Political Economy Series No.5

Clark Johnson

Uncommon Arguments on Common Topics

Essays on Political Economy and Diplomacy

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Clark Johnson
USA

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ISBN: 978-625-7501-75-0 (e-Book)
KSP Books 2022

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Essays on Political Economy and Diplomacy

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Preface

Much of the credit for this open-access book should go to Bilal Kargi, the Editor of KSP Journals and KSP Books. KSP Journals has published several of my articles on economics and diplomatic history, including in the *Journal of Economics Library*, the *Journal of Economics and Political Economy*, the *Journal of Social and Administrative Sciences* and the *Journal of Economic and Social Thought*. Bilal asked me in late summer 2021 if I would put these articles and others that had appeared elsewhere, or that I might want to publish for the first time, into a collection. I told him I would consider it – noting that past articles would need revisions if they were to appear again, and to have a longer shelf-life. I heard back from him within a day or two advising me that he was "waiting impatiently" for my Word updates. The collection here also includes "A different Cold War? The European Settlement of 1963 and Aftermath" and "Inflation Policy, 2022: Background," both of which I have prepared during the last few months.

I wrote decades ago on the causes of the Great Depression, emphasizing the roles of both the post-WW1 undervaluation

of gold and the deflationary policies of the Federal Reserve and, even more, of the Bank of France. Since publication of *Gold, France, and the Great Depression* (1997), we have seen the Asian crisis of the late 1990s, the Great Recession of 2007-2009, a subsequent decade of slow growth, and the pandemic and subsequent inflation of 2020-2022. Contents here include comments on each of these. I also became interested in theoretical issues involving monetary and fiscal policy, especially as they appear in J.M. Keynes and in Robert Mundell. Elsewhere, it has loomed for me as an unfinished task to understand better why Cold War events, including Berlin and Vietnam, unfolded as they did. I include two papers here that are clarifying, including of the roles of US and international leaders. Finally, I spent years working on economic development and political reconstruction in the Middle East and central Asia, and include observations on what happened there and what should have been done differently.

In about 2009, I sent a note to Mundell observing that occasions Keynes cited in his *Treatise on Money* (1930) as evidence of monetary policy failure were anything but that. In the cases discussed, Keynes mis-interpreted or overlooked evidence. This matters because Keynes' arguments then and later for fiscal intervention to overcome economic slowdowns followed similar inadequate summaries of monetary history. Mundell encouraged me to "write it up." With delay, my article "Did Keynes Make His Case?" followed – and is included here as Chapter 1. It turns out that Keynes' deeper argument had less to do with monetary economics (to which he made large contributions) than with doubts about capitalism and financial markets. These were frequent concerns during the depressionary Thirties; they led to much confusion, which unfortunately Keynes abetted, about the workings of monetary economics.

Mundell's monetary and fiscal "policy mix" arguments have important implications for macroeconomic policy. Going back to the early 1960s, Mundell's analysis was usually invoked – including by himself – in favor of the "supply-side" mix of tight money and easy fiscal policy, the last to include lower

tax rates. The tight money/ easy fiscal mix was intended for a situation of stagflation – slow domestic growth, rising unemployment, and rising prices. But, as outlined in Chapter 2, there is a larger symmetry in the policy mix framework. Under conditions of low inflation and a rising national currency, easier money might be appropriate; and with monetary expansion, tax cuts would mean either over-heating or redistribution in favor of those with more income or wealth. The Trump tax cuts of 2017 came in a macroeconomic juncture for which a supply-side remedy was not suitable.

In Chapter 3, I review Scott Sumner's *Midas Paradox* (2015), which is an informative study of the course of the Great Depression in the United States, especially from Roosevelt's accession to power in March 1933. Sumner wanted to use the title *Midas "Curse"* – to emphasize the workings of the international gold standard that generated the monetary contraction that became the Depression – but his publisher rejected that title as too edgy. He argues that the Depression lingered because the US kept reverting to deflationary monetary doctrine, while left-Rooseveltian forces were simultaneously advancing agenda of unionization and higher minimum wages (the policy combination squeezed aggregate demand, investment, and employment.) Sumner's macroeconomic argument, which he supports with abundant data, is quite strong; it is a stand-alone contribution to the literature. But there was more to the Roosevelt experiment: there was groundbreaking redistribution of income to those in lower brackets through the decade – all co-existing with measurably large productivity gains at the time. I used the review to consider some causality in the origins and persistence of economic slump that lasted for most of a decade, and to revisit, along with Sumner, arguments on what Keynes might or might not have gotten right.

The germ of Chapter 4, "A Different Cold War?" was a stray mention in John Mearsheimer's Tragedy of Great Power Politics (2014) that Eisenhower wanted to withdraw US forces from Europe during the middle-1950s. Eisenhower's intentions led to near panic by those around Khrushchev in Moscow, who feared that US withdrawal would greenlight West

German nuclear ambitions. Khrushchev responded with a succession of ultimatums over Berlin, the first in November 1958. Meanwhile, the Eisenhower administration undertook interventions in Cuba, Laos and the Congo; in a word, Eisenhower left a breathtaking foreign policy mess by the end of his second term in January 1961. Under Kennedy's subsequent oversight, the US, Soviet Union, UK and West Germany constructed a European Peace by mid-1963 that would stabilize an ongoing US role in Europe, with the self-enforcing understanding that there would be no German nuclear weapons, and no Soviet-driven changes to the status-quo in central Europe. The peace lasted into the 1990s, when its breakdown led to wars over Ukraine in 2014 and 2022. Puzzlingly, the 1963 peace was little understood at the time, or since, even by such foreign policy luminaries as Hans Morgenthau and Henry Kissinger. As Europe was stabilizing, time was right to dial down tensions elsewhere, including on the world's political periphery – meaning that central Africa, Indochina, and even Cuba could be taken off the Cold War chessboard. Khrushchev and DeGaulle were Kennedy's sometime collaborators in this effort. But when Kennedy, and then Khrushchev, left the scene in late 1963 and 1964, many policy patterns reverted back to where they had been under Eisenhower, and the "containment" concept (which treated events everywhere as part of the chessboard) was re-booted.

The write-up that became Chapter 5 began as a review of Niall Ferguson's (2015) biography of Kissinger. Ferguson's perspective reflects what a researcher gets from perusing box loads of Kissinger's left-behind documents, and is largely sympathetic to its subject. But information gathered in Ferguson's long account nevertheless supports a more skeptical view of Kissinger's legacy. Ferguson reports that Kissinger was ready to use nuclear weapons over Berlin, and again during the 1962 Cuban missile crisis. Ferguson defends Kissinger as having some deep difference with the premises or manner of the Johnson administration's build-up in Vietnam during 1963-1968; but this reader found that most of Ferguson's evidence pointed otherwise, to Kissinger's shared assumptions with and reliable public support for Johnson's

Vietnam policy. Ferguson argues that Kissinger was not the "realist" he is often taken to be, but was – at least during the 1950s and 1960s – a "Kantian idealist." This distinction advances little, as there is no inconsistency in being both a foreign policy realist and an epistemological idealist. We would be on stronger ground in concluding that Kissinger gave realism a bad name by malpractice of it. A revealing error in Ferguson's narrative is his acceptance of Kissinger's inaccurate assertion that Kennedy was adding US forces in Vietnam when he was assassinated in November 1963 – when, in fact, a US departure was underway. The inaccurate claim, and its echoes in other contexts, contributes to misreading an era of Cold War diplomacy.

