Why did the Golden Age of Capitalism come to an end?

Objectives:
Students would be able to:
- Analyze the casual relationships that ended the golden age of capitalism
- Evaluate the relative significance of the various crisis that afflicted the global economy

Introduction:

"I have…suspend temporarily the convertibility of the dollar into gold or other reserve assets, except in amounts and conditions determined to be in the interest of monetary stability and in the best interests of the United States…

If you want to buy a foreign car or take a trip abroad, market conditions may cause your dollar to buy slightly less. But if you are among the overwhelming majority of Americans who buy American-made products in America, your dollar will be worth just as much tomorrow as it is today…

Now, this 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."

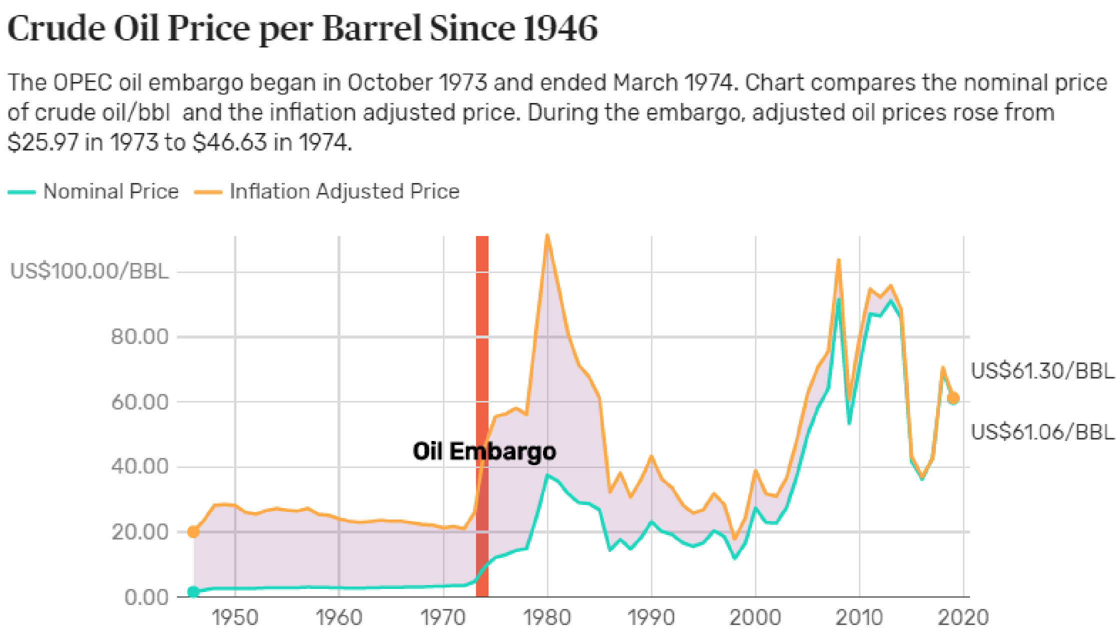
- *Richard Nixon, 1971*

For multilateral trade cooperation, the 1970s and 1980s were particularly stressful decades, as turbulent economic events ended the sense of security and predictability that had marked the economic climate of the previous two decades. A heightened mood of commercial uncertainty and social insecurity in the developed countries generated a demand for action to relieve conditions, this merged with nationalist sentiment to channel much political response into protectionist trade measures. Protectionist sentiments and unilateral action to shelter specific industries from foreign competition have almost always been present in every country. In the 1970s and 80s, industrialized countries especially took numerous actions to restrict access to their markets.

While the governments after WWII made rules in establishing an orderly conduct for trade relations, the economic circumstances placed the rules under stress and GATT could not accommodate those nationalist reactions to domestic effects of recessions, slower economic growth, swings in exchange rates or rapid structural changes. It got to the point where in 1982 GATT convened a ministerial meeting on trade policy for countries to curb further protectionist measures.

Though the world economy grew more slowly in 1970s and 80s, world trade continued to expand more rapidly than world production. The USA was the leading nation whose export of goods rose from 1969 to 1989 and thus there was a drive behind the search for markets and sources of supply.

Challenge 1a: The 1973 Oil Crisis



The 1973 Oil Crisis began on October 17, 1973, when the members of Organization of Arab Petroleum Exporting Countries announced that they would no longer ship petroleum to nations that had supported Israel in its conflict with Syria and Egypt, as a result of the ongoing Yom Kippur War. Since the embargo, OPEC has continued to use its influence to manage oil prices. Today, OPEC controls about 42% of the world's oil supply. It also controls 60% of oil exports and 72% of proven oil reserves.[1]

About the same time, OPEC members agreed to use their leverage over the world price setting mechanism for oil in order to raise world oil prices, after attempts at negotiation with the "Seven Sisters" earlier in the month failed miserably.

[1] Kimberly Amadeo, *OPEC Oil Embargo, Its Causes, and the Effects of the Crisis.* Retrieved from: https://www.thebalance.com/opec-oil-embargo-causes-and-effects-of-the-crisis-3305806

Background to the 1973 oil crisis

The **Seven Sisters** were seven major oil companies. With their dominance of oil production, refinement and distribution, they were able to take advantage of the rapidly increasing demand for oil and turn immense profits. Well organized and acting as a cartel, they were able to have their way with most Third World oil producers. It was only when the Arab states began to gain control over oil prices and production through the formation of OPEC in 1960, and really gaining power by the 1970s that the Seven Sisters' influence declined.

In 1971, President Richard Nixon prompted the embargo when he decided to take the United States off of the gold standard. The **Nixon Shock** was an economic policy shift undertaken by President Nixon to prioritize the United States' economic growth in terms of jobs and exchange rate stability.

- Nixon cited tax cuts and a 90-day hold on prices and wages as the best options for boosting the job market and tamping down cost of living. As for speculative behavior toward the dollar, Nixon supported suspending the dollar’s convertibility into gold. In addition, Nixon proposed an additional 10% tax on all imports that were subject to duties. Similar to the strategy of suspending dollar convertibility, the levy intended to encourage the United States’ main trading partners to raise the value of their currencies.
- The Bretton Woods Agreement revolved around the external values of foreign currencies. Fixed versus the U.S. dollar, the value of foreign currencies was expressed in gold at a price determined by Congress. However, a dollar surplus imperiled the system in the 1960s. At the time, the U.S. did not have enough gold to cover the volume of dollars circulating throughout the world.

As a result, countries could no longer redeem the U.S. dollars in their foreign exchange reserves for gold. With this action, Nixon went against the 1944 Bretton Woods Agreement. His move sent the price of gold skyrocketing. The history of the gold standard reveals this was inevitable. But Nixon's action was so sudden and unexpected that it also sent the value of the dollar down.

- Anxiety eventually crept into the foreign exchange market, with traders abroad fearful of an eventual dollar devaluation. As a result, they began selling USD in greater amounts and more frequently.
- The plummeting value of the dollar hurt OPEC countries. Their oil contracts were priced in U.S. dollars. That meant their revenue fell along with the dollar. The cost of imports that were denominated in other currencies stayed the same or rose. OPEC even considered pricing oil in gold, instead of dollars, to keep revenue from disappearing.
- On October 19, 1973, Nixon requested $2.2 billion from Congress in emergency military aid for Israel. The Arab members of OPEC responded by halting oil exports to the United States and other Israeli allies. Egypt, Syria, and Israel declared a truce on October 25, 1973. OPEC continued the embargo until March 1974. By then, oil prices had skyrocketed from $2.90/barrel to $11.65/barrel.

Effects of the Oil Shocks

The oil embargo is widely blamed for causing the 1973-1975 recession. Due to the dependence of the industrialized world on crude oil, and the predominant role of OPEC as a global supplier, these price increases brought **dramatic inflation to the economies of embargoed countries, while at the same time suppressing economic activity** [Stagflation]. These countries responded with a wide variety range of initiatives to contain their further dependency.

U.S. government policies helped cause the recession and the stagflation that accompanied it. They included Nixon's wage-price controls and the Federal Reserve's stop-go monetary policy. Wage-price controls forced companies to keep wages high, which meant businesses laid off workers to reduce costs. At the same time, they couldn't lower prices to stimulate demand. It had fallen when people lost their jobs.

