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Tariffs and Currency Pacts: Lessons from the Smithsonian

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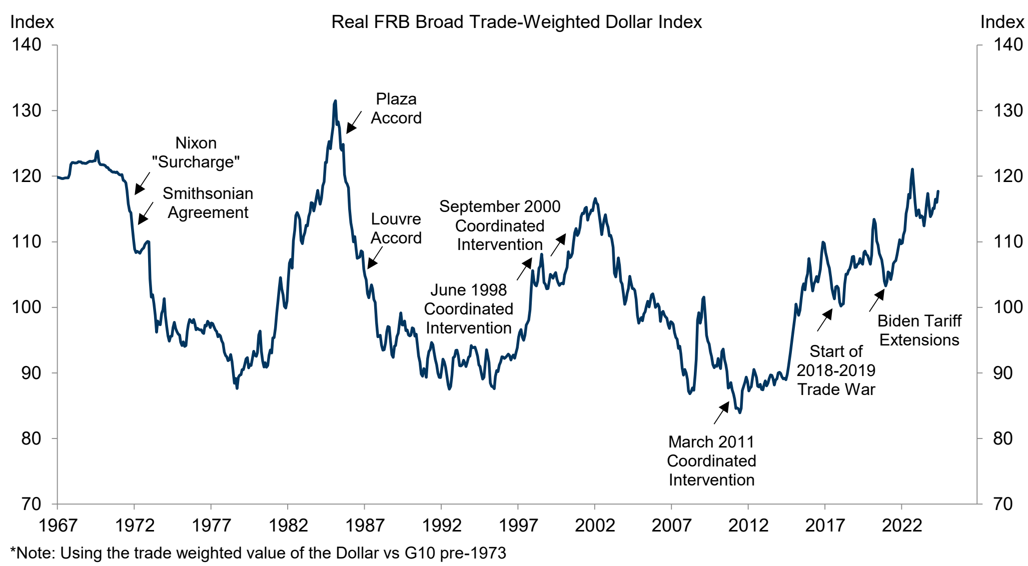
- Former President Trump made it a goal of his first term to reshape global trade in the US's interests. He and his advisors are considering a variety of policies to make US exports more competitive in a potential second term, including tariffs and devaluing the Dollar.
- Tariffs and currency devaluation have been used together in the past, most notably in 1971 when the Nixon administration imposed a 10% "surcharge" on goods imports as a means to pressure trading partners to revalue their currencies, and avoid the "loss of prestige" associated with unilaterally devaluing the Dollar.
- Many conditions surrounding the "Nixon Shock" are still prevalent today. But there are also some critical differences. While the Dollar is still at the center of global foreign exchange markets, current market pressures are supporting the Dollar's high valuation. And with foreign positioning in US assets at historical highs, there is no evidence today of an ongoing run on Dollars. Additionally, the global move away from pegged arrangements towards flexible exchange rates and less aggressive foreign exchange reserve management has made the notion of currency "agreements" more challenging. The US current account balance has also shifted drastically, with China and Mexico accounting for a much greater share of the deficit.
- We see substantial challenges to a currency agreement today. Some of these challenges though, are primarily conventions and surmountable political hurdles. However, others such as the required purchases of foreign debt and structural changes in the FX market are greater obstacles, and demonstrate the ways that FX policies of the 70's and 80's are not applicable today. (1) Currency agreements and intervention have become less popular in a world of mostly floating rates, (2) the US Treasury has rarely intervened in recent decades, (3) a weaker Dollar may be a tough sell to some critical countries that would need to participate, (4) there are important trade-offs to intervention for both the US and its trading partners, and (5) the Dollar's position at the center of global trade weakens US incentives for a weaker currency.
- Given these challenges, we think a unified and meaningful currency agreement looks unlikely. However, with tariffs clearly on the agenda, the US will continue to encourage other countries to take steps to rebalance global trade. Recent

Treasury reports under both the Trump and Biden administrations have advocated for fiscal expansion in places like China and Europe. And US fiscal consolidation would be a helpful step, even if it seems unlikely on our estimates. We think that is a more plausible and productive path to rebalance global trade and weaken the Dollar.

Tariffs and Currency Pacts: Lessons from the Smithsonian

Former President Trump made it a goal of his first term to reshape global trade in the US' interests and advance a protectionist stance on trade policy. Reports suggest that his advisors and former trade chief, Robert Lighthizer, are considering a variety of potential policies to make US exports more competitive, with a focus on bilateral trade imbalances, including imposing additional tariffs—possibly with the aim of using them as a negotiation tool to devalue the Dollar. Throughout his campaign, the former president has floated tariffs that are large by postwar standards. The main proposals include a 10% surcharge on all US imports and a 60% tariff on imports from China. In a larger sense, it should not be surprising to see these types of policies gaining traction. The Dollar has been highly valued for a decade and is now close to all-time highs (Exhibit 1). In the past, extreme FX pressures were often coupled with currency pacts and coordinated intervention. On some occasions, the US has used tariffs and threats of other protectionist measures to persuade trading partners to participate in these currency agreements.