Chapter 6 (June 2022) looks at the context of inflation in the US in 2021 and 2022. One take-away is that "broad" money quantity growth (ie, M3 or M4) reliably accompanies price inflation. But other potential monetary guideposts were also available for the Federal Reserve during 2021 and 2022, including average inflation targeting (AIT) and nominal income (NGDP) targeting. The Fed missed all of its plausible targets, at cost to its credibility; Chair Powell should consider resigning. The chapter also discusses whether fiscal borrowing in 2022 is likely to have inflationary consequences. The political economy circumstance of large US fiscal deficits is that world-wide demand for US treasuries is very high, and often exceeds supply; of itself, such borrowing should bring no pressure upon the central bank to buy up treasury securities.

The next two chapters consider economic theory related to understanding the financial crisis and Great Recession of 2007-2009. Chapter 7 offers a myth-vs-reality format to address a number of public misconceptions about monetary policy and to explain that an expansionary policy would have facilitated a much more rapid economic recovery. A shorter version of the article appeared in the *Milken Institute Review* in 2011 and was well received among economics bloggers; the somewhat longer version here includes discussion of ECB policy and the near-depression that occurred in Greece. Chapter 8 looks at unraveling of "monetarist" premises

starting from the early 1980s and moves to more recent reassertion of essentials of monetary analysis. NGDP targeting has emerged as a credible successor to earlier frameworks. The chapter concludes with evidence that the financial crisis simmering into mid-2008 was triggered by balance sheet and counterparty risk; but subsequent to that, monetary contraction – more than the banking crisis – deepened the economic slump.

In Chapter 9, I recount some of the history of the financial crisis that erupted in Mexico in 1995, followed two-and-a-half years later by crises in Thailand, South Korea, Indonesia, Malaysia and the Philippines, and then in Russia and, going into 1999, in Brazil. The IMF, and others – including many economists -- treated the crises as monetary and (especially) fiscal events, best treated by currency devaluations, budget cuts and tax increases. Financial markets disdained that diagnosis, with sell-offs greeting each announcement. Instead, all were balance sheet crises, caused by mismatches of short-term liabilities against long-term assets and of foreign hard currency liabilities against domestic currency assets. An important consequence of the crises was the effort by emerging market monetary authorities over the next decade to augment FX reserves – roughly the sovereign equivalent of adding long-term capital to financial institutions. A message here is that a crisis must be properly diagnosed before it can be remedied. There is also a reminder that economic cycles do not always reflect monetary events; as with the 2007-2008 financial crisis, capital structure matters.

Most of the remaining chapters took root during my time in-theatre as a civilian in Iraq and Afghanistan during portions of 2003-2014. Of both venues, I retain disappointment that the US government, whether in its military, diplomatic or advisory roles, was unable to incorporate new understanding, or new information, into mission-wide strategies. In Chapter 10, "Missing Economic Strategy in Iraq," I outline phases of mission planning, and with them de-escalation of expectations, for a vision of a future Iraq economy less dependent upon oil exports. By the time of our 2009 Joint Campaign Plan, our unclassified

Economic Annex comprised a bottom-up patchwork, nearly all of it boilerplate, which included a paragraph or two for each Washington bureaucracy with enough on-site visibility to be considered a stakeholder. My narrative, originally published in *Small Wars Journal* (2016) works through some of the story of how very little got done. Chapter 11 republishes a short article, "...Bad advice, misdirected policy," that originally appeared in the Iraqi journal *Dialogues* in 2009. In the article, I outline three areas that should have been part of any development and diversification plan for Iraq: monetary stabilization against a hard currency; generating access to enterprise finance outside of conventional banking; and, reinforcing the last, advancing legal recognition of property rights.

Chapter 12, on the "virtual economy" in Kyrgyzstan, was an internal memorandum, prepared in 1999 for the Prime Minister's Office on behalf of the Asian Development Bank. It summarizes what the "starting point" for economic development in a former Soviet republic must be – one where enterprise profits scarcely existed, and where legal structures, including enforcement of laws of contracts, were mostly absent.

The final two chapters are reprints of articles, with minor changes, on the US/NATO war in Afghanistan. The problems start with the manner of US engagement: military and diplomatic personnel were rotated in-and-out on time frames too short to enable understanding a complex and utterly different culture. DoD and NATO took the lead in-theater, with predictable focus on military rather than political factors; rather than challenge military premises, or seek to advance awareness of political complexities of Afghanistan, State Department diplomats usually deferred to military judgements. Then, based on what I heard from diplomats, and even more from soldiers, Washington headquarters treated assignment in-theater as a box to be ticked-off, generally not as high-priority in Home office. With that, it is hardly a surprise that we spent year after year, for nearly two decades, trying to fulfill the development agenda most familiar to Westerners. We sought to build a central government in

Kabul – placing our bets that the population would treat it as legitimate, while doing very little with provincial-levels officials, or with tribal and religious leaders. Opportunities to expand our network of allies (which, according to Clausewitz, is a key to winning wars) were wasted, indeed were scarcely acknowledged. Chapter 13 on the "Missing Political Front in Afghanistan" appeared first in *Small Wars Journal* (2015). It outlines cycles of war that we never interrupted. Chapter 14 is a rerun of a short article from July 2021 advising the US and NATO, once again, to look for ways to stabilize the Afghan situation even as the government in Kabul was about to collapse. The 2021 piece explains that the US had little national interest in the outcome in Afghanistan, and probably never did, and that this premise would drive Biden administration policy. There was surely no reason to expect what had been elusive since 2001, or earlier: a wiser approach within Afghanistan. When I looked again at the article prior to including it here, I decided that I had little to add in an Epilogue.

Is there a common theme in papers collected here? I think it is a conviction that we can do better in setting and implementing public policy. The pattern runs from mission strategy in war zones, to using monetary policy and capital structure to stabilize economic performance, to understanding the historical dynamics of Cold War and containment.

Clark Johnson
18 June, 2022
USA.

1 Did Keynes make his case? *

Much popular and academic commentary in the years after 2008 stoked fear that aggressive monetary policy would work too well, and hence would trigger accelerated price inflation. But by 2016, very few central banks had met even their modest inflation targets, despite well-publicized use of "unconventional" monetary expansion in the US, Britain, Japan, and the Eurozone. Inflationary fears were misplaced.

Meanwhile, many self-identified Keynesians argued, much to the contrary, that effectiveness of monetary policy would be sharply constrained under recessionary conditions. Lawrence Summers, who was President Obama's chief economist during 2009-2010, and who continued afterward to be a frequent advisor, called upon the US and other governments to increase borrowing at very low interest rates (Summers, 2012). Paul Krugman has made similar arguments in his *New York Times* columns. Both economists argued that

* An earlier version of this paper was published in the *Journal of Economics and Political Economy*, March 2016, and in *Lars Christensen's The Market Monetarist* blog in 2012.

governments should look on such rates as an opportunity both to boost government demand in the short period and to improve their fiscal balance in the long-term.

