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Nixon's Desperate Attempt to Fight Inflation

by Dr Dietrich Kebschull and Carsten R. Moser, Hamburg

Because of continuing inflation and rising unemployment, Americans were beginning to feel rather frustrated with the Nixon Administration for their non-actions on the economic front. As an answer to this growing feeling of anxiety the US-President introduced an economic programme which has caused quite a stir in the USA as well as abroad. The author's intent is to discuss the national and international effects the Nixon programme will probably have.

President Nixon has shocked the world for the second time in a row. After the bold move he made on July 15, by accepting the invitation to visit China during the next half year, on August 15, he came forward with a package deal for the US economy, with which he breaks decisively with all proved rules of the market economy in the hope to fight more successfully than up to now the evils of "stagflation". The main reasons for his activity are to be seen in the fact that during the last months economic deterioration became the nation's number one political issue. The increase in the consumer price index and in the unemployment rate reached nearly 7 p.c., the balance of payments deficit went up during the first half of 1971 to a new record high of \$ 11,3 bn and the foreign indebtedness of the USA increased to \$ 52 bn, being in no way covered by its gold reserves, which declined to \$ 10 bn.

Too Many Aims

After a period of virtually no action, the Nixon Administration finally accepted in this way the advice given by a growing number of businessmen, labour leaders, congressmen and experts that the time had come for more direct business intervention by the Administration if a higher degree of wage and price stability coupled with stimulation of business activity were to be achieved at all before the presidential elections in 1972.

Contrary to the rules of the market economy, the IMF and the GATT, the Administration decided upon the following principal measures:

- The possibilities for foreign creditors to change dollars into gold were cancelled.
- On more than 50 p.c. of all imports a supplementary tax of 10 p.c. has been imposed.
- A wage and price freeze has been introduced for the next 90 days.
- In order to speed up economic revival, the personal income tax burden has been reduced,

the excise tax on automobiles has been cancelled and business will be granted a tax bonus of 10 p.c.

- Government expenditure is to be reduced by \$ 4,7 bn, funds for the foreign aid programme by 10 p.c. and the number of civil servants by 5 p.c. In addition to his a number of social legislation plans will be postponed.

With the help of this programme, Nixon hopes to check inflation, give the economy incentives and thus decrease unemployment, reduce the balance of payments deficit and defend the position of the dollar which during the past years had become the weakest major currency in the world. But will this direct attack on inflation show the desired effects? This is the most discussed question not only in the USA but also all over the world.

Reform of the Monetary System . . .

Regarding the freeing of the dollar from the gold price, this measure alone could have led to panic reactions and a steep fall of this currency's rate of exchange. This was, however, prevented through the closing down of almost every major foreign exchange market for one week. But instead of acknowledging this rather obliging attitude President Nixon did something which enraged his partners – and specially France: He sent his Treasury Under Secretary Paul A. Volcker to Paris and London, not to discuss extensively and try to find a solution for the problems concerning an international realignment, but to demand that the other important currencies should be revaluated in order to save the dollar from devaluation. Not only the French had the impression that the US Government, which more than 20 years ago had helped Europe to start its impressive economic recovery, now and for all eternity expects the Europeans to show how grateful they are. As if the old Continent hadn't prevented a dollar crisis already much earlier through its exemplary behaviour!

... with Difficulties

Due to this France, which demands a devaluation of the dollar, and the remaining EEC partners, who are ready to accept the plan put forward by the Federal Minister of Economics and Finance, Professor Karl Schiller, to return to fixed parities within the Common Market and to retain floating exchange rates with the rest of the world, were not able to agree on a common line and to come forward with one solution. Even taking into consideration that the French point of view is reasonable—for why should all other major currencies be revalued, if the same effect could be achieved by the devaluation of the dollar—, a very good chance to advance towards a European economic and monetary union was missed by the Six, which goes to show once more that some members are not yet willing to give up certain sovereign rights for cooperative behaviour.

In any way, the international monetary system based on gold and dollar has been seriously impaired. The question that will be discussed extensively during the forthcoming weeks is whether other currencies—i.e. the Swiss franc, the yen or some EEC currencies—or the special drawing rights should step beside the dollar or take over as reserve currencies. World monetary experts have undoubtedly a very difficult task to solve. It would be helpful if the Americans and the French relinquish their rather uncompromising attitude and if the Germans give up their believe that they always have the best solutions to all economic and monetary problems (in spite of the fact that they may have really the best idea at the moment to save the old-fashioned system!).

Wrong Measures against Inflation?

In order to fight economic inflation which in the opinion of many experts is proceeding at a both unacceptable and dangerous rate, the most important measures President Nixon and his advisers have taken are the increase in the tax burden of imports, the de facto devaluation of the dollar, and a wage and price freeze. But will these measures produce the desired effect? This is by no means sure, for in spite of the trend towards a balance of trade deficit the growing deterioration of the balance of payment's position was in the past mainly due to the still very heavy Vietnam engagement and to the flowing out of large dollar sums because of the growing lack of confidence of business in the American economy and politics.