Exhibit 1: The Dollar has been highly valued for a decade, with intervention often occurring around peaks in the Dollar's value



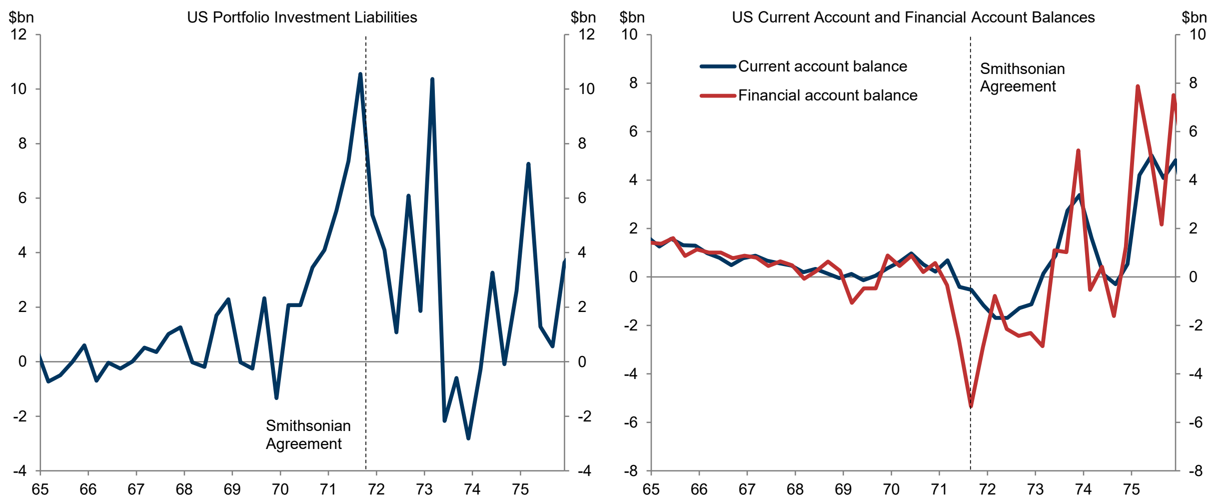
Source: Federal Reserve Board, Haver Analytics, Goldman Sachs Global Investment Research

The Smithsonian Agreement: "Our currency, your problem"

Tariffs and currency devaluation have been used together in past attempts to shift the global trade balance. The 1971 Smithsonian Agreement is one salient example. In the early 1970's, after the Nixon administration came to office in 1969, the United States was facing a yawning trade deficit, downward pressure on the Dollar, and diminishing gold reserves. Concerned about the balance of payments and falling gold reserves, but deeply averse to the "loss of prestige" associated with unilaterally devaluing the Dollar, policymakers leveraged a 10% tariff to pressure other countries to revalue their currencies, generating a weaker Dollar.

The Dollar was the cornerstone of the international monetary system then, as it is today, but even more formally. The Bretton Woods agreement nearly three decades prior established a system of fixed exchange rates to the US Dollar, which was itself pegged to gold. However, by the early 1970's, the US was facing a growing balance of payments deficit (Exhibit 2). The current account balance was deteriorating with the US importing more goods than it was exporting, portfolio liabilities were growing, and the gold reserves propping up the Dollar's value were dwindling rapidly.

Exhibit 2: Policymakers were facing a growing balance of payments deficit, rising liabilities, shrinking gold reserves, and a declining current account balance



Source: IMF, Haver Analytics, Goldman Sachs Global Investment Research

These factors put downward pressure on the Dollar and gold reserves, leaving policymakers with two choices to alter the payments imbalance: tighter monetary policy or a weaker currency. While the more straightforward solution was higher interest rates, this was viewed as costly for economic growth. With the Federal Reserve (and President Nixon) concerned about setting off a potential recession, this option was set aside.[1] This left the more complicated option of an exchange rate adjustment. However, under Bretton Woods, the Dollar was pegged to gold and could not weaken without a formal devaluation.