Their deeper argument was that monetary measures would do little to stimulate the US economy in the wake of the sharp 2008-2009 downturn. Summers wrote repeatedly that there was no point in "quantitative easing," the prominent open-market mechanism the Federal Reserve uses to inject reserves, as interest rates were already rock-bottom – his premise is that monetary easing works only through the mechanism of lowering interest rates (Summers, 2012). Presumably, this is what he for years told Mr. Obama.

Krugman has argued since 2008 that the US has been in a liquidity trap, which Keynes defined as a condition where "almost everyone" prefers holding cash to lending (Keynes, 1936, p.207). Krugman believes Keynes' view of the dynamics of depression is superior to others, and has in his columns tirelessly expounded the case for increased government spending to offset slack spending in the private sector. Keynes (1936, p.317) similarly argued:

> It is the return of confidence, to speak in ordinary language, which is so insusceptible to control... This is the aspect of the slump which bankers and business men have been right in emphasizing, and which economists who have put their faith in a "purely monetary" remedy have underestimated.

I believe Keynes was, and Summers and Krugman are, mistaken. Let us consider real-history evidence Keynes himself cited against effectiveness of monetary policy; it is much weaker than he and his followers have thought. I will then return to his liquidity preference and other arguments offered in the *General Theory* and elsewhere – the coherence of the arguments themselves should be considered. It turns out that the weakness of Keynes" examples reflects not merely careless use of evidence, but flaws in underlying concept.

Keynes's real-history illustrations

A portion of Keynes" reputation as an economist, and of his place in history, rests on his diagnoses of crisis situations

and his proposed remedies. Well-known examples include his tract on the post-World War One Versailles Conference, *The Economic Consequences of the Peace* (1921), and subsequent writings on hyperinflations and then on British deflation during the 1920s. Another, less well-known, was his discussion of French monetary and political crises during 1925 and 1926, which I credited in my own work on the period (Johnson, 1997; Chs. 5 and 8). His two-volume *Treatise on Money* (1930) provided detailed and often shrewd observations on a wide range of questions, with frequent comment on current and past economic events.

In contrast, the *General Theory*, the heart of Keynes' contribution to economic ideas, is light on historical or even contemporary illustration. So the reader seeks to fill the gaps by turning to other writings. Consider four prominent cases as they reflect on Keynes" view of roles of monetary and fiscal policy.

British deflation in the 1890s

An unexpected embrace of fiscal activism comes in the *Treatise* discussion of the deflation of the early 1890s, where Keynes argued that the Bank of England's gold reserves were abundant and credit was easy. But prices in Britain and the world nevertheless went into decline, which undermined profit and investment and reduced employment. He wrote:

> I consider, therefore, that the history of this period [1890-1896] is a perfect example of a prolonged Commodity Deflation – developing and persisting in spite of a great increase in the total volume of Bank-Money. There has been no other case where one can trace so clearly the effects of a prolonged withdrawal of entrepreneurs from undertaking the production of new fixed capital on a scale commensurate with current savings.

Keynes then concluded (anticipating his arguments a few years later, including in the *General Theory,*) that monetary expansion does not always work, and that there might therefore be a role for public investment projects to boost demand (Keynes, 1930, vol.2, pp.169-170).

Did Keynes make his case?

Keynes' discussion of the 1890s misses the point. Britain in the late nineteenth century was part of an open world economy, with easy movement of goods, people, and especially capital. Keynes neglected to mention that system-wide demand for gold rose much more than the supply from the 1870s through the mid-1890s as nearly two dozen countries adopted or re-adopted the gold standard, and hence needed to accumulate reserves. Two of the world's largest economies, the United States and France, also made growing use of gold coins. Indeed, demand drove the commodity-exchange value of gold to the highest level it was to reach in four centuries of record-keeping (Jastram, 1977) -- the flip-side of deflation of other commodity prices. The commodity price decline squeezed profits and chilled investment demand; but commodity prices were determined in international markets, not in Britain.

While demand for gold was surging, the world's monetary gold supply in the mid-1890s was at the lowest point it was ever to reach relative to its 1800-1920 trend line (Johnson, 1997; p.52[2]). As the mines in the South African Rand cranked up production in the 1890s, relative gold supply and commodity prices increased nearly in tandem after 1896 – thus ending the Commodity Deflation, and initiating a gentle inflation. A growing money stock affected not just the supply of credit (as reflected in a declining interest rate), but also the demand for goods and services. A result was nearly two decades of economic growth in all of the industrial powers, a pattern that was sadly interrupted by the First World War.

Monetary events were at the heart of both the origins of and recovery from the depression of the early 1890s. Keynes himself gave this backhand acknowledgement with his comment a few paragraphs later that "the fall of prices [in the early 1890s] could only have been avoided by a much greater expansion of the volume of bank-money." It is revealing that Keynes would discuss price deflation during that period without mentioning the geographic expansion of the gold

[2] League of Nations chart, reproduced in (Johnson, 1997). [2] (Keynes, 1924; pp.134-135) made a similar argument.

standard – easily the most important monetary event of the era.

The onset of the Great Depression

Moving to then contemporary events, Keynes' discussion of the "slump of 1930," an early stage of the Great Depression, also in the *Treatise,* builds on similar themes. While the US stayed on a gold standard throughout, most European countries left it early in WWI, then restored it during the 1920s. Economists Gustav Cassel, Ralph Hawtrey and Charles Rist had argued a few years earlier that the undervaluation of gold following restorations at prewar gold prices in Britain, France, Germany, and Italy would force world-wide monetary contraction. Keynes, in contrast, told the Royal Commission on Indian Currency in 1926 that central banks would adjust their currency reserve cover ratios if their gold stocks became inadequate - which allowed him to dismiss the danger (Keynes, 1989a; p. 482).[2] Keynes turned out to be wrong, as he underestimated what we might call the mystique of gold money, which would generate resistance to efforts to reduce gold ratios or to use foreign exchange as a gold equivalent.

Keynes listed factors driving interest rates higher during the 1920s: corporate borrowing for new industries; governments borrowing to pay reparations and war debts; central banks borrowing to add reserves as they restored gold convertibility; and speculators borrowing to buy shares of stock. He identified but was less able to explain the collapse internationally in anticipated returns on investment - what he would later call the marginal efficiency of capital - that occurred in the mid-1920s. As in considering the early 1890s, he did not connect the fall-off in real yields on new investment with systemic monetary constraint.

> For these [above listed] events, *though they had no bearing whatever on the real yield of new investment*, were a powerful influence on the market-rate of interest (Keynes, 1930, vol.2, p.379). (Italics added.)

Parallel to what happened in the 1890s, the middle and late 1920s saw a commodity deflation as restoration of gold standards led to a rise in demand for gold. Keynes wrote that

the only ways to boost demand for goods and services was by lowering interest rates, especially long-term rates – or, alternatively, by government fiscal activism. His explanation missed the underlying monetary problem: that improved returns on investment would require more liquidity, either through a higher gold price to restore gold-to-currency reserve ratios, or perhaps by abandoning the gold standard altogether.