To make matters worse, the Fed raised and lowered interest rates so many times that businesses were unable to plan for the future. As a result, companies kept prices high which worsened inflation. They were afraid to hire new workers, worsening the recession.

The oil embargo aggravated inflation by raising oil prices. It came at a vulnerable time for the U.S. economy. Domestic oil producers were running at full tilt. They were unable to produce more oil to make up the slack. Furthermore, non-OPEC oil production had declined as a percentage of world output.

It also worsened the recession. First, higher gas prices meant consumers had less money to spend on other goods and services. This lowered demand. It also weakened consumer confidence. People were forced to change habits, making it feel like a crisis that the government tried unsuccessfully to resolve. This lack of confidence made people spend less.

- For example, drivers were forced to wait in lines that often snaked around the block. They woke up before dawn or waited until dusk to avoid the lines. Gas stations posted color-coded signs: green when gas was available, yellow when it was rationed, and red when it was gone. States introduced odd-even rationing: drivers with license plates ending with odd numbers could get gas on odd-numbered days.

What were the conditions for the oil shock?

Dependence on imported petroleum

In 1972, the world was dependent on Middle-Eastern oil, which made up 64.4% of energy used. From transportation to domestic use, saw to vast consumptions of oil. Oil provided cheap energy which prompted economic growth and prosperity. In 1973, Nixon accepted unlimited imports. The USA was totally dependent on oil in its economy and way of life.

Unity of the oil-producers (OPEC)

OPEC had been formed on September 14, 1960 to protest pressure by major oil companies (mostly owned by U.S., British, and Dutch nationals) to reduce oil prices and payments to producers. The result was a sharp loss of revenue for producing countries thus these countries were jolted into action.

At first it had operated as an informal bargaining unit for the sale of oil by Third World nations. It confined its activities to gaining a larger share of the revenues produced by Western oil companies and greater control over the levels of production. However, in the early 1970s it began to display its strength. Since OPEC controls a large proportion of oil output, it exerts a strong influence on the global price of oil.

Determination of OPEC to use economic power even at own risk

On August 15, 1971 the United States pulled out of the Bretton Woods system in the so called Nixon shock. The result was a depreciation of the value of the US dollar against many other currencies. Since oil was priced in dollars, this meant that oil producers were receiving less income for the same price. OPEC ministers had not developed the institutional mechanisms to update prices rapidly enough to keep up with changing market conditions, so their real incomes lagged for several years.

Impact of the Arab-Israeli conflicts

In 1967, during the Six-Day War, a number of Arab oil-producing countries attempted to use oil as a weapon by imposing an embargo on oil exports to countries supporting Israel. This was called off when the war ended.

In 1968, the Arab members of OPEC formed their own structure, the Organization of Arab Petroleum Exporting Countries (OAPEC), giving them a freer hand. Egypt and Syria, though not major oil-exporting countries, joined the latter grouping to help articulate its objectives.

Later, the Yom Kippur War of 1973 galvanized Arab opinion. During the war the Arab world imposed the 1973 oil embargo against the United States, Western Europe, and Japan. By the early 1970s Western oil conglomerates suddenly faced a unified bloc of producers. The Arab-Israeli conflict triggered a crisis already in the making.

The West could not continue to increase its energy use 5% annually; pay low oil prices yet sell inflation-priced goods to the petroleum producers in the Third World. This was stressed by the Shah of Iran, whose nation was the world's second-largest exporter of oil and the closest ally of the United States in the Middle East at the time.

Arab oil embargo

On October 16th, 1973, as part of the political strategy that included the Yom Kippur War, OPEC cut production of oil, and placed an embargo on shipments of crude oil to the West, with the United States and the Netherlands specifically targeted. Also imposed was a boycott of Israel, and price increases.

Since oil demand falls little with price rises, prices had to rise dramatically to reduce demand to the new, lower, level of supply. Four of the six states undertook progressive reductions in productions. The price of a barrel rose from $3.00 to $11.65 per barrel. The reduction in oil produced, 15.8 million per day (at its lowest) was compounded by alarm among the oil consuming countries, amounting to panic. Anticipating this, the market price for oil immediately rose substantially. A world financial system already under pressure from the breakdown of the Bretton Woods agreement would be set on a path of a series of recessions and high inflation that would persist until the early 1980s, and elevated oil prices that would persist until 1986.

Over the long, term, the oil embargo would change the nature of policy in the West, towards more exploration, towards energy conservation, and towards more restrictive monetary policy, which more aggressively fought inflation.

Impact of the 1973 Oil Crisis?

Higher costs of production in both developed and developing countries

The effects of the embargo were immediate. OPEC forced the oil companies to increase payments drastically as they determined the price of oil sold. In essence this led to higher costs of production in both oil importing developed and developing countries. The price of quadrupled by 1974 to nearly US$12 per US barrel (75 US$/m^3).

<u>Impact on oil-exporting nations</u>

i) Petrodollars[2]

[2] The petrodollar is any U.S. dollar paid to oil-exporting countries in exchange for oil. Since the dollar is a global currency, all international transactions are priced in dollars.

This increase in the price of oil had a dramatic effect on oil exporting nations, for the countries of the Middle East who had long been dominated by the industrial powers seen to have acquired control of a vital commodity. The traditional flow of capital reversed as oil exporting nations accumulated vast wealth.

Some of the income was dispensed in the form of aid to other underdeveloped nations whose economies had been caught between higher prices of oil and lower prices for their own export commodities and raw materials amid shrinking Western demand for their goods. Much of it, however, fell into the hands of elites who reinvested it in the West or enhanced their own wellbeing, e.g. skyscrapers, airports, luxury imports etc.

Much was absorbed in massive arms purchases that exacerbated political tensions, particularly in the Middle East. Many of the oil-states still had enormous amounts to invest, which became available to Western banks.

ii) Nationalization of oil companies

OPEC-member states in the developing world withheld the prospect of nationalization of the companies' holdings in their countries. Most notably, the Saudis acquired operating control of Aramco, fully nationalizing it in 1980 under the leadership of Ahmed Zaki Yamani.

As other OPEC nations followed suit, the cartel's income soared. Saudi Arabia undertook a series of ambitious five-year development plans in 1980, which called for the expenditure of $250 billion. Other cartel members also under took major economic development programmes.

<u>Impact on oil-importing countries</u>

i) Fuel shortage and increase in oil prices

In the US, the retail price of a gallon of gasoline rose from a national average of 38.5 cents in May 1973 to 55.1 cents in June 1974. Meanwhile, New York Stock Exchange shares lost $97 billion in value in six weeks. With the onset of the embargo, U.S. imports of oil from the Arab countries dropped from 1.2 million barrels (190,000 m^3) a day to a mere 19,000 barrels (3,000 m^3). Daily consumption dropped by 6.1% from September to February, and by the summer of 1974, by 7% as the United States suffered its first fuel shortage since WWII.

ii) Stagflation

Underscoring the interdependence of the world societies and economies, oil-importing nations in the noncommunist industrial world saw sudden inflation and economic recession. In the industrialized countries, especially the United States, the crisis was for the most part borne by the unemployed, the marginalized social groups, certain categories of ageing workers, and increasingly, by younger workers. Schools and offices in the U.S. often closed down to save on heating oil; and factories cut production and laid off workers. In France, the oil crisis spelt the end of the Trente Glorieuses, 30 years of very high economic growth, and announced the ensuing decades of permanent unemployment.

In 1974-75, countries suffered economic decline, accompanied by high inflation, producing a phenomenon called **stagflation (stagnant economy plus rampant inflation).** It was in this atmosphere that the G-7 was formed in 1975 discuss the oil crisis. These countries were Britain, USA, France, Japan, Italy, West Germany and Canada.

USA however tried to tackle the problem by raising interest rates which drew capital into USA, raised the value of the dollar on international exchange rates but in turn, contributed to a worsening of the depression in Europe.

iii) Embargo on Europe and energy crisis in Europe

The embargo was not uniform across Europe. Of the nine members of the European Economic Community, the Dutch faced a complete embargo (having voiced support for and supplied arms to Israel and allowed the Americans to use Dutch airfields for supply runs to Israel).

