John Wiley and Son, New York, 2012.

Beyen, J. W.: *Money in a Maelstrom*, Macmillan & Co. London, 1951.

Beyen, J. W.: *Het Spel en de Knikkers*, Ad. Donker, Rotterdam, 1968.

Biven, W. Carl: *Jimmy Carter's Economy: Policy in an Age of Limits*, University of North Carolina Press, Chapel Hill, 2002.

Black, Conrad: *A Life in Full: Richard Nixon*, Public Affairs, New York, 2007.

Bolloten, Burnett: *The Spanish Civil War: Revolution and Counterrevolution*, University of North Carolina Press, Chapel Hill, 1991.

Boughton, James M.: "The Case of Harry Dexter White: Still Not Proven," International Monetary Fund, *Working Paper 0/49*, 2000.

Bretton Woods Conference: *Verslag van de Nederlandse Delegatie bij de Monetaire en Financiële Conferentie van de Verenigde Naties*, 1944.

Bretton Woods Transcripts: *See* Schuler, Kurt.

Brinkley, Douglas: *Gerald R. Ford*, The American Presidents Series, Times Books, Henry Holt and Company, New York, 2007.

Burns, Arthur F.: "The Anguish of Central Banking," *Per Jacobsson Lecture*, Belgrade, October 1979; www.perjacobsson.org/lecture/1979.

Burns, Arthur F.: *Inside the Nixon Administration: The Secret Diary of Arthur Burns*, ed. Robert H. Ferrell, University Press of Kansas, Lawrence KS, 2010.

Carter, Jimmy: *White House Diary*, Farrar, Straus and Giroux, New York, 2010.

Cassel, Gustav: *Money and Foreign Exchange after 1914*, Macmillan, London, 1930.

Cassel, Gustav: *Report of the Gold Delegation: Note of Dissent*, League of Nations, Geneva, 1932.

Churchill, Winston S.: *The Second World War: The Grand Alliance*, Houghton Mifflin Company, Boston, 1950.

Churchill, Winston S.: *The Second World War: Triumph and Tragedy*, Houghton Mifflin Company, Boston, 1953.

Clarke, Stephen V. O.: *Central Bank Cooperation 1924–31*, Federal Reserve Bank of New York, New York, 1967.

Committee on Reform of the International Monetary System and Related Issues (Committee of Twenty): *International Monetary Reform*, International Monetary Fund, Washington, DC, 1974.

Connally, John B., with Mickey Herskowitz: *In History's Shadow: An American Odyssey*, Hyperion, New York, 1993.

Corcelette, Jean, and Frederic Abadie: *Valéry Giscard d'Estaing*, Nouveau Monde, Paris, 1997.

Dam, Kenneth W.: *The Rules of the Game: Reform and Evolution in the International Monetary System*, University of Chicago Press, Chicago, 1982.

Dean, John W.: *The Nixon Defense*, The Penguin Press, New York, 2014.

De Gaulle, Charles: *Conférence de Presse*, Paris, February 4, 1965.

De Gaulle, Charles: *Mémoires d'Espoir: Le Renouveau 1958–1962*, Paris, 1970.

Destler, I. M., and C. Randall Henning: *Dollar politics: Exchange Rate Policy Making in the United States*, Institute for International Economics, Washington, DC, 1989.

De Vries, Joh.: *Geschiedenis van De Nederlandsche Bank 1914–1948:Visserings's Tijdvak 1914–1931*, Nederlands Instituut voor Bank-en Effectenbedrijf, Amsterdam, 1989.

De Vries, Margaret Garretsen: *The International Monetary Fund 1966–1971: The System under Stress*, IMF, Washington D.C., 1976.

De Vries, Margaret Garretsen: *The International Monetary Fund 1972–1978: Cooperation on Trial*, IMF, Washington DC, 1985.

Di Fonzo, Luigi: *St. Peter's Banker*, Franklin Watts, New York, 1983.

Dini, Lamberto: "Turbulence in Financial Markets," in A.Bakker et al. (eds.), *Monetary Stability through International Cooperation: Essays in Honour of André Szász*, De Nederlandsche Bank, Amsterdam, 1994, pp. 227–238.

Drew, Elizabeth: *Washington Journal: The Events of 1973–74*, Random House, New York, 1974.

Ebenstein, Lanny: *Milton Friedman: A Biography*, Palgrave Macmillan, Basingstoke, 2007.

Eichengreen, Barry: *Golden Fetters: The Gold Standard and the Great Depression*, Oxford University Press, Oxford, 1992.

Eichengreen, Barry: *Global Imbalances and the Lessons of Bretton Woods*, MIT Press, Cambridge, MA, 2010.

Eichengreen, Barry: *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*, Oxford University Press, Oxford, 2011.

Eizenstat, Stuart: Brief on release of the report *U.S. and Allied Wartime and Post-wartime Negotiations with Argentina, Portugal, Spain, Sweden and Turkey on Looted Gold and German External Assets and U.S. Concerns about the Fate of Wartime Ustashe Treasury,* Washington, DC, June 2, 1998.

Emery, Fred: *Watergate: The Corruption of American Politics and the Fall of Richard Nixon*, Touchstone, New York, 1994.

Emminger, Otmar: *D-Mark, Dollar, Währungskriese: Erinnerungen eines Ehemaliges Bundesbank Präsidenten*, Deutsche Verlags-Anstalt, Stuttgart, 1986.

Erlichman, John: *Witness to Power: The Nixon Years*, Simon and Schuster, New York, 1982.

European Central Bank: “The Great Inflation: Lessons for Monetary Policy,” *Monthly Bulletin,* May 2010, 99–110.

Fase, Martin M. G.: *Geschiedenis van De Nederlandsche Bank 1948–1973: Tussen Behoud en Vernieuwing*, SDU Uitgevers, Den Haag, 2000.

Ferrant, Catherine, and Jean Slooven: *Robert Triffin: Conseiller des Princes, Souvenirs et Documents*, Fondation International Triffin, P.I.E. Peter Lang, Bruxelles, 2010.