The Roosevelt recovery in 1933

Keynes‟ comments in January 1934 on the monetary-fiscal mix in the US were baffling. In one of Roosevelt‟s initial acts as President in March 1933, the dollar was allowed to depreciate against gold – thus providing the higher gold price mentioned a moment ago. This was a momentous event in monetary history – the underlying cause of the interwar deflation had been removed, and the international gold standard was never to be restored with the same conviction. Keynes nevertheless wrote:

> One half of [Roosevelt‟s] programme has consisted in abandoning the gold standard, which was probably wise, and in taking various measures… to depreciate the gold value of the dollar… [But i]t is not easy to bring about business expansion *merely* by monetary manipulation. The other half of his programme, however, is infinitely more important and offers in my opinion much greater hopes. I mean the effort to cure unemployment by large-scale expenditure on public works and similar purposes (Keynes, 1989c; p.308).

This summary scarcely acknowledges the results of expansionary monetary policy undertaken in the US within the previous year. Dollar depreciation succeeded at least to the extent any advocate could have expected. Industrial production soared by 57 percent during March-June 1933, the first four months of the Roosevelt Administration – this was the one-off increase, not an annualized rate -- making up half of what had been lost since 1929 (Federal Reserve data). It was, and remains, the fastest rate of expansion in industrial production recorded over a four month period in the history

of the US. Yet Keynes apparently considered this event to be "infinitely" less important than the boost that might come from fiscal borrowing for public works programs.

Had the experiment continued a few months more, pre-crash production levels might have been recovered. Unfortunately, the NIRA (National Industrial Recovery Act), announced in July 1933, brought micro-policy changes that had the effect of stopping the recovery in its tracks. The NRA (National Recovery Administration), set up under NIRA, then negotiated specific sets of codes with leaders of the nation's major industries; the most important provisions were anti-deflationary floors below which no company would lower prices or wages, and agreements on maintaining employment and production. Within a short time, the NRA reached agreements with most major industries. In a sentence, the NIRA wanted to increase prices by restricting output rather than by increasing demand. Sumner (2015) provides several rounds of evidence for the contractionary impact of NIRA and subsequent New Deal policy.

Lest the above appear suspect as a garden-variety right-wing critique of New Deal economics, consider that Keynes himself pointed to the "fallacy" of the NRA approach. He noted in January 1934 that "rising prices caused by deliberately increasing prime costs or by restricting output have a vastly inferior value to rising prices which are the natural result of an increase in the nation's purchasing power." He added that it was "hard to detect any material aid to recovery in the National Industrial Recovery Act" (Keynes, 1989b; p.299). Within four months after the NRA was announced, industrial production had lost half of the gains recorded during Roosevelt's more successful initial months in office (Sumner, 2015; Table 6.1).

Here we are. We saw an historically unmatched recovery for four months during 1933, driven almost entirely by a decision to break the straightjacket imposed on monetary policy by the international gold standard. Keynes had been an able critic of the gold standard in the *Tract on Monetary Reform* (1924) and again in several chapters of the *Treatise*. The 1933 recovery was then stalled by micro-policies of which

he was explicitly critical. Yet Keynes seemed to dismiss data from this entire episode in his call a few months later for fiscal stimulus!

The 1937-38 contraction in the US

A few years later, Keynes disregarded evidence of the role of monetary policy in triggering a sharp relapse into near-depression conditions in the US during 1937-1938. The dollar depreciation of 1933 and the formal increase of the gold price to $35/ ounce in 1934 meant automatic revaluation of central bank gold stocks and gave impetus to increased gold exploration and production – concentrated, as it happened, in the Soviet Union. (Keynes noted the irony that increased Soviet efficiency in mining of gold was bailing out world capitalism!) He also noted that new gold reserves were bringing increased effective demand to the world economy that might result in "abnormal profits" (Keynes, 1989d). Keynes sometimes acknowledged the role of monetary factors in the economic recovery of the mid-1930s.

In a major policy mistake, the US Treasury responded to rising wholesale prices in 1936 by deliberately sterilizing new gold inflows. In this process, dollars issued against new gold were drained by sales of other central bank assets. A money supply measure, M2, that increased by 12 percent annually during 1934-1936, suddenly turned flat and even slightly negative from about January 1937 to July 1938 (Irwin, 2012). Real GDP fell by 11 percent during this period, and industrial production fell by 30 percent. Rather than sterilize incoming gold, had the Fed intervened in financial markets to target a modest rate of increase in any of a number of variables – a money supply indicator, a price index, industrial production, or either real or nominal GDP growth – much or most of the 1937-1938 contraction could have been avoided. By April 1938, sterilization was discontinued, and economic recovery resumed by that summer.

In February 1938, Keynes offered advice in a private letter to President Roosevelt that mentioned little of this. He did acknowledge that addressing "credit and insolvency

problems" was an essential step toward recovery, as doing so would create a necessary "supply of credit" – while, one infers, demand for that credit would have to come from elsewhere. This comment reflected Keynes' more frequent 1930s view that expected returns on investment – and demand for goods and services generally – were not much affected by monetary factors. He went on to recommend that the US could "maintain prosperity at a reasonable level" only through "large-scale recourse to… public works and other Investments aided by Government funds or guarantees" (Keynes, 1989f).

Despite Keynes' recommendations, the lesson of *all four* of the illustrations here is that increasing money balances – through central bank open market purchases, or through new gold or foreign exchange reserves – *does* affect expected returns on investment in plant and equipment, in equities, and in real estate.

Arguments for fiscal activism

We could stop here, having assembled evidence of Keynes" doubtful conclusions about the role of monetary factors in specific pivotal events. Indeed, evidence from these cases points strongly in the opposite direction, toward recognizing the crucial role of such factors. Summers', Krugman's, and other Keynesians' argument that monetary policy is ineffective in environments of weak demand is undermined. But the prominence of Keynes' fiscalist legacy requires that we go further. Evidence aside, what was Keynes' argument? In fact, he had a sequence of arguments.

In 1929, Keynes offered a comparative argument in favor of fiscal stimulus, and against monetary stimulus, specific to economic circumstances in Britain at the time (Keynes, 1931; p.124). Keynes anticipated a portion of an argument Robert Mundell was to make decades later regarding the "policy mix," that is, the appropriate mix of monetary and fiscal policy to meet both domestic output and external exchange rate targets (Mundell, 1971). Britain in 1929 was on the international gold standard, hence was constrained externally by the need to maintain gold reserves. The Bank of England could not simply

create credit, because, Keynes reasoned, "such credit might find its way to foreign borrowers, with the result of a drain of gold out of the Bank." (More generally, a country loses control over monetary policy under fixed exchange rate conditions (Mundell, 1963). Hence, Keynes proposed fiscal stimulus to increase domestic demand and employment, alongside monetary constraint to maintain Britain‟s reserve and exchange rate targets.

This well-grounded argument also offers possible insight into the economy of the early 1890s, where rising demand among central banks for limited gold reserves generated monetary contraction. Keynes, as we saw, did not make that argument – but we can construct it *ex post*. The best solution might have been some international agreement to increase demand by modifying the international gold standard, perhaps by raising the currency price of gold, or even by a return to bimetallism – boosting the stock of monetary reserves by adding silver (Friedman, 1992). Absent such creative adjustments in monetary policy, a purely national approach could have looked to a fiscalist demand boost. But the rush of gold from South African mines soon gave life to the prewar gold standard, making structural change unnecessary – and, indeed, associating the prewar gold standard with an age of lost prosperity in much popular memory.