The United Kingdom and France received almost uninterrupted supplies (having refused to allow America to use their airfields and embargoed arms and supplies to both the Arabs and the Israelis), whilst the other six faced only partial cutbacks.

The members of the EEC had been unable to achieve a common policy during the first month of the Yom Kippur War. The Community finally issued a statement on 6 November, after the embargo and price rises had begun. The statement supported the Franco-British line on the war and OPEC duly lifted its embargo from all members of the EEC.

The price rises had a much greater impact in Europe than the embargo, particularly in the UK (where they combined with industrial action by coal miners to cause an energy crisis over the winter of 1973-74, a major factor in the breakdown of the post-war consensus and ultimately the rise of Thatcherism*)
*Thatcherism: advocated individualism over collectivism with self-help as the core.

<u>Aftermath of the embargo</u>

i) Soaring price inflation
A few months later, the crisis eased, the embargo was lifted in March 1974 after negotiations at the Washington Oil Summit, but the effects of the energy crisis lingered on throughout the 1970s. The price of energy continued increasing in the following year, amid the weakening competitive position of the dollar in world markets; and no single factor did more to produce the soaring price inflation of the 1970s in the United States.

ii) Price controls and rationing

The crisis was further exacerbated by government price controls in the United States, which limited the price of "old oil" (that already discovered) while allowing newly discovered oil to be sold at a higher price, resulting in a withdrawal of old oil from the market and artificial scarcity. The rule had been intended to promote oil exploration. This scarcity was dealt with by rationing of gasoline (which occurred in many countries), with motorists facing long lines at gas stations.

In the U.S., drivers of vehicles with license plates having an odd-number as the last digit were allowed to purchase gasoline for their cars only on odd-numbered days of the month, and vice versa.

iii) Conservation and reduction in demand/alternative sources of energy

The U.S. government response to the embargo was quick but of limited effectiveness. A National Maximum Speed Limit of 55 mph (88 km/h) was imposed to help reduce consumption. President Nixon named William Simon as an official "energy Tsar," and in 1977, a cabinet-level Department of Energy was created, leading to the creation of the United States' Strategic Petroleum Reserve. The National Energy Act of 1978 was also a response to this crisis.

The energy crisis led to greater interest in renewable energy, especially wood fuel and spurred research in solar power and wind power. It also led to greater pressure to exploit North American oil sources, and increased the West's dependence on coal and nuclear power. Electricity generation from nuclear power and natural gas, home heating from natural gas and ethanol-blended gasoline all reduced the demand for oil. Soon, other sources of supply actually became profitable as the price increased. But the initial moves toward more efficient automobiles and alternative sources of energy stalled as oil prices fell and memories of gasoline shortages of 1973 faded.

France embarked on a nuclear power programme which reduced dependence on oil in the long-run while Britain exploited its own oil fields in the North Sea and became self-sufficient by the end of the 1970s. Brazil began a nuclear programme and purchased eight nuclear reactors from West Germany in 1975.

Impact on other oil-important countries

i) Japan

Japan received about 33% less oil than what was expected from the Middle East. Major international oil companies, which control about 70% of Japan's oil diverted their crude oil from Iran and Indonesia away from Japan to their other customers. Japan was also largely made up of thermal power plants, operated by burning imported oil. With the increased cost of this resource, electricity prices increased exponentially.

Despite being a target of the embargo as well, Japan fared particularly well in the aftermath of the world energy crisis of the 1970s compared to other oil-importing developed nations.

- The years 1973 and 1974 brought about restrictions in power use. The government's number one priority became stopping inflation via reducing energy consumption and reorientation.

The increasing dependence on fuel prices pushed Japan towards intense research in the field of saving raw materials, energy and of course the substitution of such products. A new type of industry became privileged, the Japanese focusing on integrated circuits, computer machines, industrial robotics, electronic materials, etc.

- Japanese automakers led the way in an ensuing revolution in car manufacturing. The large automobiles of the 1950s and 1960s were replaced by far more compact and energy efficient models.

The crisis essentially prompted the economy of Japan to shift away from oil-intensive industries and resulted in huge investments in industries like electronics. Japan introduced 'knowledge intensive' industries based on microchips and computers. The Japanese understood their vulnerability to international fuel price evolutions and reorganized their entire industry.

Impact on industrialized oil-exporting countries

ii) Canada

For the handful of industrialized nations that were net energy exporters the effects of the oil crisis were very different. In Canada the industrial east suffered many of the same problems of the United States. In oil rich Alberta there was a sudden and massive influx of money that quickly made it the richest province in the country.

The federal government attempted to correct this imbalance through the creation of the government-owned Petro-Canada and later the National Energy Program. These efforts produced a great deal of anger in the west producing a sentiment of alienation that has remained a central element of Canadian politics to this day.

Overall the-oil embargo had a sharply negative effect on the Canadian economy. The economic malaise in the United States easily crossed the border and increases in unemployment and stagflation hit Canada as hard, despite Canadian fuel reserves.

iii) Soviet Union

The Soviet Union was also a net oil exporter and the increase in the price of oil had an immediate effect on that country. The Soviet economy had stagnated for several years and the increase in the price of oil had a beneficial effect, especially after the bloc's internal terms of trade were adjusted to reflect the increased value of Russian oil.The increase in foreign currency reserves allowed the import of grain and other foodstuffs from abroad, increased production of consumer goods and the ability to keep military spending at its traditional levels.

Some historians believe the oil revenues during this period kept the Soviet Union in existence for a considerably longer period of time than would otherwise have occurred. Soviet Union sold a large proportion of its oil to the eastern European countries of COMECON at fixed prices. Thus eastern

European states were shielded from the shock but this also prevented the Soviets from reaping extra profits from its oil exports.

Macroeconomic effects

Banks cutting of interest rates to encourage growth from stagnated economy

The Western nations' central banks decided to sharply cut interest rates to encourage growth, deciding that inflation was a secondary concern. Although this was the orthodox macroeconomic prescription at the time, the resulting stagflation surprised economists and central bankers, and the policy is now considered by some to have deepened and lengthened the adverse effects of the embargo.

Suspicions over OPEC linked companies

Long-term effects of the embargo are still being felt. Public suspicion of the oil companies, who were thought to be profiteering or even working in collusion with OPEC continues.

Effects on international relations

i) Challenge of the Third World to US: Cold War politics challenges

The Cold War policies of the Nixon administration also suffered a major blow in the aftermath of the oil embargo, as U.S. power was under attack even in Latin America.

The oil embargo was announced roughly just one month after a right-wing military coup in Chile toppled elected socialist president Salvador Allende on September 11, 1973. The U.S.'s subsequent assistance to this government did little in the short-run to curb the activities of socialist guerrillas in the region.

The response of the Nixon administration was to propose doubling of the amount of military arms sold by the United States. As a consequence, a Latin American bloc was organized and financed in part by Venezuela and its oil revenues, which quadrupled between 1970 and 1975.

ii) Changes in Western stance against Israel: Strains in the Western Alliance

In addition, Western Europe and Japan began switching from pro-Israel to more pro-Arab policies (some of which are still in effect today). This change further strained the Western alliance system, for the United States, which imported only 12% of its oil from the Middle East (compared with 80% for the Europeans and over 90% for Japan), remained staunchly committed to its backing of Israel.

iii) Challenges by the Third World in the UN

A year after the unveiling of the 1973 oil embargo, the non-aligned bloc in the United Nations passed a resolution demanding the creation of a "new international economic order". In which resources, trade, and markets would be distributed more equitably, with the local populations of nations within the global South receiving a greater share of benefits derived from the exploitation of southern resources, and greater respect for the right to self-directed development in the South be afforded by the North.

Decline of OPEC

i) Production surpassed by non-OPEC members and division in OPEC

Since 1973, OPEC failed to hold on to its pre-eminent position, and by 1981, its production was surpassed by that of other countries. The economic recession had caused industrialized countries to reduce the demand for oil and non-OPEC countries like Mexico increased their production.

Additionally, its own member nations were divided among themselves for between them were spenders (Iran needed revenue for immediate needs), savers (Saudi Arabia), conservatives (Saudi Arabia, conservative monarchy dependent on US support not about to ruin the western economy) and revolutionaries (Libya was anti-American, wanted to wreck the capitalist system).