Ford, Gerald R.: *A Time to Heal*, Harper and Row, New York, 1979.

Foreign and Commonwealth Office, Great Britain: *Nazi Gold: The London Conference*, London, 1998.

Fowler, Henry H.: *Speech before Virginia Bar Association*, U.S. Treasury Department, press release, July 11, 1965.

Friedman, Milton: “The Case for Flexible Exchange Rates,” in *Essays in Positive Economics*, University of Chicago Press, 1953.

Friedman, Milton, and Anna Jacobson Schwartz: *A Monetary History of the United States 1867–1960*, National Bureau of Economic Research, Princeton University Press, Princeton, NJ, 1963.

Friedman, Milton, and Robert V. Roosa: *Free versus Fixed Exchange Rates*, American Enterprise Institute, Washington, DC, 1967.

Galbraith, John Kenneth: *The Age of Uncertainty*, British Broadcasting Corporation, London, 1977.

Garment, Leonard: *Crazy Rhythm: From Brooklyn and Jazz to Nixon’s White House, Watergate, and Beyond,* Da Capo Press, New York, 1997.

Geology.com: *The Many Uses of Gold*, www.geology.com/minerals/gold/uses-of-gold.shtml

Giscard d’Estaing, Valéry: *Le Pouvoir et la Vie: l’Affrontement, CE 12 (Companie)*, Paris, 1991.

Giscard d’Estaing, Valéry: *Le Pouvoir et la Vie; Choisir*, France Loisir, Paris, 2006.

Greenspan, Alan: *The Age of Turbulence: Adventures in a New World*, The Penguin Press, New York, 2007.

Gyohten, Toyoo: *See* Volcker.

Haig, Alexander M. Jr., with Charles McCarry: *Inner Circles: How America Changed the World, A Memoir*, Warner Books, New York, 1992.

Haldeman, H. R.: *The Haldeman Diaries: Inside the White House*, G.P. Putnam's Sons, New York, 1994.

Haldeman, H. R., with Joseph di Mona: *The Ends of Power*, New York Times Books, New York, 1978.

Hannah, Daniel: "In a Crowded Field Edward Heath Was Our Worst Prime Minister," *The Telegraph*, London, September 6, 2010.

Hoff, Joan: *Nixon Reconsidered*, Basic Books, Harper Collins, New York, 1994.

Hoffmeyer, Erik: *The International Monetary System: An Essay in Interpretation*, North Holland, Amsterdam, 1992.

Horsefield, J. Keith: *The International Monetary Fund 1945–1965: Chronicle*, International Monetary Fund, Washington, DC, 1969.

Hume, David, "Of the Balance of Trade," *Political Discourses*, Edinburgh, 1752.

International Monetary Fund: *Annual Reports* 1969–1982. Washington, DC.

Issing, Otmar: Zur Frage der Objektiven Beurteilung einer "Angemessener" Versorgung mit Internationale Liquiditat, *Schweizerishe Zeitschrift fur Volkswirtshaft und Statistik*, March 1967.

James, Harold: *International Monetary Cooperation since Bretton Woods*, International Monetary Fund and Oxford University Press, Washington, DC, and New York, 1996.

Jenkins, Roy: *Churchill*, Pen Books, London, 2001.

Johnson, Lyndon Baines: *The Vantage Point: Perspectives of the Presidency*, Holt, Rinehart and Winston, New York, 1971.

Judt, Tony: *Postwar: A History of Europe since 1945*, The Penguin Press, New York, 2005.

Kafka, Alexandre: "Reform without Reconstitution," *Essays in International Finance*, no. 111, Princeton University, Princeton, NJ, 1976.

Kenen, Peter B.: "Financing and Adjustment: The Carrot and the Stick," in William Fellner (ed.), *Maintaining and Restoring Balance in International Payments*, Princeton University Press, Princeton, NJ, 1966, 151 et seq.

Kettl, Donald F.: *Leadership at the Fed*, Yale University Press, New Haven, CT, 1986.

Keynes, John Maynard: *Indian Currency and Finance*, Macmillan, London, 1913.

Keynes, John Maynard: *A Tract on Monetary Reform*, Macmillan, London, 1923.

Keynes, John Maynard: "Open Letter to President Roosevelt," *New York Times*, December 31, 1933.

Keynes, John Maynard: *The General Theory of Employment, Interest, and Money*, Macmillan, London, 1936.

Kindleberger, Charles P.: *The Dollar Shortage*, MIT Press, Cambridge, MA, 1950.

Kindleberger, Charles P.: *International Money: A Collection of Essays*, Allen and Unwin, London, 1981.

Kindleberger, Charles P., and James Lafargue: *Financial Crises: Theory, History and Policy*, Cambridge University Press, London, 1982.

Kissinger, Henry: *The White House Years*, Little, Brown and Company, Boston, 1979.

Kissinger, Henry: *Years of Upheaval*, Little, Brown and Company, Boston, 1982.

Krueger, Anne O.: *Struggling with Success; Challenges Facing the International Economy*, World Scientific Publishing Co., Singapore, 2012.

Kutler, Stanley I.: *The Wars of Watergate: The Last Crisis of Richard Nixon*, W.W. Norton and Co., New York, 1992.

Kutler, Stanley I.: *Abuse of Power: The New Nixon Tapes*, The Free Press, New York, 1997.

Kutler, Stanley I.: *Watergate: A Brief History with Documents*, Wiley-Blackwell, New York, 2010.

Lebor, Adam: *Tower of Basel: The Shadowy History of the Secret Bank That Runs the World*, Public Affairs, New York, 2013.

Lukas, J. Anthony: *Nightmare: The Underside of the Nixon Years*, Viking Press, New York, 1976.

Machlup, Fritz: *Plans for Reform of the International Monetary System*, Special Papers International Finance no. 3, Princeton NJ, 1964.

Machlup, Fritz: *International Money: A Collection of Essays*, Allen and Unwin, London, 1969.

Machlup, Fritz: "The Need for International Reserves," *Banca Nazionale del Lavoro Quarterly Review*, Rome, September 1966.