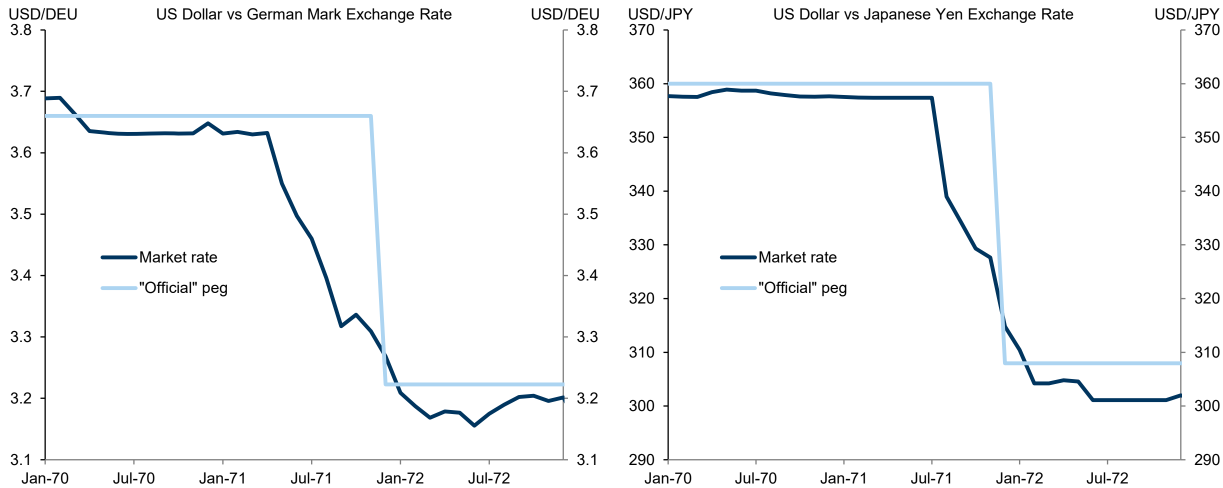
With little consensus on how an alternative to Bretton Woods would work and the need for FX stability, most countries continued to uphold the agreement for the time being. But continued support for the Dollar was not free; other Bretton Woods members were concerned about "importing inflation" by maintaining weaker currency rates. Eichengreen (1996) argues that foreign central banks—Germany in particular—were particularly fearful of inflation and concerned that the Vietnam War would cause the US to subordinate control of price pressures to other goals.[2] Eventually in the spring of

[1] Around this same time, President Nixon also pressured Federal Reserve Chairman Arthur Burns to pursue more aggressive monetary policy expansion. In return, Chairman Burns encouraged President Nixon to avoid fiscal expansion that would result in higher interest rates. See for example Abrams, Burton, A. 2006. "How Richard Nixon Pressured Arthur Burns: Evidence from the Nixon Tapes." Journal of Economic Perspectives, 20 (4): 177–188.

[2] There is disagreement about this point. Some academics argue that the BoP deficit and excessive spending led to a crisis of confidence in the Dollar that put downward pressure on USD. Eichengreen (1996)

1971, these pressures and fears accelerated Dollar flight and forced a number of countries, including Germany and Japan, to break the established Dollar pegs in favor of floating arrangements. Upon breaking away from Bretton Woods, these currencies appreciated rapidly against the Dollar. In other words, market pressures were already forcing the Dollar weaker before it was officially revalued in the Smithsonian Agreement (Exhibit 3).

Exhibit 3: Before the Smithsonian Agreement established currency pegs were already under pressure, with various countries having broken those pegs



Source: Irwin (2012), IMF, Haver Analytics, FRASER, Federal Reserve Bank of St. Louis, Goldman Sachs Global Investment Research

Afraid of the "loss of prestige" associated with unilaterally devaluing the Dollar, but facing mounting fears of dollar flight and a run on gold reserves that the US would be unable to supply, President Nixon and Treasury Secretary Connally theorized that they could force other countries to revalue their currencies instead. At Camp David on August 13, they decided to end the Dollar's convertibility with gold, and impose a 10% surcharge on goods imports to pressure foreign officials to re-peg to the Dollar at weaker levels. Once the new exchange rates were negotiated, and the "unfair" ones ended, the administration would remove the surcharge. President Nixon and Secretary Connally surmised that forcing other economies to revalue would allow the US to place the burden of adjustment on foreign countries, without the embarrassment of "devaluing" or potentially injuring US growth by raising rates.[3]

However, while this choice ostensibly "saved face," it was not without costs. This "revaluation" was simply a devaluation by another name. Market pressures had already forced the Dollar weaker, and the administration had few choices to avoid a full-blown balance of payments crisis. While markets continued to force numerous, now floating, exchange rates away from their "official" parities, formal revaluations were not established until the Smithsonian Agreement was completed in December. In the end,

disagrees, noting that there were few signs that the deficit was excessive; rather inflation intolerance and fears of importing growing price pressures from the US led to the decisions to float away from the Dollar.

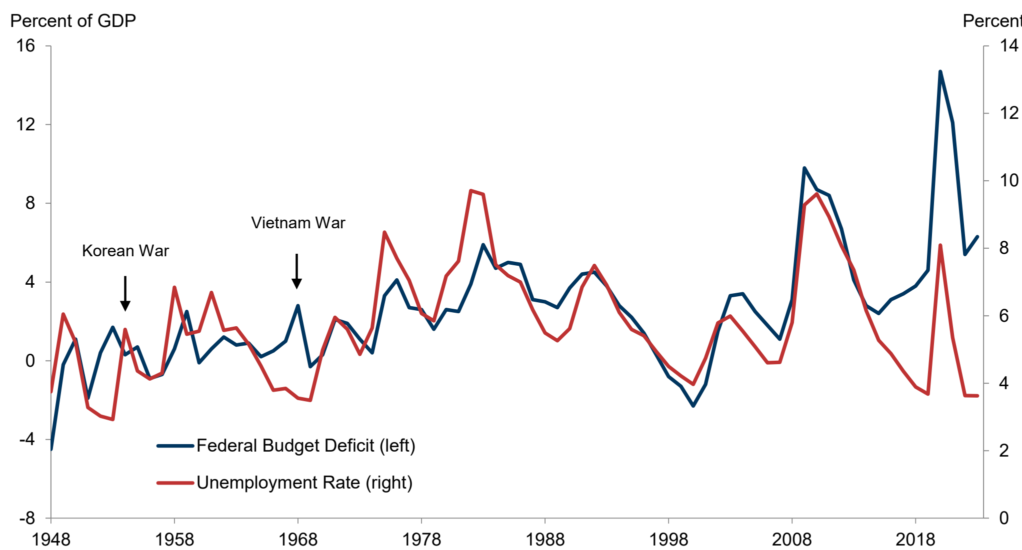
[3] Treasury Secretary Connally famously said to a group of foreign ministers around this time that the Dollar might be "our currency, but it's your problem." The Smithsonian Agreement undeniably exemplifies that mindset.