Removing external constraints

Keynes soon abandoned this policy-mix argument. Unlike the case in Britain, the US in 1929 and 1930 was well-stocked with gold reserves. An expansionary US policy at that time could have eased monetary conditions world-wide, not just in the US. In March 1933, the dollar was floated against gold, hence removing any external policy constraint – as appreciation of the value of gold increased the value of the US' vast reserves. In Keynes' embrace of public works spending from January 1934 (above), he had shifted ground from his 1929 advice. His newer interest was to argue that fiscal

activism was preferable to monetary expansion even if the latter was *not* constrained.

In Chapter 15 of the *General Theory*, "Incentives to Liquidity," Keynes offered the argument that monetary policy was specifically unsuited to boost economic demand when interest rates approached zero percent. In conditions where interest rates could not be lowered further, Keynes reasoned, a condition of "absolute liquidity preference" held. He observed, "In this event, the monetary authority would have lost effective control over the rate of interest" (Keynes, 1936; p.207). This "liquidity trap" argument is cited endlessly by latter-day Keynesians in support of a fiscalist agenda.

The argument is misleading. The one example Keynes provides for the possible existence of such absolute liquidity preference involved open market operations in the US during 1932, which, it has been asserted, did nothing to boost domestic demand. But was this because monetary expansion ran into a liquidity trap? In fact, the boost to US domestic money was offset by a loss of gold reserves, in part through private hoarding. Keynes' argument also overlooked the possible effect of gold outflow from the US in boosting demand elsewhere. In any event, the real story in 1932 was of a gold standard constraint on the supply of money, it was *not* a story of unquenchable demand for liquidity (Sumner, 2015; p.147).

Keynes' liquidity trap argument establishes much less than he needed. Keynes did not mention zero-bound interest rates as a constraint in *any* of the four situations discussed earlier – yet he called for fiscal stimulus in *all* of them. His case against monetary activism went well beyond situations of absolute liquidity preference; but as we will see in a moment, monetary policy can work even then. Much of Keynes' vision for government intervention, including fiscal activism, follows from his discussion of the fickleness of financial markets (Keynes, 1936; Ch.12). Observing the instability of private sector investment volume, he advocated a larger role by the government in stabilizing investment demand, often through direct outlays.

Keynes' argument shifted from the instability of the investment function to concern that investment was and would remain chronically weak – and hence to the conclusion that high unemployment was not self-correcting, but could persist for years. As noted earlier, Keynes in the *Treatise* pointed to a collapse in the marginal efficiency of capital as the trigger for both the depression of the 1890s and for the "slump of 1930." In Chapter 17 of the *General Theory*, on the "Essential Properties of Interest and Money," Keynes (1936; p.236) similarly noted situations where:

> …[the] rate of interest declines more slowly, as output increases, than the marginal efficiencies of capital-assets measured in terms [of the same asset].

As formulated in one of several instances in Chapter 22, "Notes on the Trade Cycle":

> A more typical, and often the predominant, explanation of the crisis is, not primarily a rise in the rate of interest, but a sudden collapse in the marginal efficiency of capital (Keynes, 1936: p.315).

This pattern of falling marginal efficiencies of capital was at the core of Keynes" increasing skepticism about monetary remedies.[3]

New money and effective demand

Keynes usually argued that monetary policy worked mainly through raising or lowering interest rates – this was certainly a premise of the liquidity trap argument. Further on in the *General Theory*, he wrote that "the primary impact of a change in the quantity of money on the quantity of effective demand is through its effect on the rate of interest" (Keynes, 1936; p.298). In the earlier *Treatise* Chapter 37 on "Control of Investment," where he calls for open market operations *a outrance*, the object is to bring "the market rate of interest…

[3] Leijonhufvud (1981) offers a variation on this theme with the comment that in Ch. 37 of the *Treatise* "the assumption that entrepreneurs are right was dispensed with" – that is, entrepreneurs became, in Keynes "judgment, excessively bearish. Leijonhufvud argues that Keynes" subsequent arguments relied on fiscal intervention to overcome bearishness.

down to the limiting point (Keynes, 1930; vol.2, p.371).” Later, in 1937 articles on “finance,” where Keynes (1989e) stressed the crucial role of monetary policy in economic recovery, he again emphasized the channel of lowering interest rates.

Keynes’ interest rate argument is not credible. Monetary economics routinely identifies channels other than interest rates through which additional money creation can affect demand. For example, Frederic Mishkin, a former member of the Federal Reserve Board of Governors, has identified channels of exchange rates, financial asset prices, real estate prices, wealth effects on consumption, and increase in bank lending capacity (among others) through which demand can be increased (Mishkin, 1996). Pertinent here, Keynes himself sometimes rejected the interest rate argument to make the case that monetary expansion could boost demand directly.

For example, in Chapter 17 of the *Treatise,* on “Monetary Factors,” Keynes noted that monetary stimulus might bring together a previously “unsatisfied fringe of would-be entrepreneur borrowers who were ready to borrow… even at the old terms [i.e., without lowering interest rates], and … an unemployed fringe of the factors of production [i.e., workers] to offer employment to additional quantity of the factors of production.” In an additional impact, he wrote that “certain entrepreneurs may now be willing to increase their output even if this means making higher offers than before to the factors of production because (as the ultimate result of the influx of new money) they forsee profits” (Keynes, 1930; vol.1, pp.263-264). As Keynes here illustrates, the underlying goal of monetary expansion is to satisfy an unmet demand for money. The consequence may be to lower interest rates, but it may also work by directly increasing demand for goods and services, and for credit to purchase them.

The *General Theory* has comparable passages. In Chapter 11, on the “Marginal Efficiency of Capital,” Keynes linked changes in investment prospects to prior changes in prices. He wrote, “the expectation of a fall in the value of money [i.e., price inflation] stimulates investment, and hence employment generally, because it raises the schedule of the marginal efficiency of capital, i.e., the investment demand schedule”

(Keynes, 1936; pp.141-142). Consider that it is just this link between higher prices – as a result of the dollar depreciation -- and the large increase in industrial production that Keynes minimized in his earlier-cited comments on the US recovery in 1933. In Chapter 21, on the "Theory of Prices," Keynes noted that "new money" could lead directly to increases in effective demand, which would be "divided between the rise of prices, the rise of wages, and the volume of output and employment" (Keynes, 1936; p.298).

"New money," so understood, can provide the missing link toward understanding the real-history illustrations scattered through Keynes" writings. Lack of "new money" was at the heart of the commodity deflation of the 1890s, the slump of 1930, and the near-depression of 1937-1938. Despite Keynes' claims regarding real-history evidence, the way he understood monetary policy to work did *not* require him generally to reject monetary measures in order to boost aggregate demand; and it did not make monetary policy ineffective even with zero-bound interest rates. But, Keynes wanted the premise that monetary policy was powerless as a lead-in to his view of a system in crisis. His views on monetary policy and his sometimes anti-capitalist social philosophy came together in his forecast for a declining marginal efficiency of capital.