Marsh, David: *The Most Powerful Bank: Inside Germany's Bundesbank*, Times Books, New York, 1992.

Martin, Justin: *Greenspan: The Man behind the Money*, Perseus Publishing, Cambridge MA, 2000.

Matusow, Allen J.: *Nixon's Economy: Booms, Busts, Dollars and Votes*, University of Kansas Press, Lawrence, 1998.

Meltzer, Allan H.: *A History of the Federal Reserve*: vol. 2, book 2, *1970–1986*, University of Chicago Press, Chicago, 2009.

Meyer, Martin: *The Fate of the Dollar*, Times Books, New York, 1980.

Mises, Ludwig von: *Theorie des Geldes*, Vienna, 1913.

Moggeridge, D. E.: *Maynard Keynes: An Economist's Biography*, Routledge, London, 1992.

Morgan, Ted: *FDR: A Biography*, Simon and Schuster, New York, 1985.

Morris, Roger: *Haig: The General's Progress*, Playboy Press, New York, 1982.

Mundell, Robert, Op-ed. on gold, *Wall Street Journal*, December 10, 1999.

National Mining Association: *The History of Gold*, Washington, DC, www.nma.org/pdf/gold/gold-history.pdf

Neikirk, William R.: *Volcker: Portrait of a Money Man*, Congdon and Weed, New York, 1987.

Nixon, Richard M.: *Inaugural Presidential Address*, Washington, DC, January 20, 1969.

Nixon, Richard M.: *Address to the Nation on Economic Policy and Productivity*, Washington, DC, June 17, 1970.

Nixon, Richard M.: *The Memoirs of Richard Nixon*, Grosset and Dunlap, New York, 1978.

Nixon, Richard M.: *Appearance on Meet the Press*, NBC television, April 10, 1988.

Norman, Montague C.: *Diaries: 1913–1944*, Bank of England Archives, ADM34/33.

Paulson, Henry M. Jr.: *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, Business Plus, New York, 2010.

Perlstein, Rick: *Nixonland*: *The Rise of a President and the Fracturing of America*, Scribner, New York, 2008.

Polak, J. J.: *Economic Theory and Financial Policy: The Selected Essays of Jacques Polak*, vol. 1, Edward Elgar, 1994.

Preston, Paul: *Revolution and War in Spain*, Routledge, New York, 2001.

Puchinger, G.: *Dr. Jelle Zijlstra*, Strengholt, Naarden, 1978.

Putnam, Robert D., and C. Randall Henning: "The Bonn Summit of 1978: A Case Study in Coordination," in Richard N. Cooper (ed.), *Can Nations Agree?* Brookings Institution, Washington, DC, 1989.

Reeves, Richard: *President Nixon: Abuse in the White House*, Simon and Schuster, New York, 2001.

Reston, James Jr.: *The Lone Star: The Life of John Connally*, Harper and Row, New York, 1989.

Rist, Charles: *The Triumph of Gold*, translated from the French, Wisdom Library, New York, 1961.

Roth, Philip: *Our Gang: Starring Tricky and His Friends*, Vintage Books, New York, 1971.

Rueff, Jacques: *The Monetary Sin of the West*, Macmillan, London, 1971.

Safire, William: *Before the Fall*, Doubleday, Garden City, New York, 1975.

Samuelson, Robert: *The Great Inflation and Its Aftermath: The Past and Future of American Affluence*, Random House, New York, 2009.

Sayers, Richard: *The Bank of England 1891–1944*, Cambridge University Press, Cambridge, UK, 1976.

Schmidt, Helmut: *Menschen und Mächte*, Goldmann Verlag, Berlin, 1987.

Schuler, Kurt, and Andrew Rosenberg (eds.): *The Bretton Woods Transcripts*, Center for Financial Stability, New York, 2013.

Schumpeter, Joseph A.: *History of Economic Analysis*, Oxford University Press, New York, 1954.

Shaw, George Bernard: *The Intelligent Woman's Guide to Socialism and Capitalism*, London, 1928, reprinted by New Transaction Books, New Brunswick, NJ, 1984.

Shultz, George P., and Kenneth W. Dam: *Economic Policy beyond the Headlines*, 2nd edition, University of Chicago Press, Chicago, 1998.

Silber, William L.: *Volcker: The Triumph of Persistence*, Bloomsbury Press, New York, 2012.

Skidelsky, Robert: *John Maynard Keynes: Fighting for Freedom 1937–1946, Viking,* London, 2000.

Solomon, Robert: *The International Monetary System 1945–1981*, Harper and Row, New York, 1982.

Steil, Benn: *John Maynard Keynes, Harry Dexter White and the Making of a New World Order*, Princeton University Press, Princeton, NJ, 2013.

Stein, Herbert: *Presidential Economics: The Making of Economic Policy from Roosevelt to Clinton*, American Enterprise Institute Press, Washington, DC, 1994.

Suskind, Ron: *Confidence Men: Wall Street, Washington and the Education of a President*, Harper and Collins, New York, 2011.

Sussman, Barry: *The Great Cover-Up: Nixon and the Scandal of Watergate*, 4th edition, Catapulter Books, New York, 2010.

Szász, André: *Monetaire Diplomatie: Nederlands Internationale Monetaire Politiek 1958–1987*, Stenfert Kroese, Leiden, 1988.

Szász, André: *The Road to European Monetary Union*, Macmillan Press, Basingstoke, 1999.

terHorst, Jerald: *Gerald Ford and the Future of the Presidency*, Third Press, New York, 1974.

Thatcher, Margaret: *The Downing Street Years*, HarperCollins, London, 1993.

Treaster, Joseph B.: *Paul Volcker: The Making of a Financial Legend*, John Wiley and Sons, New York, 2004.

Triffin, Robert: *Gold and the Dollar Crisis: The Future of Convertibility*, Yale University Press, New York, 1960.

Triffin, Robert: “Jamaica: Major Revision or Fiasco?” in Edward Bernstein (ed.), *Reflections on Jamaica*, Essays in International Finance no. 115, Princeton, NJ, 1976.