the Dollar was devalued by nearly 9% against gold, and the surcharge was quickly removed. Consistent with the size of the US's bilateral trade deficits, Germany and Japan were forced to revalue more significantly than other countries, such as Italy and Sweden. The Agreement lasted only a few years; it collapsed in February of 1973.

The Current Backdrop: History rhymes, but doesn't repeat

Many of the conditions that bred the "Nixon Shock" are prevalent in the US and global economic backdrop today. The Dollar remains at the center of the international monetary system as the world's reserve currency. Current account imbalances are even larger today, and a weaker Dollar could, in theory, support changes in that imbalance (though it is unclear that they are economically necessary). The US budget deficit has grown, and fiscal spending is expected to rise under a potential Trump victory (Exhibit 4). Critically, policymakers hoping to advance protectionist legislation in the US seem tempted by the "free option" of influencing exchange rates rather than implementing changes to domestic conditions—much like they were in 1971.

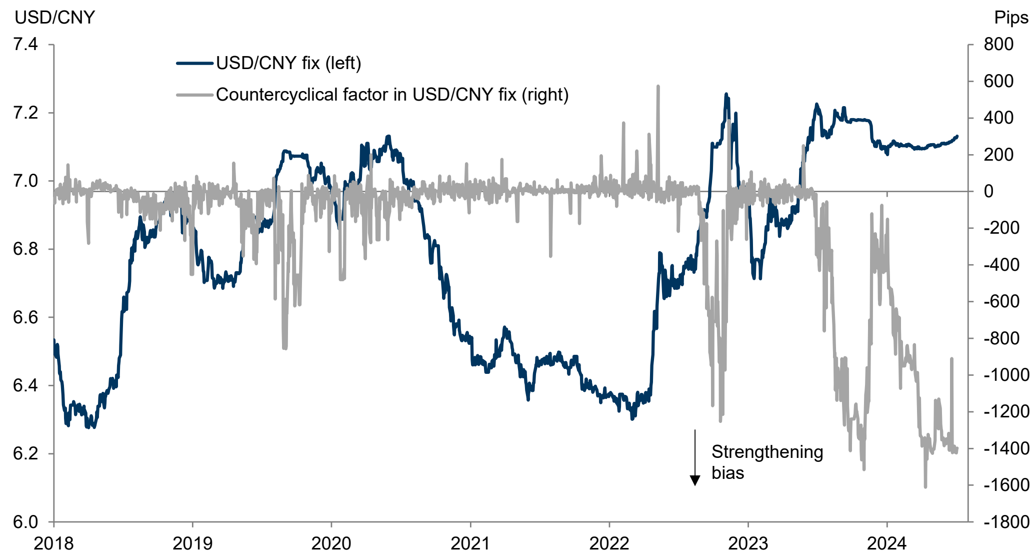
Exhibit 4: Current fiscal spending is even more elevated now, and expected to grow under a Trump White House with a unified government



Source: Haver Analytics, Goldman Sachs Global Investment Research

There are, however, important differences between today's environment and yesterday's backdrop. Most importantly, unlike the environment leading up to the Smithsonian Agreement, market factors are not pushing USD weaker. Rather, the Dollar has remained strong, and for CNY—the key constituent of the trade-weighted Dollar index—currency management is working *against* USD strength (Exhibit 5). The Smithsonian Agreement essentially realigned exchange rates with market forces, and policy intervention tends to be more successful when it aligns with fundamentals, but that would not be the case today.

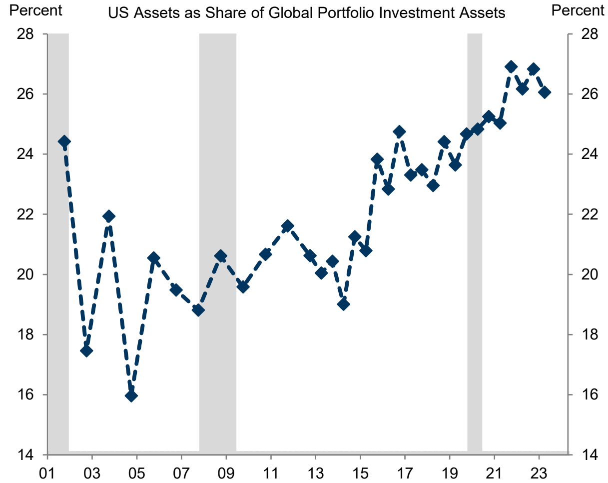
Exhibit 5: Market factors are pushing the Dollar stronger, and CNY currency management is working against further USD strength