In Chapter 16 of the *General Theory*, on "Sundry Observations Concerning the Nature of Capital," Keynes anticipated a future "where capital goods would be so abundant" that the average marginal efficiency of capital – that is, the return on investment -- would fall to zero (Keynes, 1936: pp.213f, 218). It was a logical extension of his view of financial markets, driven by fickle expectations, and of what in the early 1930s was growing "bear market" sentiment. He added in his final chapter, "Concluding Notes on the Social Philosophy Toward Which a General Theory Might Lead," that such an abundance of capital would bring about the "euthanasia of the rentier, of the functionless investor," which he described as an "aim" of public policy, one perhaps to be realized "within one or two generations" (Keynes, 1936; p.376). In some passages in the *General Theory*, a monetary shipwreck

was no longer viewed as a fate to be averted, but rather as a step toward social transformation.

Keynes' notion was similar to the Marxian concept of a declining rate of profit - following accumulation of physical capital. The stagnationist thesis, Keynesian or Marxian, resonated with the Left, especially during the depression-racked Thirties. Keynes' proposed remedy was to scale back the reach of market relations, and to replace them with an expanded role for the State. Leaving the longer-term horizon and returning to the causes of Depression, Keynes wrote at the end of the *General Theory*: "It is certain that the world will not much longer tolerate the unemployment which, apart from brief intervals of excitement, is associated – and in my opinion, inevitably associated – with present day capitalistic individualism" (Keynes, 1936; p.381).

Keynes by then saw the source of economic distress as capitalism run amuck – rather than, for example, in a persistent liquidity trap (as an earlier argument in the same *General Theory* would have suggested.) Had Keynes proposed a large boost in liquidity through open market operations, his inferred premise would have been merely that money demand was, for the moment, not being satisfied – not enough content for a self-described revolution in economic thinking. Faced with the rising appeal of Communism and Fascism in the 1930s, Keynes thought he needed more. In his social and political visions, Keynes often reflected his times; it would be hard to conclude that he transcended them.

There is little evidence since the 1930s for a collapsing rate of profit consequent upon decades of capital accumulation. Keynes underestimated potential demand for new investment, not to mention ongoing obsolescence of previous investment, in a world with billions of people, most of them seeking to enhance their material comfort and social status. A.C. Pigou, Keynes' oft-times nemesis, dismissed the stagnationist thesis almost immediately, noting "An era that has witnessed the development of electrical apparatus, motor cars, aircraft, gramophone and wireless, to say nothing of tanks and other engines of war, is not one in which we can reasonably forecast

a total disappearance of openings for new investment" (Skidelsky, 2005; p.539).

Keynes' view that the world depression of the 1930s was caused by capitalistic individualism has done more damage. The downturns during the decade of depression were driven by gold standard rigidity, reserve shortages, inopportune central bank sterilization, and to a lesser extent by anti-market micro-economic policies associated with the New Deal, the Popular Font and equivalents elsewhere. Major economic boosts came from currency depreciations against gold and other monetary initiatives. The Depression was *not* caused by market dysfunction, irrational pessimism on stock exchanges, excessive capital accumulation, or lack of government stimulus. Whatever the all-in contribution of the *General Theory*, it had the unfortunate consequence of diverting attention from the monetary dynamics that generated depression. Alas, Keynes' legacy as received some three generations on has contributed to the confusion that fiscal stimulus is the best way to boost demand, while monetary policy is often taken to be either ineffective or as beside-the-point tinkering. Keynes did not make his case.

Conclusion: Keynes, Say Law, and monetary factors

Leaving aside his visionary interludes, Keynes essential claim in the *General Theory* was that unemployment could persist for years, *even if wages and other factor costs were flexible*. The point was that even if factor costs fell, the marginal efficiency of capital might not recover because it was driven by market expectations -- which were volatile, and trending downward. Falling costs might even be taken, not as restorative, but as evidence of weak demand and sagging investment prospects. Investment might then stay below the level needed to maintain full employment. Keynes did *not* claim that *general* equilibrium was maintained in the face of unemployment, as some critics were later to assert. He used the term "equilibrium" more modestly to mean that unemployment could persist, hence was not self-correcting.

Keynes, at least in his darker moments, saw accumulation of physical capital as inexorably leading to lower capital efficiency and declining profits. With this premise, an attempt to reboot investment by increasing money and prices – even if it succeeded in the short run -- would just mean more rapid accumulation of capital, and hence more rapid decline in profits, in a self-reinforcing stagnationist circle. This argument could be put to empirical test, and it has been falsified by subsequent decades of growth. To be fair, it pushes Keynes" suppositions to the edge of what his text might support, and Keynes did not write it down, not in so many words.

Keynes narrower conclusion, that unemployment could persist despite flexible input costs, draws on his well-known discussion of Say's Law near the beginning of the *General Theory*. Keynes quotes John Stuart Mill's description of the "classical" doctrine according to which "supply creates its own demand" as a counterpoint to his own grand design. Keynes quoted Mill to demonstrate that classical economists thought it possible to "double the purchasing power" merely by "doub[ling] the supply of commodities in every market" (Keynes, 1936: p.18). Perplexingly, Keynes then chopped off the rest of Mill's paragraph, in which was included –

> …money is a commodity; and if all commodities are supposed to be doubled in quantity, we must suppose money to be doubled too, and then prices would no more fall than values would (Mill, 1909; p.558).

Algebraically, an excess supply in one market must be matched by an excess demand in another. A shortfall of demand for goods implies a matching excess (unsatisfied) demand for money. An additional supply of goods creates its own demand *only if* demand for money is also satisfied. Mill and other Classics recognized this – and far from finding a flaw in Mill's argument, Keynes mis-stated it. Regarding Keynes' omission, Mundell wrote:

> …Keynes perpetrated an historical error in the economics profession lasting several years, a distortion of the classical position that to this day remains in the elementary textbooks. By thus attacking the logic of

> the central feature of the classical theory through carelessness or mischievous omission of its essential parts, Keynes was able to win disciples over to the belief that there was a fatal logical defect, an absurd premise, in the classical system (Mundell, 1968; p.110).[4]

As suggested earlier, Keynes wanted his critique of monetary policy as a premise for a broader critique of capitalism. His historical evidence, alas, does not support either his monetary premise or his broader conclusion.

As we acknowledge Mill's premise that increased money can satisfy the demand for liquidity, and thereby directly boost demand for goods and services, Keynes arguments focused narrowly on the effect of increased money on interest rates are undermined further. Keynes overall disregard of the supply of gold in the 1890s and 1920s, and his de-emphasis of the price of gold then and again in 1933, followed closely upon his neglect (in his critique of Say's Law) of the link between monetary adequacy and demand for goods and services.