Truman, Edwin M.: The International Monetary System or “Nonsytem”? in C. Fred Bergsten and C. Randall Henning (eds.), *Global Economics in Extraordinary Times: Essays in Honor of John Williamson*, Peterson Institute for International Economics, Washington, DC, 2012.

United Nations: *United Nations Monetary and Financial Conference: Final Act and Documents*, Bretton Woods, NH, United States Government Printing Office, Washington, DC, 1944.

Van Lennep, Emile, with Evert Schoorl: *Emile van Lennep in de Wereldecomie: Herinneringen van een Internationale Nederlander*, Stenfert Kroese, Leiden, 1991.

Volcker, Paul A.: “The Triumph of Central Banking?” *Per Jacobsson Lecture*, Washington, DC, September 23, 1990, www.perjacobsson.org/lecture/1990

Volcker, Paul A., and Toyoo Gyohten: *Changing Fortunes: The World’s Money and the Threat to American Leadership*, Times Books, New York, 1992.

Wijnholds, H. W. J.: *The Budget Theory of Money*, Academic Press, Amsterdam, 1960.

Williamson, John: *The Failure of World Monetary Reform, 1971–74*, Nelson & Sons, Sunbury-on-Thames, Middlesex, 1977.

Witteveen, H. Johannes, with Saskia Rosdorff: *De Magie van Harmonie: Een Visie op de Wereldeconomie* (Autobiography), Gibbon Uitgeefagentschap, Amsterdam, 2012.

Woodward, Bob: *Greenspan’s Fed and the American Boom*, Simon and Schuster, New York, 2000.

World Gold Council: *Gold Bulletin*, various issues.

Yan, Shih: “Why U.S. Opposes a Return to the Gold Standard,” *Peking Review*, February 26, 1965.

Zijlstra, Jelle: *Per Slot van Rekening: Memoires*, Uitgeverij Contact, Amsterdam, 1992.

Zumwalt, Elmo R. Jr.: *On Watch*, Quadrangle, New York, 1976.

This page intentionally left blank

Index

Acheson, Dean, 23
Agnew, Spiro, 62, 63, 136, 174
Aichi, Kiichi, 146
Albert, Carl, 174
alchemy, 10
Algeria, 190
Allied gold pool, 30
American–French deal on monetary reform, 223–26
American gold rush teams, 30
American troops in Europe (burden sharing), 48, 84, 91, 116
Andreotti, Giulio, 235, 236
Apel, Hans, 218
Ash, Roy, 195, 205
Assad, Hafez, 200
Australia, 46, 53
Austria, 27, 75, 89
Azores agreement, 124, 125

Bagehot, Walter, 14
Bank for International Settlements (BIS), 19, 24, 25, 28, 39, 46, 58, 75
Bank of England, 13, 21, 22, 27–29, 44, 45, 96, 229, 230
Banque de France, 21, 22, 29
Bank of Japan (*see* Japan)
Barber, Anthony, 74, 133, 146,
Barre, Raymond, 121, 126, 252
Belgium, 21, 22, 27, 29, 47, 95, 190, 252
Bellagio group of economists, 51
Bergsten, C. Fred, 97, 239, 240, 242
benign neglect policy, 80, 83–86, 258
Bernstein, Carl, 140, 215
Bernstein, Edward, 39, 96
Beyen, J. Willem, 12, 28, 35
Bimetalism, 11
Blessing, Karl, 47, 73
  and dollar conversion, 50
  wartime activity of, 74, 75
Blum, Leon, 24
Blumenthal, Michael, 238, 242, 245, 250
Bonn currency conference (*see* Group of Ten)
Boumeddiene, Houari, 190
Brandt, Willy, 6, 115, 125, 128, 132, 142, 153, 182, 183, 140
Brazil, 11, 46
Bretton Woods conference, ix, 32–34
Bretton Woods system, 32–38, 41–46, 58, 61, 67, 71, 80, 84, 90, 94, 95, 147–49, 227, 229
  collapse of, 87, 96, 100–106, 138, 153, 220
Brezhnev, Leonid, 4, 45, 142, 156, 159, 160, 174, 201
Bryan, William Jennings, 11
Buchanan, Patrick, 196
Buckley, James, 195
Burger, Warren, 208
Burns, Arthur, 63, 78, 155, 218, 238
  and incomes policy, 79
  and international monetary system, 89, 96, 98–103, 114–17, 120, 126–28, 130, 137, 147, 165, 232
  monetary policy conducted by, 77–79, 82, 131, 137, 144, 194, 203–5, 217–20, 228, 239, 244, 255
  and Richard Nixon, 63, 76–79, 81, 100, 101, 113, 118, 119, 137, 142, 187, 195
Butterfield, Alexander, 156, 157
Buzhardt, Fred, 175, 208
Byrd, Robert, 174

Callaghan, James, 54, 230–39
Cambodia, 75, 158
Camp David
  secret meeting at, 98–103
Canada, 128, 131, 150, 177, 190, 223, 225

capital controls, 33, 112, 115, 132, 133, 193
Carli, Guido, 47, 54, 74, 131, 220
Carter bonds, 245, 248
Carter, James Earl, 154, 215, 220, 237–57
Cassel, Gustav, 17, 22
Catto, Lord Thomas, 31
Central Intelligence Agency (US), 140
Chaban-Delmas, Jacques, 184
Chapin, Dwight, 65, 140
Child, Joshua, 13
China, 34, 49, 62, 95, 124, 212
Chou en Lai, 142
Churchill, Winston, 18, 20, 23, 98, 183
Clappier, Bernard, 20, 47
Clarke, Stephen, 20
clean floating, 109, 114, 148, 206
Colombo, Emilio, 54, 55, 235
Colson, Charles, 4, 65, 76, 139
Connable, Barber, 197
Connally, John, 5, 64, 81–88, 115, 135, 136, 142, 149, 150, 155–58, 174, 175, 223
  and international monetary system, 82–87, 91, 114, 120–32
  economic philosophy of, 82, 84
  personality of, 81, 82, 120, 121
Conservative Party (Great Britain), 133, 184, 252
Coombs, Charles, 44, 47, 61, 94, 96, 100
Cooper, Richard, 239, 242,
Cox, Archibald, 173, 174
Cripps, Stafford, 38
Crockett, Andrew, 169, 188, 189
Cromer, Lord (Roland Baring), 46
Cross, Sam, 145, 221, 223
Cummings, Homer, 23
Czechoslovakia, 27, 28