Saudi Arabia, trying to gain back market share, increased production and caused downward pressure on prices, making high-cost oil production facilities less profitable or even unprofitable.

The world price of oil, which had reached a peak in 1979, at more than US$80 a barrel, decreased during the early 1980s to US$38 a barrel. In real prices, oil briefly fell back to pre1973 levels. Overall, the reduction in price was a windfall for the oil-consuming nations: United States, Japan, Europe and especially the Third World.

ii) Move away towards alternate sources of energy

Part of the decline in prices and economic and geopolitical power of OPEC comes from the move away from oil consumption to alternate energy sources.

OPEC had relied on price inelasticity of oil demand, but had underestimated the extent to which other sources of supply would become profitable as the price increased. Electricity generation from nuclear power and natural gas, home heating from natural gas and ethanolblended gasoline all reduced the demand for oil.

iii) Drop in oil prices had severe economic repercussions for oil-producing countries

At the same time, the drop in prices represented a serious problem for oil-producing countries in Northern Europe and the Persian Gulf region.

For a handful of heavily populated, impoverished countries, whose economies were largely dependent on oil — including Mexico, Nigeria, Algeria; and Libya — governments and business leaders failed to prepare for a market reversal, the price drop placed them in wrenching, sometimes desperate situations. When reduced demand and over-production produced a glut on the world market in the mid-1980s; oil prices plummeted and the cartel lost its unity.

Oil exporters such as Mexico, Nigeria, and Venezuela, whose economies had expanded frantically, were plunged into near-bankruptcy, and even Saudi Arabian economic power was significantly weakened. The divisions within OPEC made subsequent concerted action more difficult.

Long Term Impact

i) Increasing dependence on West in the long run

Despite efforts by the Arab States to use the "oil weapon" to display Western energy vulnerability and the futility of maintaining a heavy handed pro-Israeli policy, it can be argued that the Arab States ultimately traded diplomatic gains for ever increasing dependence on the West for economic and military security.

The sharp reaction by the United States, Western Europe and Japan, the Soviet Union, and the influx of new oil wealth would have dire effects for the Arab States in the years following the 1973 Yom Kippur War and OAPEC embargo.

Prior to the embargo, the geo-political competition between the Soviet Union and the United States, in combination with low oil prices that hindered the necessity and feasibility for the West to seek alternate energy sources, presented the Arab States with financial security, moderate economic growth, and disproportionate international bargaining power.

Following the embargo, higher oil prices opened new avenues for energy exploration or expansion including Alaska, the North Sea, the Caspian, and Trans-Caucasia.

ii) Changes to Middle East/Cold War dynamics

Prior to the ascendance of Mohammed Anwar Al Sadat to president of Egypt in 1970, the Middle East had been an important arena in the global superpower competition, most lucidly displayed in the arms sells and cooperation between the American and Soviet governments with Israel, Saudi Arabia, and Iran on one hand and Egypt, Syria, and Iraq on the other.

Although none of these states entered into any formal alliances comparative to the North Atlantic Treaty Organization, they did benefit greatly from the geopolitical competition in the region and vacillations in alignment often resulted in greater gains of assistance.

This competitive environment, beneficial to the regional states involved, was mitigated sharply after 1970 as the successive events of Sadat's dismissal of Soviet specialists in Egypt and dramatic price increases in hydrocarbons hardened relations with all of the Middle East. This created new opportunities for the export of Soviet oil and made exploration in the Caspian Basin and Siberia more cost effective.

Former cooperation evolved into a far more adversarial relationship as the Soviet Union increased oil production and export (by 1980 the Soviet Union was the world's largest producer of oil) to take advantage of the supply problems in the West created by OPEC's production reductions.

This growing economic competition turned into genuine feats of military aggression after the 1979 Soviet invasion of Afghanistan, leaving the Gulf States to look to the United States for the type of security guarantees against Soviet military action in the Persian Gulf that the Israelis had exclusively received only a decade earlier.

iii) Growing Security Concerns in the Middle East

The Soviet invasion of Afghanistan was only part of the growing security destabilization in the Middle East, most obviously seen in the increased sale of American weapons, technology, and outright military presence.

Saudi Arabia and Iran became increasingly dependent on bi-lateral American security assurances to combat both external and internal threats, including increased military competition between both of these states due to the increased oil revenues. Both states were seemingly competing for pre-eminence in the Persian Gulf and using increased revenues on disproportionately powerful military forces. By 1979, Saudi weapon purchases from the United States were in excess of five times the amount that Israel was purchasing annually.

Following the failure of the Shah during January 1979 to maintain control of Iran, the Saudis were forced to deal with the prospect of internal destabilization via Islamic Fundamentalism, a -reality which would quickly be revealed in the seizure of the Great Mosque in Mecca by Wahhabi extremists during November and a Shia revolt in al-Hasa during December.

Conclusion

Growing fears about eventual Western energy independence, various security threats, and the absence of a Western rival in the geo-political competition over the Middle East led the Arab States in a more dependent relationship with the West. This is most explicit in Saudi Arabia's consistent policy of price and production moderation in an effort to reduce the chances of Western alienation and the opportunity costs for alternative energy production.

The exchange for Western moderation in Arab-Israeli affairs ultimately led to a reshaping of the Middle-Eastern geo-political landscape that was significantly less advantageous than prior to 1973. Nevertheless, the 1973 oil shock provided dramatic evidence of the potential power of Third World resource suppliers in dealing with the developed world. The vast reserves of the leading Middle East producers guaranteed the region its strategic importance, but the politics of oil still proves dangerous for all concerned to this.

Challenge 1b: The 1979 Iranian revolution and the second oil shocks

Effects of Toppling the Shah of Iran

The 1979 (or second) oil crisis in the United States occurred in the wake of the Iranian Revolution. Amid massive protests, the Shah of Iran, Mohammad Reza Pahlavi, fled his country in early 1979, allowing Ayatollah Khomeini to gain control.

The protests shattered the Iranian oil sector. While the new regime resumed oil exports, it was inconsistent and at a lower volume, forcing up prices. Saudi Arabia and other OPEC nations increased production to offset the decline, and the overall loss in production was about 4%.

The oil companies began to compete to build up stocks, pushing up prices as costs of production also increased. However, a widespread panic resulted, driving the price far higher than would be expected under normal circumstances. In the United States, the Carter-administration instituted price controls.

Effects of the Iran-Iraq war 1980

In September 1980, war between Iran and Iraq broke out[3]. This war was one of religion and politics because Ayatollah had condemned the Ba'athist regime in Iraq, headed by Saddam Hussein, as hostile to Islam. Iraqi forces invaded Iran and each bombed the other's oil wells and refineries.

The conflict became a war of attrition with heavy casualties on both sides and last 8 years until both sides made a peace of exhaustion in 1988. Meanwhile, an early effect of the war had been to reduce the oil production of both countries. Iranian production was nearly 156 million tonnes in 1979 not and not quite 65 million in 1981; Iraqi production was 169 million tonnes in 1979 and only 43 million in 1981.