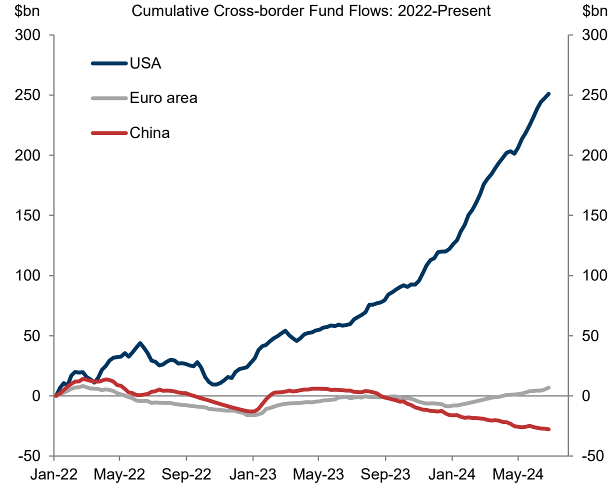


Source: Bloomberg, Goldman Sachs Global Investment Research

Unlike the early 1970's, there is no evidence of an ongoing run on Dollars or Dollar-denominated assets. In fact, foreign positioning in US portfolio assets is at historical highs, likely related to tech sector dominance in equity markets and elevated US risk-free rates (Exhibit 6, left). Recent flows exacerbated this trend, with US equity and bond funds attracting a much larger share of foreign demand versus the Euro area and mainland China, both of which have struggled to see foreign portfolio inflows (Exhibit 6, right). Highly competitive returns have made holding US equities and bonds especially attractive for foreign investors. The size of the deficit remains a concern for some policymakers and market participants as a potential reason for a future loss of confidence in the Dollar. Though the size of the fiscal deficit may be a reason to be worried about the Dollar's status as the world's reserve currency, the depth of the US capital market is also the foundation for the Dollar's dominance—deep and liquid capital markets are a key component of reserve currency status, and a factor that holds back many of the Dollar's challengers.

Exhibit 6: Foreign positioning in US portfolio assets is at historical highs and we see no evidence of a run on Dollars

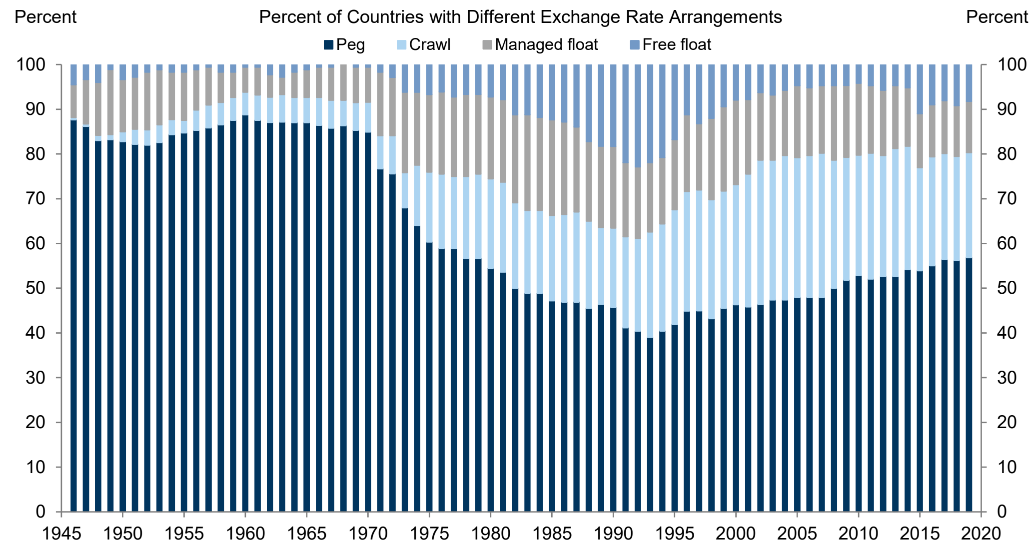




Source: CPIS, IMF, EPFR, Haver Analytics, Goldman Sachs Global Investment Research

In addition, the foreign exchange market today is very different from what prevailed in the 1970s and 1980s when sweeping currency pacts were more common. The global move away from pegged arrangements towards flexible exchange rates and—more recently—less aggressive foreign exchange reserve management should make the notion of currency "agreements" more challenging (Exhibit 7). In some ways, the factors that put pressure on Bretton Woods and led to the Smithsonian Agreement precipitated this change. The year of the Smithsonian Agreement marks a sharp drop in the number of pegged exchange rates; from 1970 to 2019 the number of hard currency pegs dropped from around 80% of exchange arrangements to a little over 50%. This likely understates the shift in FX market dynamics. While only 20% of currencies are floating today, EUR/USD alone accounts for almost a quarter of all FX trades, and USD/DM trading accounts for close to two-thirds of all transactions. While China's position on exchange rate management comes with some important nuances, Japan's recent experience with intervention offers some important caveats as well. Recent efforts to curb Yen weakness have been expensive, and resulted in only temporary deviations from trend, highlighting the difficulty of intervention when macro factors are pushing the exchange rate in the opposite direction.