Daane, Dewy, 52, 94, 107
Dale, William, 96, 172, 190
Danzig, 27
Dean, John, 139–43, 150, 155, 158, 177, 198
Debre, Michel, 48, 152
De Gaulle, Charles, 3, 5, 7, 39, 44, 48, 49, 60–62, 151, 223
De Larosiere, Jacques, 223–26, 246
Deming, Fred, 54, 58
Democratic Party (US), 1, 63, 64, 104, 139
Denmark, 118
Dillon, Douglas, 42, 54
dirty floating, 109, 148, 206
Doar, John, 207
dollar (US)
  ascent of, 16, 33
  crisis of, 67, 134, 144, 242–48
  decoupling from gold of (*see* Camp David)
  devaluation of, 23, 43, 44, 83, 92, 96, 120, 125, 145
  glut of, 3, 40
  recovery of, 227, 250, 256–258
  scarcity of, 38
  sell off of, 87, 88, 94–97, 105, 206, 240, 254
  talking down of, 242
  undershooting of, 245, 254
  dollar standard, 125, 129
Drew, Elizabeth, 143

Eberle, William, 124
Egypt, 4, 158–61
Eisenhower, Dwight, 62, 67, 77, 98, 212
Eizenstat, Stuart, 30, 237, 258
Emminger, Otmar, 54, 55, 88, 89, 107–9, 115, 130, 146, 151, 183, 220, 242–45
Erlichman, John, 64, 65, 79, 98, 137, 155, 158
Ervin Committee, 143, 156–58, 172, 176, 210
Ervin, Sam, 143, 207
Europe
  common exchange rate of (snake in the tunnel), 133, 148, 245
  payments surpluses of, 3, 47, 94, 221
European Common Market, 84, 87, 90 106, 109, 112, 116, 121, 125, 133, 148, 218
European Monetary Union, 133, 152, 218
European Recovery Program, 37, 38

Faisal, King Abdul Aziz, 161, 189, 200
Federal Bureau of Investigation (US), 140
Federal Reserve Bank of New York,
  currency swap network of, 45, 94, 97, 245
Federal Reserve System (*see also* Arthur Burns, William McChesney Martin, Paul Volcker), 15, 53, 69–72, 78, 144, 149, 217, 219, 238, 248, 257, 258
Felt, Mark, 141,
Ferdinand, King of Spain, 11
fixed exchange rates, 33, 39, 125, 194, 220, 222
Fleming, Marcus, 221
floating exchange rates, 25, 31, 51, 52, 67, 84, 193, 194, 220–22
Foot, Michael, 250
Ford, Gerald, 154, 174–76, 196, 200, 207, 210, 213–20, 224–28
foreign exchange controls, 25, 31, 89
Fourcade, Jean Pierre, 222, 223, 226, 227
Fowler, Henry, 49, 53, 56, 59, 60
France
  gold of, 20
  dollar conversion by, 44, 47, 94, 97
  and international monetary system (*see* De Gaulle, Giscard d'Estaing, Pompidou)
  foreign and monetary policy of, 44, 52, 183, 184, 223, 252
Franco, Francisco, 26
Franklin National Bank, 193, 203, 204
French franc, 24, 38, 59–61, 245
Friedman, Milton, 51, 52, 67–70, 96, 97, 104, 118, 150, 193, 220
Fukuda, Takeo, 149
fundamental disequilibrium, 33, 90

Galbraith, John Kenneth, 18
Garment, Leonard, 76, 157, 175, 196
General Agreement on Tariffs and Trade, 106, 233
General Arrangements to Borrow (*see also* Group of Ten), 46
German Bundesbank, 78, 180, 218, 245, 251
  monetary policy of, 51, 55, 87, 132, 148, 183, 183, 228, 239, 251, 254, 259
German mark,
  floating of, 88, 106, 243–45
  revaluation of,40, 59–61 129, 148, 245
German Reichsbank, 27–30, 251
Germany (West),
  burden sharing by (*see* American troops in Europe)
  capital controls of (*see also* Klasen, Schiller), 87
  dollar conversion by, 47, 75
  economic miracle of, 39
  and Nazi gold, 28–31
  payments surplus of, 87, 242
  reserves of, 28, 41, 87, 88, 232, 242, 244
Giap, Vo Nguyen, 212
Giscard d'Estaing, Valery, 5, 48, 49, 61, 73, 187, 206, 218, 222, 252, 253
  and international monetary system, 73, 87, 90, 108–11, 115, 120, 126–28, 135, 145, 148, 149, 165, 184, 224–28
  personality of, 151–54
Gold
  demonitization of, 50, 107, 220, 221
  discovery of, 9, 15
  looting of, 27–31
  price of, 11, 23, 24, 33, 44, 63, 96, 121, 122, 125, 149, 222, 258
  uses of, 8,9
  as war chest, 9, 12, 25–27, 222
gold bloc, 22, 23
gold standard, 12–17, 20, 25, 230
  and gold bullion standard, 15
  and gold coin standard, 12
  and gold dollar standard, 33, 42
  and gold exchange standard, 15–18
gold pool, 44, 45, 58
gold reserves (world), 24–26
gold window (*see* United States)
Gold, Joseph, 226
Goldenweiser, Emanuel, 35