Dramatic increase in oil prices

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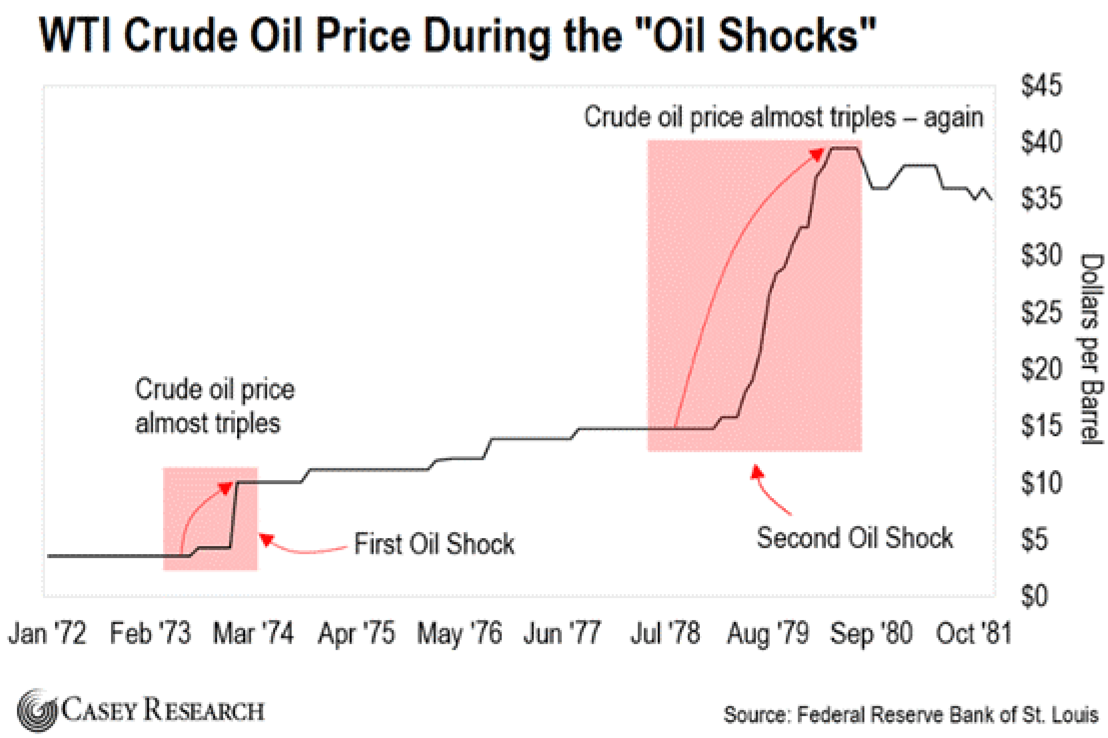
[3] **Iraq** invaded **Iran** on 22 September 1980, triggering a bitter eight-year **war** which destabilised the region and devastated both countries. The then **Iraqi** leader Saddam Hussein claimed as a reason for the **invasion** a territorial dispute over the Shatt al-Arab, the waterway which forms the boundary between the two countries.

At the beginning of October 1979, the price of oil was $13 per barrel and in 1981 it reached $34. In comparison, the beginning of October 1973 saw the price of oil at $3 per barrel. Oil consumers grappled with the new costs of paying imports and all over the world, oil prices brought up the costs of other aspects of living as well, with harsh consequences for the poorest countries.



Impact on Developed Countries

The western industrialized countries which had been adjusting to the new situation since 1974 coped the best. They had new supplies of oil from the North Sea and were developing nuclear power. The USA and Japan succeeded in resuming economic growth in the early 1980s but other countries faced increasing difficulties.

Impact on developing Asian and Latin American economies. In East Asia, the rapidly developing 'tiger economies' in Taiwan, Singapore and South Korea were hard hit. South Korea borrowed heavily to pay for its oil imports and in Latin America, Brazil and Argentina borrowed to meet their oil bills and incurred enormous debts.

Effects on the poorest Third World countries

The gravest effects were suffered by the poorest countries of the Third World which imported all their energy and had to borrow to pay new oil prices even though they were heavily in debt. By 1979 Zaire had accumulated a debt of $3 billion. By early 1980s, far from showing any recovery from the oil shocks, Third World countries had contracted debts on which they could not pay the interest and repayment was out of the question. This situation threatened not only the indebted countries but also the banks and governments which provided loans which would never be repaid.

Effects on the oil producing countries

Less severe problems of debt even struck some of the oil-producing countries. Mexico, Venezuela and Indonesia used their increased revenues to such poor effect that they too had to borrow. Indonesia borrowed about $6 billion and defaulted on payments. In 1982, Mexico and Venezuela both introduced drastic programmes of deflation to reduce their debts and improve their balance of payments.

The most extraordinary effects of the oil shocks rose from the use made of the immense new revenues. In 1974-77, after the first wave of oil shocks, it was estimated that Arab oil producers had about half of the world's liquid currency reserves, even if they indulged in the most extravagant expenditure, they could not spend the wealth at their disposal.

At that time, they had no banking systems of their own so they invested their surpluses in the commercial banks of USA, Western Europe; the very countries against which the oil weapon had been directed against in the first place.

Vast sums in 'petrodollars' thus returned to the industrialized countries and the banks in turn made large loans to Third World countries to pay their oil bills. The early purposes of the Arab oil weapon were entirely lost to sight, the western banking system, which gained the most of the Arab investments, lost them again in the bottomless pit of Third World debt

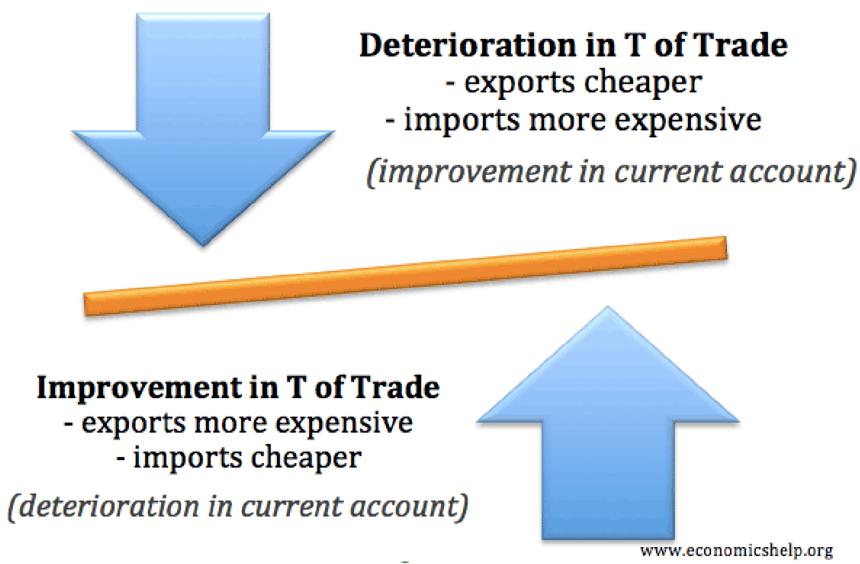
Challenge 2: Trade imbalances

Introduction

Despite the introduction of the Bretton Woods institutions, the global political economy did not revive in the way the world had conceived it to be. Western Europe and Japan were stalled in a vicious development cycle. The war had devastated the economy, political institutions and psyche of the people in these countries. Many of their economies remained stagnant, and were dependent on the US for vital imports of energy, food, machinery, medicine, vehicles and hundreds of other products to revive their economies but had no money to pay for them.

The result was a dollar gap. Thus the world economy remained stagnant and by 1947, many feared it would slide into another depression with chaos and renewed aggression.

Balance of trade → The balance of trade (or *net exports)* is the difference between the monetary value of exports and imports in an economy over a certain period of time. A positive balance of trade is known as a trade surplus and consists of exporting more than is imported; a negative balance of trade is known as a trade deficit or, informally, a trade gap.



T of Trade → Terms of Trade

Causes of trade imbalances

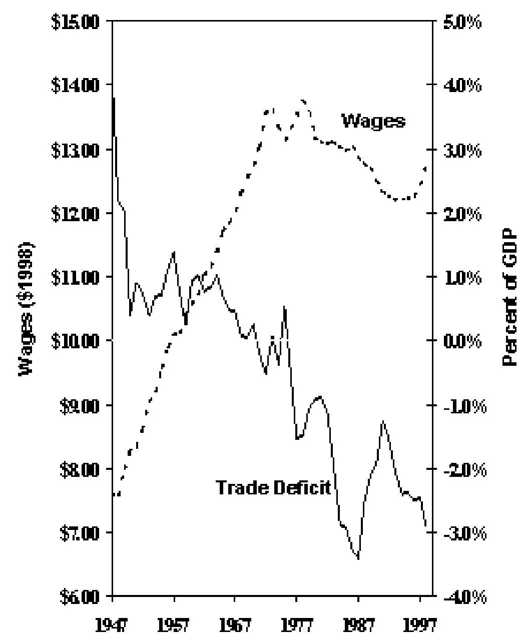
Overcoming the dollar gap[4] after WWII

The Cold War between the USA and USSR was a catalyst for overcoming the dollar gap. In 1947, Truman announced the onset of the containment policy whereby Soviet and communist advances could be checked by rebuilding Europe and Japan through massive aid and helping any government threatened by communism. From 1947 to 1952, USA poured $17 billion of grants into 16 western European countries and $2.2 billion into Japan and expended billions more by deploying troops in those lands.