Exhibit 7: There has been a global move away from pegged arrangements to flexible exchange rates

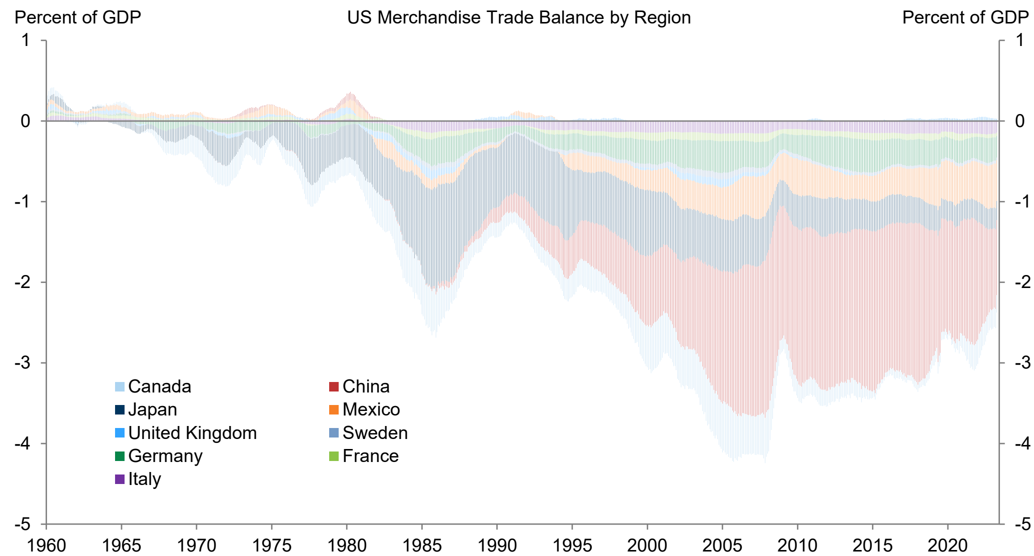


Each category describes various arrangements. Pegs: Countries with no separate legal tender, pre-announced pegs, currency boards, horizonal bands, and de-facto pegs. Crawl: Pre-announced and de-facto crawling pegs and bands. Managed float: Wider crawling bands, moving bands, and managed floating. Free float: Freely floating and freely falling. Chart uses end-of-year data.

Source: Ilzetzki et al. (2019), Goldman Sachs Global Investment Research

Current trade relationships also differ from those in the period leading up to the Smithsonian Agreement. At the time, the US's deepest merchandise trade balance deficits were with **Canada, Japan, and Germany**, all of which were politically aligned with the US during the Cold War (Exhibit 8). Now, its biggest trade deficit is with **China, followed by Mexico**. If the countries involved in the Smithsonian Agreement were to revalue by the same amounts today (assuming a GDP-weighted average of Germany, Italy, and France as a substitute for the Euro area), the trade-weighted Dollar would only weaken by **3.5%.** In other words, the Yuan matters much more for the value of the Dollar today, just as China matters more for the current account balance. Without China's participation in a revaluation, it would be challenging for the Dollar to see material weakness. That said, with China already taking steps to stabilize the Renminbi, this is not an unreasonable expectation.

Exhibit 8: The US merchandise trade deficit has shifted from Canada, Germany, and Japan to mainland China and Mexico