Goldstein, Harold, 76
Goldwater, Barry, 173, 214
Great Britain,
dollar conversion by, 47
economic collapse of, 37, 184–86
economic malaise in, 178, 183, 184, 228–34, 252
and gold standard, 13, 14, 20
and International Monetary Fund, 38, 192, 231–324
and international monetary system, 31, 53, 223
reserves of, 94, 229, 244
Great Depression, 25
Great Moderation, 259, 260
Greenspan, Alan, 64, 76, 216
Group of Five, 150
Group of Seven, 46, 150, 241, 245, 252
Group of Ten, 46, 53–55, 59, 110, 111, 120–24, 149, 194, 220, 225,226
and Bonn conference, 59–61
and membership of, 46
Gutt, Camille, 37
Gyothen, Toyoo, 54, 93, 105, 106, 181, 242

Haberler, Gottfried, 70, 84
Haig, Alexander, 3, 160, 176, 197–99, 207–21, 213, 214
Harvey, Ernest, 19, 21
Hayes, Alfred, 46
Haldeman, H. R. (Bob), 64, 65, 76, 98, 101, 119, 136,138, 140, 141, 155–58, 187, 206–8, 210
Healy, Denis, 133, 191, 230–34, 243
Heath, Edward, 133, 142, 182–85
Heller, Walter, 67, 180
Hirohito, Emperor Showa, 253
Hitler, Adolf, 16, 19, 25, 75,177
Ho Chi Min, 212
Hodgson, James, 76
Holtrop, Marius, 47, 54
hot money, 20, 24, 93, 132
Houthakker, Hendrik, 84
Hume, David, 13
Humphrey, Hubert, 1
Humphrey-Hawkins Act, 237
Hunt, Howard, 141

import tariff surcharge (*see also* Camp David), 97–104, 114, 118, 125, 135, 179
incomes policy, 75, 83, 97–104, 131, 145, 219, 307
India, 15, 46, 212
inflation (*see* stagflation)
interest rates (*see* monetary policy),
International Emergency Powers Act, 244
International Energy Agency, 187
International Monetary Fund, 33–40, 53, 69, 73, 77, 80, 83, 87, 89, 178–80, 218, 220–23, 227, 247, 257
annual meetings of, 42, 55, 56, 113, 114, 142, 169, 231, 254
Committee to Study the International Monetary System (C20) of, 142, 168, 170, 193, 221
as designed at Bretton Woods, 33–36
early days of, 37–40
and Great Britain, 228–234
Interim Committee of Ministers and Governors of, 223
and Italy, 234–37
oil facility of, 170–72, 187–92
position of, 110, 130, 165, 171, 221
United States role in (*see* United States)
international monetary system (*see also* Bretton Woods system), 31, 59, 80, 106–8, 215, 220–28
Iran, 170, 249
Shah of, 162, 188
Iraq, 170
Israel, 4, 157–61
Issing, Otmar, 51
Italy, 22, 29, 144, 150, 192
dollar conversion by,47
economic malaise in, 178, 183, 184, 228, 234–37, 252

Jacobsson, Per, 39, 40
Japan
economic recovery of, 228, 237, 239, 252, 253
exchange rate of (*see* yen)
inflation in, 161, 178, 181, 228

and international monetary system, 47, 86, 93, 123, 124
low profile of, 47, 54, 93
payments surpluses of, 86, 93, 145, 241
reserves of, 40, 86, 94, 105, 181, 242
Jaworski, Leon, 175, 176, 188, 199, 208, 214
Jenkins, Roy, 60, 74
Jobert, Michel, 186,187
Johnson, Lyndon, 3, 49, 57, 62, 69, 81, 212

Kafka, Alexandre, 111, 227
Kahn, Alfred, 247
Kahneman, Daniel, 249
Kaiser Wilhelm II, 16
Kashiwagi, Yusuko, 107
Kemmerer, Edwin, 17, 18, 42
Kenen, Peter, 51
Kennedy, David, 63, 64, 68, 73
Kennedy, John F., 42–46, 66, 71, 77, 102, 204, 231, 237, 247
Keynes, John Maynard,
on gold, 7, 15, 25
on gold standard, 17, 23
on international monetary system, 31–36
Keynesian economics, 52, 67, 69, 166, 180, 204, 231, 237, 247
Kharmawan, Byanti, 165
Kindleberger, Charles, 57
King, Marin Luther Jr., 1
Kissinger, Henry, 4, 65, 72, 84, 113, 118, 124, 125, 135, 141, 157–61, 172, 176, 178, 183, 186, 187, 191, 192, 196, 200, 207, 208, 211–13, 215, 236
Kissinger facility, 191
Klasen, Karl, 73, 77, 88, 89, 220
Klein, Lawrence, 237, 238
Kleindienst, Richard, 155
Klondike, 15
Krogh, Egil, 66
Kruchchev, Nikita, 62
Kuwait, 189

Labour Party (Great Britain), 38, 133, 185, 230, 231
Laval, Pierre, 22, 24
Lamsdorff, Otto von, 253
Lance, Bert, 238
League of Nations, 17, 22, 40
Lebanon, 190
Le Duc Tho, 211
Le May, Curtis, 143
Liddy, Gordon, 141
Lieftinck, Pieter, ix, 35, 111, 235
Lindsay, Ronald, 23
locomotive strategy, 240–42, 245
Los Angeles Times, 155
Lothian, Lord (Philip Kerr), 27

MacDonald, Ramsey, 20
Machlup, Fritz, 50, 51
Magruder, Jeb Stuart, 64, 141
Malagodi, Giovanni, 147
Malkin, Lawrence, 122
managed floating, 148
Mao, Zedong, 138, 142
Marchais, Georges, 252
Marshall, George, 37
Marshall Plan (*see* European Recovery Program)
Martin, William McChesney, 46, 50, 54, 59–61, 63, 69, 71, 77, 220
Matthofer, Hans, 254
Mayo, Robert, 64, 71
McCord, James, 143
McCracken, Paul, 63, 71, 79, 98, 119
Mc Govern, George, 104, 139
McIntyre, James, 238
McKinley, William, 11
McNamara, Robert, 188
Meany, George, 134, 172
Meir, Golda, 160, 200
Mendes-France, Pierre, 34
Mexico, 45
Miki, Takeo, 224
Miller, William, 247–52, 254
misery index, 216, 220, 250, 257
Mises, Ludwig von, 16
Mitchell, John, 64, 66, 141, 156
Miterrand, Francois, 152, 252
Mizuta, Mikio, 121, 126–29, 131, 136
Modigliani, Franco, 180
Molotov, Vyacheslav, 36
monetary counterrevolution, 52

monetary policy (*see* Bank of England, Federal Reserve System, German Bundesbank)
Mondale, Walter (Fritz), 239, 240
Moreau, Emile, 18
Morgan, Ted, 23
Morgenthau, Henry, 23, 26, 36
Moro, Aldo, 183, 224
Morse, Jeremy, 54, 107, 193
Mundell, Robert, 40
Muskie, Edmund, 138