USA also tolerated European and Japanese protectionism which allowed industries in those countries to resume production, exports and creation of wealth. With access to massive American aid and markets, Japan and the western European countries rapidly reconstructed and developed their economies.

Despite or perhaps due to the Cold War, the global economy grew quickly throughout the 1950s and 1960s but it was at the expense of the US i.e. widening trade deficit in the 1970s. The US was the world's leading export powerhouse and the US initially ran a substantial trade surplus, benefitting initially from strong export demand in a wide-range of industries.

Real Wages & Trade Deficit, U.S., 1947-98



Source: Economic Policy Institute

From the figure, US trade surplus was about 1% of Gross Domestic Product. This was to change in the 1970s when the US moved from a trade surplus to a deficit position.

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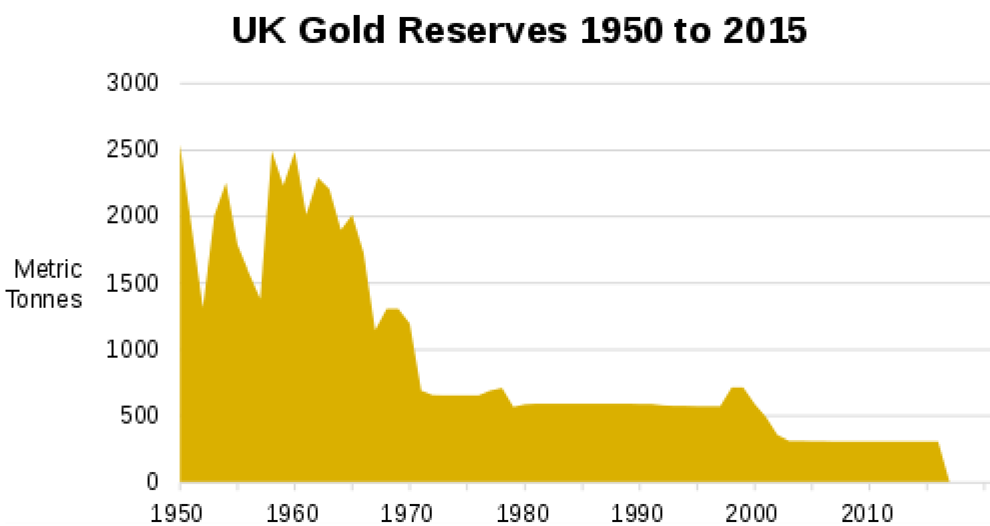
[4] The difference, measured in U.S. dollars, between the earnings of a foreign country through sales and investments in the U.S. and the payments made by that country to the U.S.

The dollar glut[5] that resulted in a dollar overhang

The US continued to send far more dollars into the global economy than it took back, thus suffering continuous balance-of-payments deficits. By 1959, the European and Japanese holdings of US dollars was $19.4 billion, slightly less than the US gold reserves of $19.5 billion. New gold could not be produced fast enough to keep up with the expansion of dollars. The following year, the amount of dollars in foreign hands exceeded U.S gold reserves, a problem known as the dollar overhang, this deficit deepened each year thereafter.

Deepening crisis of lack of confidence in dollar's ability

The result of the dollar overhang was a deepening crisis of confidence in the dollar's ability to support the global economy. If the Europeans and Japanese decided to buy American gold with their dollars, both the U.S gold reserve and foundation for the fixed currency system would be wiped out. Starting in 1960, there were minor speculations on USA's gold reserves but no government challenged the system because its collapse would hurt everyone. As long as the gold/dollar ratio remained constant and dollars could be redeemed in gold, countries were not hurt by holding dollars. In fact, most preferred the dollars than gold as dollars earned interest and were 'liquid', easily used for transactions.



In 1960, the United States held $19.4 billion in gold reserves, including $1.6 billion in the International Monetary Fund. As the U.S. economy prospered, Americans bought more imported goods, paying in dollars. This large balance of payments deficit worried foreign governments that the United States

[5] The **dollar glut** is a term for the accumulation of American **dollars** outside of the United States as a reserve currency, contrasted with the **dollar** gap, which led to the creation of the Marshall Plan following World War II.

would no longer back up the dollar in gold. By 1970, the United States only held $14.5 billion in gold against foreign dollar holdings of $45.7 billion.

Why did USA face a Balance of Payment deficit?

Due to its vast military and aid commitment, USA faced payments deficit and embarked on strict deflationary policies---cutting back government expenditures, devaluing the-currency.

However, by holding rather than converting American dollars into gold, those governments were financially supporting US policy, including the Vietnam War, web of overseas bases, support for a range of brutal dictators such as Rhee of South Korea, Thieu of South Vietnam.

The Balance Of Payments

KEY TAKEAWAYS

- The balance of payments include both the current account and capital account.
- The current account includes a nation's net trade in goods and services, its net earnings on cross-border investments, and its net transfer payments.
- The capital account consists of a nation's imports and exports of capital and foreign aid.
- The sum of all transactions recorded in the balance of payments should be zero; however, exchange rate fluctuations and differences in accounting practices may hinder this in practice.

U.S. Balance-of-Payments Problems and Policies in 1971

by CHRISTOPHER L. BACH

President Richard M. Nixon's Economic Policies

How Nixon Destroyed the Dollar

French challenge to the Bretton Woods system

French President Charles de Gaulle throughout the 1960s demanded US gold for /dollars and challenged the Bretton Woods system. This was part of his attempt to rebuild French prestige and power while simultaneously undermining USA. He condemned the war in Vietnam, he tested an atomic bomb in 1964 and built a French force de frappe (nuclear strike force) and withdrew France from NATO's military command in 1966 (but was still a member).

Managing the dollar crisis: The formation of the Group of Ten

The group was composed of leading industrial nations—USA, Great Britain, France, West Germany, Japan, Italy, Canada, Sweden, Switzerland, the Netherlands and Belgium, met throughout the 1960s to manage the dollar crisis by intervening in currency markets to maintain the prices. Essentially their currencies were under-valued against the over-valued US dollar.

In 1968, they created a two-tier system in which gold prices could fluctuate in a free market and would remain fixed in a government system. In 1969, the Group of Ten created **Special Drawing Rights (SDRs)**, an artificial currency that could be used instead of the dollar to settle international accounts. Yet only $6 billion of SDRs were created that year, whereas $100 billion in currency circulated throughout the global system.

USA's high inflation caused by the Vietnam War

USA tried to improve its balance of payments by trying to stimulate exports and inhibit American foreign investment. But any gains were wiped out by the money sent to finance the Vietnam War. President Johnson's refusal to raise taxes to pay for both his Great Society set of welfare programmes and the Vietnam War caused high inflation that further eroded America's competitiveness.

Dollar's overvaluation
Another severe problem was the dollar's increased overvaluation throughout the 1960s, thus exacerbating America's growing payments deficits and starting 1971, trade deficits. The dollar became overvalued as European and Japanese growth in GNP and productivity exceeded those of the USA. The fixed exchange rates were not adjusted to reflect the steadily diminishing competitiveness of America's economy, thus making it even more difficult for American producers to compete abroad or at home.

A. US abandonment of gold/dollar parity in 1971

In 1971, the USA suffered its first trade deficit since 1893, running up $2 billion in merchandise and $10.6 billion in payments deficits. Meanwhile, its gold reserves shrank to $10 billion and foreign holdings of dollars rose to over $80 billion.

On August 15, 1971, President Nixon dealt with these interrelated problems by announcing two international policies—henceforth the dollar would no longer be converted into gold and there would be a temporary 10% surcharge added to existing U.S. tariffs. In 1971 December, the leading industrial nations signed the Smithsonian Accord, in which the dollar was devalued 10% against the existing price of gold, other currencies were re-valued against the dollar and currencies could now float within a 2.5% margin of the fixed rate.

- **The Nixon shock and end of the Bretton Woods System**

The term Nixon Shock is used to refer to two different policy measures taken by U.S. President Richard Nixon in 1971 and 1972. In 1971 Nixon unilaterally cancelled the Bretton Woods system and stopped the direct convertibility of the United States dollar to gold. The second shock was Nixon's 1972 visit to China; a surprising new twist to Cold War diplomacy.