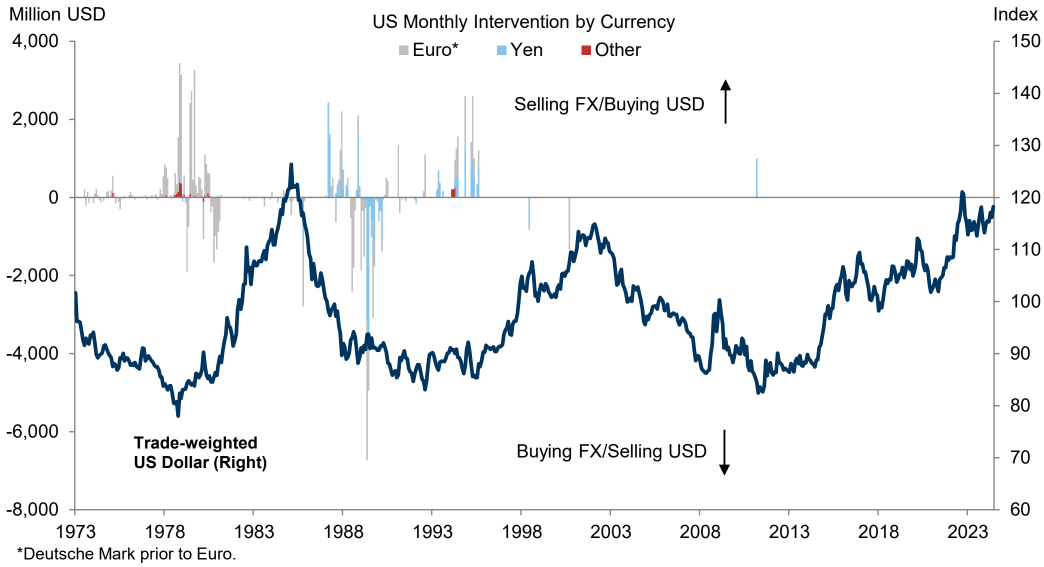


Source: IMF, Goldman Sachs Global Investment Research

Challenges to Tariffs & Currency Agreements: The list goes on and on

As it stands today, there are substantial challenges to seeing a new currency agreement. Some of these challenges though, are primarily conventions and surmountable political hurdles. However, others such as the required purchases of foreign debt and structural changes in the FX market are greater obstacles, and demonstrate the ways that FX policies of the 70's and 80's are not applicable today. First, on only very rare occasions has the US entered into bilateral or multilateral currency arrangements in the last 30 years. It has participated in coordinated intervention only three times since the mid-1990s around special circumstances, most recently after the 2011 earthquake in Japan (Exhibit 9). The US has generally avoided using intervention as a policy tool, and it has largely gone out of fashion as many governments have switched to flexible arrangements to better tailor monetary policy to domestic factors.

Exhibit 9: US intervention in the Dollar has become rarer in the last 30 years

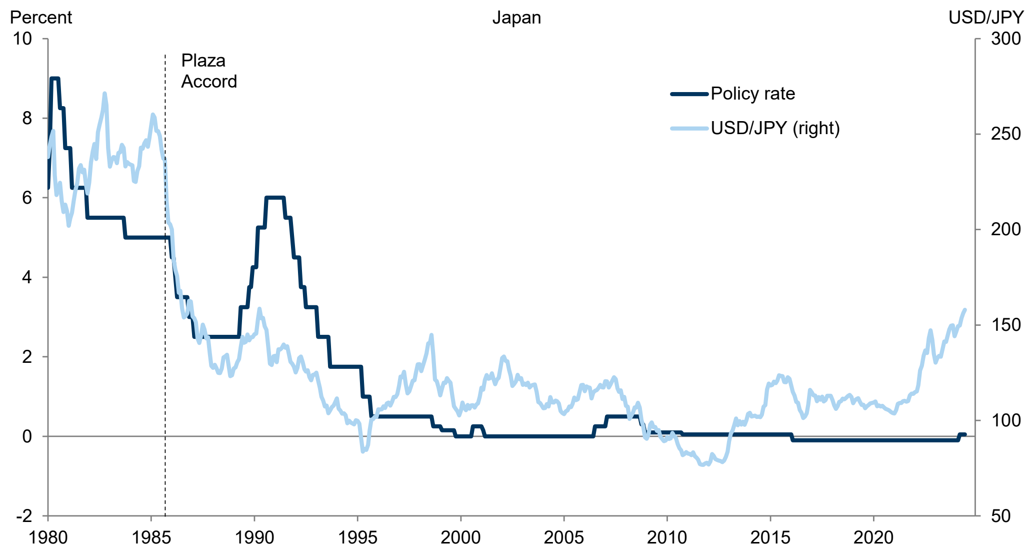


Source: Domestic sources, Bloomberg, Goldman Sachs Global Investment Research

Second, the US Treasury has taken a firm stance against foreign currency intervention against the Dollar. In fact, the Trump administration labeled China, Switzerland, and Vietnam "currency manipulators." More recently, the Biden administration used the Treasury's exchange rate report to remind Japan that "intervention should be reserved only for very exceptional circumstances." Intervention to weaken the Dollar versus CNY and JPY could be mutually agreeable to some extent, but might weaken the US' negotiating position in other currency matters. The US regularly reminds its trading partners of existing G-7 and G-20 commitments to maintain market-determined exchange rates and intervene only to curb excess volatility. It is also possible that tariffs and intervention could erode the Dollar's reserve currency status over time, as both can introduce volatility and damage existing trade relationships.

Third, large FX appreciation could be unpopular with other regions struggling with weaker growth than the US. Japan's struggles with rapid Yen appreciation following the Plaza Accord serve as a cautionary tale for other trading partners. In order to offset the negative economic impact of a stronger currency, the BoJ was forced to conduct aggressive easing to prop up the domestic economy (Exhibit 10). Although there were a number of other important factors, the easing augmented existing asset price bubbles. A little over a year after the BoJ began hiking in 1989, the bubbles collapsed, exacerbating the negative impact on the economy. As we have discussed before, rapid currency fluctuations are not seamless. They can, for example, cause substantial earnings volatility for firms that hedge foreign currency exposures and cause inflation swings. These factors would likely push both private and official actors to caution against large policy changes that cause extreme adjustments in major exchange rates. Indeed, this is one reason why official G-7 and G-20 policy has been to contain FX volatility—not encourage it.