With somewhat more effect, Keynes did provide a critique of the conventional Quantity Theory of money – which he had himself endorsed in his earlier *Tract*. In the *Treatise*, he argued the case over several chapters that some cost and other factor price increases were tied directly to increases in the quantity of money, while price increases that feed into profits might be less correlated with changes in the money supply. Indeed, where uncertainty drives an increase in demand for money balances, a higher quantity of money might even coincide with lower aggregate profits and hence with lower prices (Keynes, 1936; pp.208-209). Slaying the Quantity Theory was important to many of Keynes' early

[4] It was not only elementary textbooks that transmitted Keynes' distortion. To take a recent instance, Anwar Shaikh (2016), in his massive *Capitalism: Competition, Conflict, Crises*, writes: "Say's Law amounts to the claim that any supply will generate a matching demand, so that the only important limits are those to supply – such as the availability of labor at full employment" (p.552). But as noted above, Say's Law, correctly understood, requires that the quantity of money increase alongside increases in the supply of goods – otherwise added supply of goods will not generate matching demand for them.

followers, in whose understanding it opened the way to an active role for the State and to deploying an array of fiscal "multipliers."

It is otherwise less important. Monetary economics has by now moved past the Quantity Theory, or growth of the money supply, as an essential policy marker. Many, if not most central banks now seek to stabilize expectations by targeting a steady rate of price inflation. Lars Svensson (2008) recorded that Milton Friedman, the most prominent monetary economist of his era, told him late in his life that he (Friedman) agreed monetarists should target changes in prices rather than growth in the money supply.

Scott Sumner (2012) and other "market monetarists" urge central banks instead to target a rate of growth in Nominal GDP. The Federal Reserve has moved a step closer to NGDP targeting with its Average Inflation Targeting (AIT) policy, announced in August 2020. These are all advances beyond targeting interest rates or money quantities. Mundell often urged stabilizing the dollar-euro exchange rate, especially during financial crises. Nothing about moving beyond the Quantity Theory makes monetary policy less important, or makes aggressive fiscal policy a substitute for monetary factors in overcoming demand shortfall.[5]

The irony is that Keynes, the acclaimed revolutionary of Depression economics, had so little to say about the uses of monetary policy when interest rates fell to historic lows and anticipated returns on investment went even lower. Correctly understood, the real-history evidence in the opening section suggests that economic slumps and unemployment persisted because effective monetary expansion did not occur. This was true where the marginal efficiency of capital was falling sharply, and even where interest rates were already very low. The de-stabilizing factor was inept monetary policy, beginning with inability to adapt or revise the international gold standard.

[5] For more on macroeconomic "policy mix", see Johnson, "Supply-side Economics and the 2017 Tax Act." Included elsewhere in this volume.

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2 Supply-side economics, the 2017 Tax Act, and beyond *

An interesting backstory regarding the 2017 Tax Cuts and Jobs Act is that its lead whisperers, who were to some extent also its drafters, were advocates from the late 1970s Stagflation and early Reagan years: Stephen Moore, Art Laffer, Larry Kudlow, and Steve Forbes. All of them self-identify as 'supply-siders', a description that has lost favor. But in their minds, this is a supply-side tax bill, a victory for the view they have been advocating, and writing iterative op-ed columns about, for nearly 40 years. It will be useful to review both the conceptual framework of the supply-side 'policy mix' and some history of its implementation.

The academic heavyweight of the cause was Robert Mundell, who won the 1999 Nobel Prize for work on international monetary theory. He joined the IMF Research Department in 1961; his first foray into policy-making came

* An earlier version of this paper appeared in *Journal of Economics and Political Economy*, March 2018. it also appeared in Johns Hopkins University *Studies in Applied Economics*, January 2018.

soon after. The then-new Kennedy Administration was concerned about a combination of slow US growth alongside an outflow of US gold reserves. The US was pursuing what was called a "neo-classical synthesis", a policy mix of: 1) easy money, to encourage domestic growth; and 2) a budget surplus, to syphon off excess liquidity, and hence to reduce the outflow of US gold reserves. The policy was not working, as evidenced by a slow recovery from the 1960-1961 recession, a stock market plunge in mid-1962, and continued gold losses. Mundell proposed reversing the policy mix. At the end of 1962, Kennedy embraced the reversal, and announced tax reductions to spur the domestic economy and stiffer interest rates to protect the balance of payments.[2] This was a first round for the supply-side template that would be adopted again a couple of decades later. The tax cut, which reduced the top marginal rate from 91 to 70 percent, was passed in early 1964 (after Kennedy's death) and probably strengthened recovery from the recession.

The improvement was temporary. The US budget swelled as the Vietnam War build-up began in 1965. The US resorted to accommodative monetary policy – which again put the dollar's gold convertibility as risk. Inflationary forces gathered steam by 1968; lapsing again into the "neo-classical synthesis" view of 1961-1962, the US responded with continued monetary expansion combined with a tax surcharge. The result was a recession in 1969-1971 alongside growing inflation, and continued reserve pressure on the dollar. But the dollar's gold convertibility and exchange value were unsustainable in any event. An international shortage of monetary gold meant there was a demand for US dollars as a substitute reserve; but the only way the US could provide dollar reserves was to continue running balance of payments deficits, which undermined credibility of the gold link. By the early 1970s, the postwar gold exchange standard had collapsed, major countries allowed their currencies to float, and years of worldwide inflation were underway.

[2] See account in Mundell (1999, Section II).

By 1980 the US had an economic environment with parallels to where it had been at the beginning of the Kennedy Administration. Gold convertibility had long been abandoned, the dollar exchange was weak, and inflation was often running into double-digit annual rates; real tax rates were rising due to "bracket creep"[3], and real growth had slowed. The Carter Administration had in the late 1970s again followed the neoclassical synthesis of easy money combined with fiscal contraction. There was a widely-held view that the US needed a new macro-economic policy. Supply-side economics, as it by then came to be called, drove much of the Reagan Administration's economic policy mix. The Economic Recovery Tax Act of 1981 lowered the top marginal rate from 70 to 50 percent; but the fiscal portion of the mix included deficit-financed ("demand side") stepped-up defense spending. In 1986, the top individual rate was lowered further to 28 percent, and the corporate rate was also lowered. Paul Volcker's Federal Reserve subdued price inflation - the latter at the cost of a sharp intervening recession during 1981-1983. Supply-siders[4], including Mundell (1993, p.120), criticized policy during the first Reagan term for: 1) spreading the tax cuts over a three-year period, which delayed their expansionary offset to the Fed's tight money policy; and 2) not using a gold-link, or perhaps another fixed standard, more rapidly to stabilize expectations about the domestic and international values of the dollar. Economic growth resumed in the US in 1983, with much less inflation than during most of the 1970s.

[3] "Bracket creep" refers to interaction between progressive income taxation and inflation. Taxpayers move into higher tax brackets as price inflation brings about an increase in nominal taxable income – even in the event that real income is unchanged.

[4] Prominent supply siders included, among others, the four names listed at the outset, Bruce Bartlett, Paul Craig Roberts, and several members of the *Wall Street Journal's* Editorial Page. Mundell had several often-recounted meetings with the last beginning in late 1974. Two *WSJ* writers went on to author important popular books on supply side economics, (Wanniski, 1978 and Bartley, 1992).