- **The end of the Bretton Woods system**

By the early 1970s, as the Vietnam War accelerated inflation, the United States was running not just a balance of payments deficit but also a trade deficit (for the first time in the twentieth century). The crucial turning point was 1970, which saw U.S. gold coverage of the paper dollar deteriorated from 55% to 22%. This represented the point where holders of the dollar had lost faith in the U.S. ability to cut its budget and trade deficits.

In 1971 more and more dollars were being printed in Washington, then being pumped overseas, to pay for the nation's military expenditures and private investments. In the first six months of 1971, assets for $22 billion fled the United States. Because of the excessive printing of paper dollars, and the negative balance of U.S. trade, other nations were increasingly demanding fulfillment of America's "promise to pay". That is, they were demanding gold from the U.S. in exchange for paper dollars. France, in particular, made heavy and repeated demands and acquired large amounts of gold in that manner.

- **Nixon Shock**

In response, on August 15, 1971, Nixon unilaterally imposed 90-day wage and price controls, a 10% import surcharge, and most importantly 'closing the gold window', making the dollar inconvertible to gold directly, except on the open market. Unusually, this decision was made without consulting members of the international monetary system or even with his State Department.

The surcharge was dropped in December 1971 as part of a general revaluation of major currencies, which were allowed 2.25 percent devaluations from the agreed exchange rate. However, the more flexible official rates could not be defended against the speculators. By March 1976, all the world's major currencies were floated—in other words, exchange rates were no longer the principal target used by governments to administer monetary policy.

- **Impact of the Smithsonian Accord: Floating currencies**

This new economic policy unraveled quickly with Britain and Ireland breaking off from the fixed rate system and allowing their currencies to float on international markets in 1972.

Other countries followed suit and America's trade and payments deficits continued to mount and were unaffected by another 10%-dollar devaluation in February 1973. By March 1973, the fixed rate system was abandoned and a floating system adopted in which currency values were set by market forces rather than government intervention. Thus the onset of currency and payment problems.

B. Dealing with the trade imbalances by the US and other industrialized nations

i) Coordination of broad macroeconomic policies

In 1975, the Group of 7 (G-7), made up of USA., Japan, Great Britain, France, Germany, Italy and Canada began meeting annually to coordinate broad macroeconomic policies and deal with any crises.

ii) Special Drawing Rights (SDR) to replace gold

In 1976, the IMF amended its charter to allow SDRs to replace gold as the world economy's principle reserve asset. Special drawing rights (SDR) refer to an international type of monetary reserve currency created by the International Monetary Fund (IMF) in 1969 that operates as a supplement to the existing money reserves of member countries. An SDR is essentially an artificial currency instrument used by the IMF, and is built from a basket of important national currencies.

iii) Reduction of non-tariff barriers

During the Tokyo Round of GATT (1973-1979), Washington achieved some success in negotiating the reduction of non-tariff as well as tariff barriers. Along with reduced tariffs, the Tokyo Round succeeded in creating a Code on Subsidies and Countervailing Duties and a Code on Government Procurement, the first comprehensive attempts to deal with some nontariff barriers. Each code included rules, surveillance and dispute mechanisms, although these codes were vaguely written and relatively easily evaded.

An assessment of the measures

These efforts nibbled around the problem's edges but did not address the global economy's central problem which was the rise in oil from $2.75 to $34 a barrel between 1973 and 1980 and the corresponding stagflation (slow growth and high prices).

Market rather than government action alleviated the high energy price problem. The high prices encouraged consumers to invest in energy conservation and efficiency. Meanwhile, those countries with unexploited oil reserves could now afford to invest in production. Finally, OPEC members began to cheat on their quotas to garner more revenue. The result was an oil glut by the mid-1980s that brought prices down to $20 a barrel, which in real prices (adjusted for inflation) were actually cheaper than before 1973.

i) Deepening US payment and trade deficits

These gains for the global economy provided little relief for the USA which by the mid-1980s was facing an ever deepening payments and trade deficit crisis. This crisis was largely the fault of misguided American policies.

The Reagan administration had hoped that by following a supply-side policy of massive tax cuts[6] the economy would grow and the government would later recoup earlier revenue losses as larger business and household incomes generated more taxes. This conservative economic policy by Reagan to address the 1981-1982 recession was termed → **<u>Reaganomics</u>.**

Cutting taxes was only one part of Reagan's national agenda of slashing government spending. Reagan believed the federal government had become too large and interfering. During his presidency, he cut social programs and worked to reduce or eliminate government regulations that affected the consumer, workplace, and environment.

- But he did spend on the military. In the wake of the disastrous Vietnam War, Reagan successfully pushed for big budget increases for defense spending by arguing that the U.S. had neglected its military.
- In the end, the reduction in taxes combined with increased military spending outweighed the spending reductions on domestic social programs. This resulted in a federal budget deficit that went well beyond the deficit levels of the early 1980s. From $74 billion in 1980, the federal budget deficit ballooned to $221 billion in 1986.

ii) Impact of trade imbalances on USA

<u>Encouragement of foreign investments to cope with budget deficit</u>

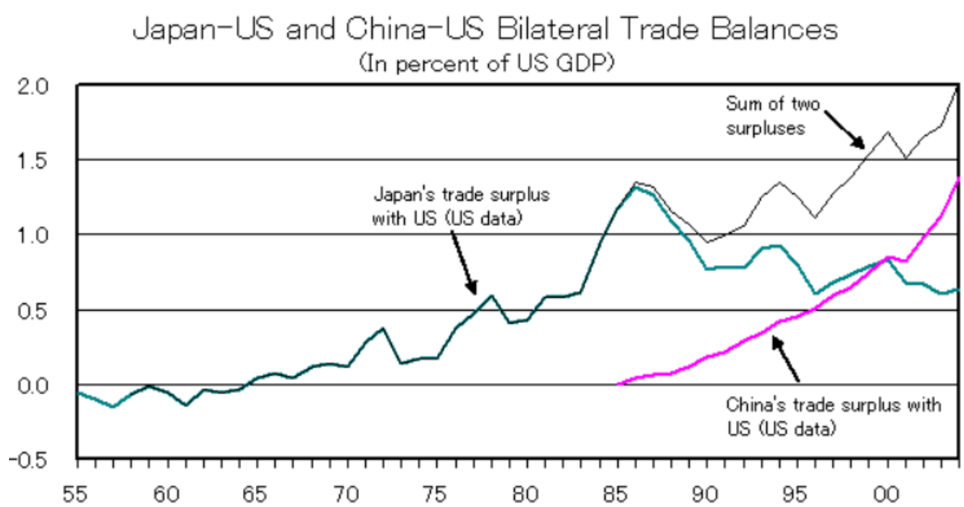
The Federal Reserve raised interest rates to cut inflation and encouraged both domestic and foreign investors to lend money to the US government to help pay for the rising budget deficit. Foreigners

[6] Reagan operated on the basis of supply-side economics—the theory that advocates lower tax rates so people can keep more of their income. Proponents argue that supply-side economics results in more savings, investment, production, and, ultimately, greater economic growth.

invested hundreds of billions of dollars in the USA, buying government bonds, playing financial markets, taking over US companies or property and starting new subsidiaries. When they invested in the US, the foreigners exchanged their currency for dollars. As foreign demand rose for a stable supply of dollars, the dollar's value soared. The result for the US was an increasingly severe trade deficit and lower American economic growth.

Shift in global economic power balance

In 1985, USA was transformed from being the world's greatest creditor country into the worst debtor nation as the amount of foreign money invested in the USA exceeded that of American money flowing overseas by $112 billion. By 1987, America's global trade deficit peaked at $171 billion and its deficit with Japan at $59 billion. That same year, Japan enjoyed a trade surplus of $96.5 billion and Germany (West-Germany) one of $70 billion. Japan took over America's role as the global creditor nation, amassing $241 billion in net external credit in 1987.



Sources: US Bureau of Economic Analysis, US Census Bureau.

The USA was trapped in a vicious economic cycle composed of high interest rates, an overvalued dollar, deep trade and payment deficits, low economic growth, low government revenues, high government deficits and long-term debt, and high interest rates. During the first 5 years, the Reagan administration seemed indifferent to the worsening crisis, arguing that the "magic of the market place" would take care of everything. Treasury Secretary Don Regan talked up the dollar's value, claiming that "a strong dollar represents a strong America."