The effectiveness of the tax increase on imports—whose protectionist character is certainly a severe blow against GATT principles and the idea of free world trade—and the de facto devaluation

of the dollar depend on the decision of other countries whether or not to take protectionist measures in order to counterbalance the American steps. The US-export activity could then be endangered and this would have a negative effect on the propensity to invest of business. Doubtful remains furthermore the influence an increase in import prices will have on the aim to achieve a higher degree of price stability. At least elasticity deliberations seem to have been neglected.

The decision to adopt a wage and price stop for a period of 90 days is even more controversial, not only because of its mandatory character but also since experience with wage and price controls in other countries shows that this measure has seldom proved effective, especially over the short run. It therefore seems inevitable that Nixon and his aids will have to prolongue controls for an indefinite period of time and to intervene more directly, determined and explicitly, i.e. through the creation of wage-price boards for each industry, as proposed by the former Treasury Under Secretary Robert Roosa, if controls are to work at all. The rules of a free market economy, which according to Federal Reserve Chairman Arthur Burns have not been working quite the way they used to, will thus be abolished for some time in the future. But what will happen when the stop ends? In all probability wages and prices will then soar up.

Inadequate Labour Policy

Regarding the measures of the programme to combat unemployment a number of questions must also be raised, even when assuming that Europe and Japan would not answer with protectionist measures against US exports. For although the introduced tax reductions might enhance investment opportunities, the propensity to invest is not only dependent on the tax burden but to a much higher degree on the confidence business has in Nixon's economic policy. This is why the programme is very friendly towards business has in Nixon's economic policy. This President decided for example to increase taxes on imports instead of introducing further measures curtailing foreign investments and expenditures, as once passed by President Johnson. However, time will show if relations between Administration and business will improve, as Nixon expects, during the next months. Meanwhile the decision to reduce Federal expenditure and the number of civil servants could at first even increase unemployment. The postponement of many necessary social reforms aiming at reducing the number of jobless Americans—mainly the young and the coloured—because of the lack of funds seems also quite short-sighted and therefore inadequate.

There is no guarantee that the Administration's venture to stop inflation without a recession and a higher rate of unemployment will be successful. For if the efforts to revive the US economic activity produce the desired results, there is still the danger of an increased structural imbalance due to further bottlenecks or of new wage conflicts between Government and labour unions if earnings in some sectors rise quickly. Indeed, many other social and political factors could keep wages and prices rising, mainly if the new incomes policy fails.

Danger of World Wide Protectionism

But the effects of the US economic programme are not only restricted to the USA. The impact of the US-measures to restrict foreign imports is very strongly felt in Canada (which sends about 65 p.c. of its total exports to the USA), Japan (31 p.c.) and Europe (Great Britain: 11.7 p.c.; Italy: 10.3 p.c.; the Federal Republic of Germany: 9 p.c.; France: 5 p.c.). In Germany experts assume that the German export prices will increase by 15 to 20 p.c. because of the US-measures and the floating of the DM. No doubt the negative effects on the German economy would have been worse if the Federal Government hadn't decided to set the DM free to float some months ago, for in the other case the pressure on the DM would have been quite unbearable. Whether German industry is in danger to slide into economic recession and unemployment will depend on the success of business in finding new outlets for the products to be originally exported to the USA.

This task would be very difficult if other nations decide to take protectionist measures as an answer to the Nixon programme. The Federal Government's engagement for the principles of free world trade is therefore understandable and

desirable, for a rebirth of world protectionism cannot be in the interest of anybody.

Consequences for the Developing Countries

Not only the Western industrialised nations will feel the impact of the US-programme, but also the developing countries. They have specially criticised the fact that the reduction of foreign aid is discriminating them, although they cannot be held responsible in any way for the American economic malaise. And their believe in the USA as a defender of free world trade has also been shattered. Although the US-Government has exempted oil, coffee, textiles, meat and some other raw materials from the import tax increase (which they did not because of their friendly attitude towards the developing countries but because they need these products), the possibilities of the developing world to export semi-finished and finished products to the USA in order to earn the much needed foreign exchange have been seriously impaired. The relations between the USA and the Third World have once more been severely strained.

On the whole, there is little to be said for, and much against, Nixon's new economic programme. The question is now if other countries will follow the bad example given by the USA. If the spirit of protectionism should again revive, a process of international economic desintegration is bound to be the result. Much will therefore depend on whether the industrialised as well as the developing countries will be willing to do everything to save the principles of free world trade and to propose an international monetary arrangement that will last longer than 30 years. One can only hope that the world will find means and ways to cope with these challenges!



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