Exhibit 10: The BoJ was forced to ease policy to prop up the domestic economy due to the negative impact of JPY appreciation following the Plaza Accord

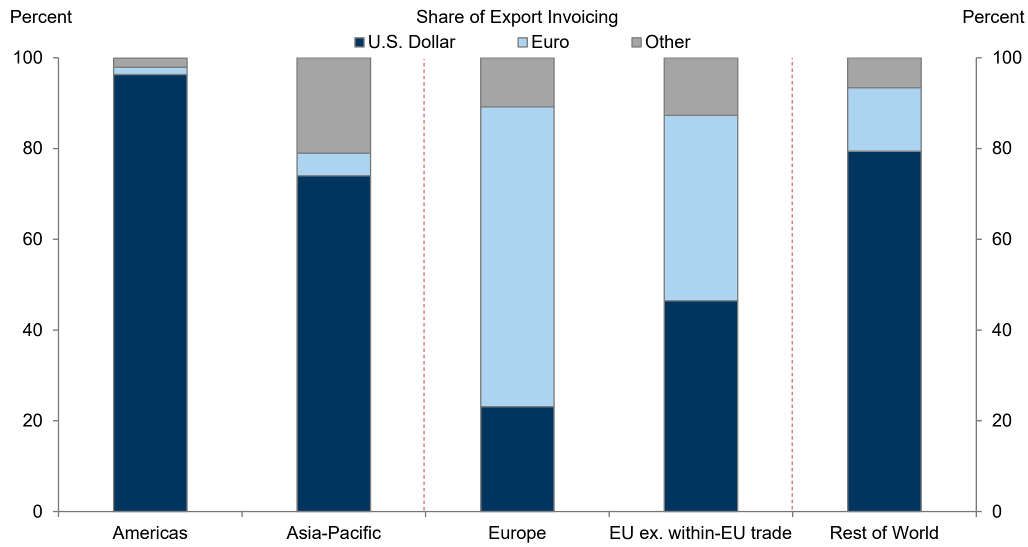


Source: Bank of Japan, Haver Analytics, Goldman Sachs Global Investment Research

Fourth, intervention of this kind would need to involve some uncomfortable tradeoffs regarding reserve management. US intervention would have to involve the Fed's balance sheet, and likely require the purchase of CNY assets, both of which come with some practical limitations, including capital controls and a limited number of investible assets, and additional geopolitical implications regarding the US official sector purchasing Chinese assets (see here and here for a more detailed discussion). In both China and beyond, there is an operational question of whether the US wants to hold foreign reserves in less-liquid (and potentially lower-rated) assets. On the international side, China and Japan have substantial holdings of Dollar assets, but an agreement would imply that the US would be encouraging foreign officials to sell a meaningful portion those holdings.

Finally, the Dollar denominates the vast majority of global trade, exceeding its share of global imports by most measures (Exhibit 11). This is one of the key reasons for the Dollar's dominance and status as the global reserve currency. However, this means that devaluing the Dollar would do little in the way of making US exports cheaper versus those of other countries. Fundamentally, FX valuation is less important for the US than it is for other countries because the US is a large, relatively insulated economy that trades almost exclusively in its own currency. From this perspective, US gains from a weaker Dollar would be relatively limited, and in our view makes all the trade-offs listed above even less palatable.

Exhibit 11: The Dollar denominates a large share of global trade



Value for Europe includes within Euro area trade.

Source: Bertaut et al. (2023), Eurostat, Goldman Sachs Global Investment Research

Today's Takeaways: Where there's a will…

Former President Trump and his associates continue to float tariffs and Dollar devaluation to gain a protectionist edge in global trade. However, there are challenges to this policy and factors that make it less tractable than it was in the 1970s and 1980s. Macro factors continue to push the Dollar stronger, not weaker, and intervention in this type of environment is challenging. In addition, large shifts in the US trade balance mean that intervention today would require a greater degree of cooperation with China and Mexico, rather than historic trading partners in Europe and Japan. Importantly however, the US shares a "coincidence of wants" with several of its largest trading partners: China and Japan would both prefer a somewhat stronger currency, and it is very plausible that some countries could respond to prospective tariffs with policy steps to offset the currency impact. However, a much stronger Yen could thwart Japan's inflationary efforts, and likewise, a much stronger Renminbi may not ultimately be in China's interest either.

Coordination could probably bring this about—but it is unclear that a currency pact is the best or most practical option. Tariffs could be used as a negotiating tool, but the potential Trump administration has floated competing uses for tariffs rather than a united message towards this particular end goal. The Republican party platform proposes using tariff revenues to lower domestic taxes, and advocates for maintaining the Dollar's reserve currency status. In different ways, both of these proposals are at odds with a major currency pact like the Smithsonian Agreement or Plaza Accord.

Given these challenges, we think a unified and meaningful currency agreement looks unlikely. However, with tariffs clearly on the agenda, the US will continue to encourage other countries to take steps to rebalance global trade. Recent Treasury reports under both the Trump and Biden administrations have advocated for fiscal expansion in places like China and Europe. And US fiscal consolidation would be a helpful step, even if it is unlikely on our estimates. We think this combination of more balanced fiscal policy is a more plausible and productive path to rebalance global trade and weaken the Dollar.

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