National Democratic Party headquarters, 1
Nelissen, Roelof, 145
New Economic Policy (US), 103, 104
Netherlands
  dollar conversion by, 47, 94
  floating exchange rate of, 88, 106
  gold of, 28, 29
  and IMF oil facility, 190, 191
  revaluation by, 128
  role in Group of Ten of, 225
Netherlands Bank (*see also* Jelle Zijlstra),
  gold sent abroad by, 27–29
  gold looted from, 29, 30
  and loss on sterling deposits, 21, 22, 95
Newton, Isaac, 11
New York Times, 122, 155, 239, 256
New Zealand, 192
Nigeria, 170, 190, 229
Nixon, Julie, 156, 209
Nixon, Pat, 199
Nixon, Richard
  and Alger Hiss case, 36
  anti-semitism of, 76, 176
  cabinet appointments by, 63–65
  economic policy of, 63, 68–72, 76–79, 83, 131, 134, 178, 186, 194, 204, 205
  and elections, 44, 77–80, 104, 131, 138, 139, 155, 195
  executive privilege claimed by, 157, 208
  foreign policy of, 95, 102, 153, 159, 174
  and George Shultz, 142, 144, 150, 151
  impeachment of, 174–76, 195, 196, 208, 210
  inauguration of, 1, 69
  and John Connally, 81, 113, 117–19, 135, 142, 155–57, 172–75, 199, 212
  and monetary issues, 62, 91, 96–103, 120, 122, 125, 129, 130, 142, 167
  and nuclear weapons, 212, 213
  pardon of, 210, 214, 215
  resignation of, 214
  tape recordings by, 156–58, 173, 176, 196, 197, 208
  and Watergate (*see* Watergate),
Norman, Montagu, 17, 18, 20, 21, 28

Obama, Barack, 260
O' Brian, Lesley, 46, 54, 60
Oil
  Arab embargo of, 161, 177, 178
  crises (*see* OPEC),
  price of, 4, 161, 249
  Okun, Arthur, 204
Organization for Economic Cooperation and Development (OECD), 73, 108, 135
Organization of Oil Exporting Countries (OPEC), 161–64, 169, 170, 183, 186–88, 190, 191, 249–51
Ortoli, Francois Xavier, 60, 61
Ossola, Rinaldo, 107

Pakistan, 212
Pandolfi, Fillipo, 236
paper gold (*see* special drawing rights)
Paulson, Henry, 66
Peking Review, 130
Peterson, Peter, 98, 130
Pierre-Brosolette, Claude, 107
Pittman, Key, 11, 12
Pohl, Karl Otto, 232, 251
Polak, Jacques, 39, 40, 53, 56, 109, 226
Poland, 24

Pompidou, Georges, 5, 61, 74, 113, 119, 121, 125, 126, 138, 142, 152, 183, 186
Poole, William, 204
Pound sterling, 10, 16, 18, 234
  devaluation of, 20, 38, 60, 228
  floating of, 20, 133
  support of, 133, 184, 228, 229
Proxmire, William, 228
protectionism (*see also* import tariff surcharge, trade pledge), 53, 84, 191–93, 232, 233

Quadriad of economic policy makers (US), 71, 79, 132

Rabin, Yitzak, 200
Rambouillet agreement, 225–28
Rasminsky, Louis, 54
Rather, Dan, 200
Raw, Rupert, 47
Reagan, Ronald, 151, 214, 257, 258
Rebozo, Bebe, 173, 199, 208
recession (global), 170, 171, 178–95, 205, 206, 215–17
Regan, Donald, 259
Rehnquist, William, 208
Republican Party (US), 64, 76, 81, 140, 155, 174, 203
Reston, James, 82
Reuss, Henry, 228
Rhodes, Cecil John, 9
Richardson, Elliott, 173, 174
Richardson, Gordon, 186
Rist, Charles, 18
Rockefeller, David, 66, 68
Rockefeller, Nelson, 157
Rodino, Peter, 174, 196, 207
Romania, 26, 75
Roosa bonds, 45
Roosa, Robert, 53
Roosevelt, Franklin, 12, 23, 26, 98
Rooth, Ivar, 19
Rostow, Eugene, 105
Ruckelshouse, William, 173
Rueff, Jacques, 48
Rumor, Mariano, 183
Rush, Kenneth, 205
Russia, 15, 16
Ryrie, William, 232

Saad, Zaki, 189
Sadat, Anwar, 161, 200
Safire, William, 98, 101, 196
Samuelson, Paul, 78, 177
Sato, Eisuko, 128, 130
Saudi Arabia, 170, 182, 189
Sayers, Richard, 21
Schacht, Hjalmar, 18, 19, 75
Schlesinger, James, 201, 213
Schiller, Karl, 54, 59–61, 73, 88–90, 109, 111, 115, 121, 126–28, 132, 153, 167
Schmidt, Helmut,
  career and personality of, 5, 153, 154, 206, 218, 240, 253
  and international monetary system, 142–45, 149, 152–54, 165, 169, 183, 186, 190, 224, 239–41, 245, 253, 254
Schultze, Charles, 238, 255, 256
Schweitzer, Pierre Paul, 55, 56, 60, 61, 92, 107, 109, 11, 114, 115, 126, 164, 165
Seidman, William, 217
seiniorage, 53
Shaw, George Bernard, 7
Shultz, George, 5, 82, 136, 171, 191, 196, 204
  career and personality of, 150–52
  and international monetary system, 90, 96, 104, 118, 144, 148, 149, 171–73, 224
  and Library Group, 149
silver, monetary role of, 11, 12
Simon, William, 167, 172, 177–91, 205, 215–17, 220, 223, 226, 240
Sindona, Michele, 203
Sirica, John, 143, 157, 208, 215
Smithsonian agreement, 127–31
Solomon, Anthony, 246, 248
Solomon, Robert, 47, 54
South Africa (*see also* gold), 9, 17, 43, 49
Southard, Frank, 55, 188