Devaluation of the dollar at the Plaza Accord

In 1985, President Reagan reshuffled some of his advisers, making free market purist Don Regan his Chief of Staff and economic realist Jim Baker his Treasury Secretary. Baker immediately sought to devalue the dollar. At the September 1985 secret Plaza Accord of the Group of Five—the USA, Japan, Germany (West Germany), France and Great Britain— finance minister meeting, it was agreed that there should be a joint effort to devalue the dollar to restore equilibrium to the global system.

Although the other states, particularly Japan, enjoyed an enormous transfer of wealth to they own economies as a result of the Reagan administration's inept policies, they realized that the USA could not continue to run a huge budget, trade and payments deficits indefinitely. The foreign debts had to be serviced, and the larger those debts, the less money the US had available to invest in its own economy. The result would be an American in steady decline, ultimately dragging down the rest of the global economy with it.

Agreeing to intervene in global currency markets by selling dollars and buying up other leading currencies, the Group of Five succeeded in devaluing the dollar, which fell most dramatically against the yen, from about 265 yen in 1985 to 125 yen in 1987. Satisfied with the devaluation, the Group of Seven met in February in 1987 in Paris and announced that the dollar had fallen far enough.

i) The Plaza Accord

The Plaza Accord was an agreement signed on September 22, 1985 at the Plaza Hotel in New York City by 5 nations - France, West Germany, Japan, the United States and the United Kingdom. The five agreed to depreciate the US dollar in relation to the Japanese yen and German Deutsche Mark by intervening in currency markets.

The exchange rate value of the dollar versus the yen declined 51% over the two years after this agreement took place. Most of this devaluation was due to the $10 billion spent by the participating central banks. Currency speculation caused the dollar to continue its fall after the end of coordinated interventions. This devaluation was planned, done in an orderly manner with pre-announcement, and did not lead to financial panic in the world markets.

ii) Reasons for the dollar devaluation

The reason for the dollar's devaluation was twofold: to reduce the US current account deficit, which had reached 3.5% of the GDP, and to help the US economy from a recession that began in the early 1980s.

The U.S. Federal Reserve System under Paul Volcker had overvalued the dollar enough to make industry in the US (particularly the automobile industry) less competitive in the global market. Devaluing the dollar made US exports cheaper to its trading partners, which in turn meant that other countries bought more American-made goods and services.

<u>The Plaza Accord was successful in reducing the US trade deficit with Western European nations but largely failed to fulfill its primary objective of alleviating the trade deficit with Japan because this deficit was due to structural rather than monetary conditions.</u> US manufactured goods became more competitive in the exports market but were still largely unable to succeed in the Japanese domestic market due to Japan's structural restrictions on imports.

The recessionary effects of the strengthened yen in Japan's export-dependent economy created an incentive for the expansionary monetary policies that led to the Japanese asset price bubble of the late 1980s.
The Louvre Accord was signed in 1987 to halt the continuing decline of the US Dollar. It is unlikely that such an arrangement would have succeeded in the long run, as the global economy is too large, heterogeneous, and fluid for even the most sophisticated central banks to effectively intervene. The signing of the Plaza Accord was significant in that it reflected Japan's emergence as a real player in managing the international monetary system.

iii) Impact of the Plaza Accord: short term solution

This realignment clearly was not enough to address the deep problems within the USA and by extension the global economy. Over the short term, America's trade and payment deficits continued to mount as the cost of imported goods already ordered rises. In October 1987, rumours that Japanese investors were going to stop buying U.S treasury bonds sent the New York Stock Market into a free fall in which it lost 15% of its value. In December 1987, the G-7 met and agreed on further measures to stabilize exchange rates and stock markets.

iv) Trade restrictions between US and other ctys

The United States imposed a wide range of trade restrictions on Japan in the 1980s. For instance, Voluntary Export Restraints (VERs) on Japanese autos were equivalent to a tariff rate exceeding 60 percent.

- America was able to exert great pressure on Japan at the time because it was both Japan's major overseas market — by a long shot — and its geopolitical defender against the Soviet Union.
- Bowing to pressure from the United States, Japanese trade negotiators agreed to a whole constellation of agreements designed to limit exports of steel and cars to the U.S., expand imports from the U.S., and eliminate "barriers" to the success of American firms in the Japanese market.
- Memorandums of Understanding, joint announcements, and communiques in the 1980s and early 1990s. There were Voluntary Export Restraints (VERs) on steel and autos, Voluntary Import Expansions (VIEs) like the U.S.-Japan Semiconductor Trade Agreement of 1986, the so-called Market Oriented Sector Specific (MOSS) negotiations that covered five sectors under Reagan, and the Structural Impediments Initiative (SII) begun under Reagan's successor, George H. W. Bush.

In spite of all the trade restrictions, the bilateral trade deficit with Japan did not go away. The bilateral trade deficit remained stubbornly high throughout the 1980s and 1990s and dramatically increased in the late 1990s and 2000s.

C. Aftermath of the 1980s trade imbalances

Since the 1990s, the dollar's value has remained stable while the global economy has grown steadily. Despite all of US' economic problems, the dollar remains the most important reserve currency.

Although the dollar is used to pay for about 65% of all international trade, deutsche marks account for about 12%, the yen about 8% and SDRs 5%.

The global economy annually expands about two to three percentage points while global trade rises even faster, about five to seven percent a year. 3/4 of all trade and investment flows among domestic industrial countries, rather than between them and the less developed countries.

i) US Revival in the Mid-1990s

The Reaganomics policies of tax cuts, increased spending and an overvalued dollar diminished American economic power by tripling the national debt and worsening the trade and payment deficits.

President Clinton's policies of cutting spending, increasing revenues, stimulating industries and technologies and forcing open foreign markets led to a renaissance of American economic power.

The economic boom of the 1990s began in the second quarter of 1991 when the total value of all goods and services produced in the economy, or gross domestic product (GDP), increased from -1.8% to 3.14%. From that point forward, for the next ten years, GDP growth was positive, with the highest quarter being the second quarter of 2000 when GDP was 7.7%. From 1990 to 1991, GDP grew from $5.5 trillion to $9.8 trillion.

First, globalization and technology was changing the economy and helping produce more goods and service.

- With the fall of the Soviet Union and Eastern European communism in the late 1980s, trade opportunities expanded greatly.
- These two factors are really partners, because technology encourages globalization and globalization increases technology, as new needs are identified and met. The 1990s was the period of rapid growth of both of these areas, including the signing of the North American Free Trade Agreement, better known as NAFTA, which allowed Mexico, the United States, and Canada to trade together much more easily, and other trade agreements throughout the world.
- Innovations in telecommunications and computer networking spawned a vast computer hardware and software industry and revolutionized the way many industries operate. The economy grew rapidly, and corporate earnings rose rapidly.[7]

Second, economic growth feeds off itself by creating jobs. And third, the government slightly increased taxes and constrained spending to turn the budget deficit from the early 1990s to a budget surplus in the mid to late 1990s.

- Over 23.6 million jobs were created in the 1990s, which made the unemployment rate drop to less than 5% in 1997, the lowest unemployment rate since 1973.

[7] Moffatt, Mike. "American Economy of the 1990s and Beyond." ThoughtCo, Feb. 11, 2020, thoughtco.com/us-economy-in-the-1990s-and-beyond-1148149.

- In 1990, tax cuts from the 1980s and continued government spending created a $220 billion deficit. This flipped over to a surplus between 1997 and 1998 of about $70 billion.

iii) Persistence of Protectionism

The trade and payment deficits remained high, though lower as a percentage of GNP than a decade earlier. Clinton failed to get Congress to re-approve the President's fast-track powers that bring trade treaties to a direct vote in both the Senate and House without being amended by special interest groups in the committees.

Despite Clinton's efforts, few other industrial and developing nations were willing to open their markets as widely was America's. Trade squabbles erupted among the industrialized countries. The WTO's conference at Seattle in November 1999 was a disaster as delegates deadlocked over measures that could further reduce trade and investment barriers while raising environment and labour standards, and anti-WTO riots raged outside.