Soviet Union, 4, 62, 30, 201, 213
  role at Bretton Woods, 34–36
  and gold, 26, 43, 49, 86
Spain, 26, 46, 192
special drawing rights (SDRs), 40, 56–58, 91, 108, 111, 221, 227, 245, 248
Sprinkel, Beryl, 258
stagflation, 4, 178–86, 194, 195, 201–6, 215–18, 250, 257
Stalin, Josef, 26, 36
Stammati, Gaetano, 236
Stans, Maurice, 64, 140
St. Clair, James, 196, 208
Stein, Herbert, 82, 98, 144, 180, 204, 205
Stepanov, M. S., 34
Sterling Area, 38, 130, 229, 234
Stevenson, Adlai, 67
Stiegler, George, 150
Strauss, Franz Josef, 54, 59–61, 73, 146
Strong, Benjamin, 18
Sweden, 129
Swiss National Bank, 21, 23, 30
Switzerland, 30, 46, 144, 244
  dollar conversion by, 47, 94
  revaluation by, 89
Syria, 4, 158

Tanaka, Kakuie, 206
terHorst, Jerry, 215
Time Magazine, 167
Thailand, 213
Thatcher, Margaret, 152, 154, 185, 247, 252, 253, 259
Tinbergen, Jan, 40, 166
Trade Pledge, 192, 193
Trading with the Enemy Act, 102
Trias Politica, 78
Triffin, Robert, 42, 43, 49–51, 227
Tripartite agreement, 24
Troika of economic policy makers (US), 71
Truman, Harry, 23, 180
Turner, John, 206

United Arab Emirates, 170, 190
United Kingdom (*see* Great Britain)
United States
  economic recovery in, 219, 228, 237
  gold reserves of, 3, 44, 47, 50, 56, 97, 248
  gold window of, 42, 47, 70, 91, 94, 97–104
  import tariff surcharge of, 97–103
  and International Monetary Fund, 31–38, 45, 46, 53, 103, 107, 111 , 132, 164, 169, 171–73, 188, 191, 215, 221
  inflation in, 44, 69, 71, 75, 79, 144, 162, 180, 181, 203, 204, 217–19, 227, 237, 246–60
  monetary policy of (*see* Federal Reserve, William McChesney Martin, Arthur Burns, William Miller, Paul Volcker)
  and oil crises, 72, 161–64, 177–79, 190, 191, 245, 249, 250–53
  overheated economy of, 69, 138, 144
  payments deficits of, 3, 41, 43, 53, 58, 86, 93, 221, 240, 244
  stagflation in, 77, 178–86, 194, 195, 215–18
  unemployment in (*see* stagflation)
United States Congress, 97, 157, 207, 209, 217, 244, 256
United States Supreme Court, 157, 199, 201, 208

Van Houtven, Leo, 171
Van Lennep, Emile, 54, 108, 112, 126, 135, 164, 186, 192
Vatican Bank, 203
Venezuela, 161, 163, 170, 190
Vietnam War, 2, 62, 69, 75, 134, 141, 211
Vinson, Fred, 33, 36
Vissering, Gerard, 18, 19, 21, 22
Volcker Group, 73
Volcker, Paul, 5, 6, 66, 143, 181, 196, 215, 240, 250
  career and personality of, 66–68, 73, 256
  economic philosophy of, 67, 204
  and domestic monetary policy, 250–60
  and international monetary policy, 73, 73, 80, 84, 86–88, 90, 94–118, 135–37, 145–49, 194, 221, 246, 254

wage and price controls (*see* incomes policy)
Wahl, Jacques, 223
Wallace, George, 207
Walker, Charls, 66
Wardhana, Ali, 193
Washington Post, ix, 139–41, 143, 155
Watergate, 195
  break in at, ix, 66, 139, 140
  coverup of, 65, 140, 143, 173–76
  endgame of, 195–202, 206–14
  scandal of, 139–41, 149, 155–58, 193
  and smoking gun, 156, 198, 208, 209
Weinberger, Caspar, 98
Werner, Pierre, 133
White, Harry Dexter, 31–36, 67, 221
White, Theodore, 199
Whittome, Alan, 231–33, 235
Wilson, Harold, 38, 74, 185, 186, 206, 224, 226, 230
Witteveen, H. Johannes, 6, 54, 55, 74, 85
  career and personality of, 166–68, 221
  economic philosophy of, 166, 167
  and Great Britain, 231–34
  and Italy, 234–36
  as Managing Director of IMF, 165, 170, 215, 221–27, 246
  Middle Eastern journey of, 188–90
  and oil crisis, 170–73, 179, 187–92
  Sufism of, 167
Witteveen facility, 246
Woods, Rosemary, 176, 197
Woodward, Robert (Bob), 140, 156, 215
World Bank, 37, 197
World Economic and Monetary Conference of 1933, 11, 12, 28
World War I, 16
World War II, 25–31

Yamani, Zaki, 163, 170
Yen
  appreciation of, 105, 122, 147, 240
  floating of,105, 181
  revaluation of, 85, 93, 128, 145
Yeo, Edwin III, 223, 226, 246
Yom Kippur War, 158–61, 174, 200

Ziegler, Ronald, 141, 157, 173, 175, 196, 199, 207
Zijlstra, Jelle, 46, 58–61, 74, 86, 94, 95, 108, 116, 117, 131, 164, 220
Zumwalt, Elmo, 176, 200