Supply-side economics - Context

Mundell argued that the advantage asserted for floating exchange rates by monetarists and others during the 1960s and 1970s is usually illusory. Movements in exchange rates are a problem, he thought, not a solution, as hopes for policy autonomy soon gave way to general inflation; another consequence of resort to currency depreciation was a breakdown in fiscal discipline. Still another was rising real tax rates, as a result of bracket creep, which took a growing wedge out of private sector revenues, and hence became a drag on investment and growth. Mundell (1971; p.16) noted that the most successful post-WW2 economies, including Germany, Japan, and Italy, regularly lowered tax rates to offset drift into higher brackets; he similarly cites Canada's decision in 1973 to index tax brackets to inflation as a supply-side success (Mundell, 1993; p.117). Inflation also meant that nominal capital gains would be taxed – even in the absence of real capital gains, or even in the face of real declines in capital value (Mundell, 1993; p.119). He argued that fiscal policy, including changes in tax regime, could be used to stabilize economic growth without resort to inflation or currency manipulation, and while avoiding major recession. He intended to "shift the Phillips Curve" (Mundell, 1999; Section III), by which he meant reducing the amount of inflation that would be associated with a given level of unemployment.

I asked Mundell, probably in 1991, if he could recommend essential readings on supply-side economics. He said, a bit impishly, that it had a "mostly oral tradition". That was not quite accurate, but it is the case that supply-side economics never gained more than limited academic circulation. In 1962, Mundell wrote "The Appropriate Use of Monetary and Fiscal Policy Under Fixed Exchange Rates" (Mundell, 1968; Ch.16), an excursus into the geometry of monetary, fiscal, and capital flow variables - which served as under-pining for the change in the Kennedy Administration's policy. He then wrote "The Dollar and the Policy Mix: 1971", which emphasized the

importance of fiscal stimulus when gathering inflation constrained monetary policy remedies (Mundell, 1971).

Contours of his argument were captured in a chart, "Effective Market Classification and the Policy Mix",[5] with four quadrants representing four possible states of macro-economic performance. The vertical axis summarizes monetary policy headings of exchange rate, reserve position, and price inflation; the horizontal headings pointed to real, internal factors – the rate of domestic economic growth and the level of unemployment. For each quadrant, Mundell identified an appropriate monetary-fiscal policy mix:

1) External (balance of payments) surplus, prices flat or declining; combined with slow domestic performance. Correct policy mix response: easier monetary policy, domestic tax cuts to boost investment
2) External surplus, prices flat or declining; domestic economy overheating. Policy mix: easier money to prevent currency from rising; tax increases or reduced government spending to slow domestic economy
3) External deficit, perhaps including rising prices; domestic economy over-heating. Policy mix: tighter money to stabilize prices and external position; tax increases or fiscal contraction to slow domestic economy
4) External deficit, perhaps including rising prices; domestic economy under-performing. Policy mix: tighter money conditions to control inflation and stabilize external position; and a combination of domestic tax cuts to boost investment and deficit spending to boost demand. *This is the supply side policy mix.* (Tax cuts usually increase fiscal deficits, so the supply and demand aspects of this policy mix are intertwined.)

Another macro-economic state is equilibrium: the point on the chart where the internal and external balance lines cross.[6] If the macro-economy is stable - if prices, the foreign position,

[5] Eg, (Salvatore, 1993); Figure 17-6. An earlier version of the chart appears in Mundell (1968; Figure 16-1).

[6] Point F in (Salvatore, 1993, Figure 17-6); point Q in (Mundell, 1968; Figure 16-1).

and domestic growth and employment are about where they should be, ie, in something close to a sustainable equilibrium - then no correction in macro policy is necessary. Indeed, the goal of effective monetary and fiscal policy is to sustain such equilibrium.[7]

Mundell argued that fiscal or tax policy had relatively more effect on the internal situation than on the exchange rate, while monetary policy had relatively more effect on the external balance. The reasoning is that fiscal expansion (contraction) may be combined with monetary expansion (contraction) so as not to change the existing balance in the supply and demand for money. Fiscal intervention therefore need not bring a change in short-term interest rates, or in short-term international capital flows. In contrast, monetary expansion (contraction), used as a separate policy instrument, works *directly* through affecting the balance of supply and demand for money – hence it more directly affects interest rates, international capital flows, and the external balance. (Mundell, 1968; p.236)[8]

By the time of his 1971 paper, Mundell used "external" balance more flexibly to include domestic price inflation – reserving "internal" balance to refer to such "real" factors as the rates of unemployment and economic growth. He elaborated: "Financial [monetary] instruments should be allocated to financial targets; real [fiscal] instruments to real targets" (Mundell, 1971; p.17). Adding detail to the 1962 paper, he noted other channels through which fiscal expansion might work – intended both to boost demand in the Keynesian tradition and to boost the *supply* of goods and services. Looking at policy errors during 1968-1971, he summarized supply-side arguments.[9]

[7] Eg, targeting nominal GDP growth seeks directly to stabilize demand. Other approaches, including targeting money supply, the rate of inflation, and interest rates, seek indirect stabilization of demand.

[8] Also summarized in (Salvatore, 1993; pp.544-545).

[9] This bears emphasis because one sometimes hears that (Mundell, 1971) made only a "Keynesian" demand side argument. In fact, the argument that cutting (raising) taxes could increase (reduce) aggregate supply was already embedded in the 1971 paper.

> ...[F]iscalists ... made costly errors in 1968. The fiscalists did not consider sufficiently the impact of the 1968 tax increase and later fiscal tightness on aggregate supply. They thought it would stop inflation; instead, it lowered the expansion rate of real output which aggravated inflation. (Mundell, 1971; p.22)

Mundell drew attention to specific effects that lower taxes might have on costs and supply – particularly against inflationary backdrops. First, there would be a once-for-all effect whereby a tax break would encourage release of built-up inventory to realize profits at the lower rates. Second, lower taxes would lessen pressure from workers to increase pre-tax incomes, hence softening the cost-push feedback loop (Mundell, 1971; pp.26-27). A premise driving business and high-bracket tax cuts is that they could boost investment by raising after-tax profit margins -that is, by “creat[ing] output incentives” (Mundell, 1999; Section III). The incentives from such tax reductions, again, are greater when taxes are being levied against inflation-bloated nominal profits.

Supply-side remedies are most effective where monetary expansion is not practical - ie, where either inflation is already strong or the central bank is losing foreign exchange reserves -and the domestic real economy is weak.[10] Consider the case of the 1969-1971 recession:

> [M]onetarists underestimated the significance of the fiscal tightness on the real economy, the tax drift [ie, bracket creep] due to the monetary inflation, and the impact of the tax increase on wage demands. As a result the monetary expansion adopted was more inflationary than realized.
>
> The *correct policy mix* was a reduction in the rate of monetary expansion ... combined with a tax reduction. This would have stopped the inflation rate without causing a depression. (Italics in original) (Mundell, 1971; pp.22-23).

The policy mix approach does not always call for tax reductions. When the monetary environment is stable, or even deflationary (eg, equilibrium or quadrants #1 or #2), a

[10] That is, where quadrant #4 conditions apply.

fiscal- or tax-driven boost in profitability and investment will have one of two consequences:

- either the new profits boost demand in the direction of overheating the economy; or
- monetary policy will be tightened to prevent an over-heating. In the latter case, higher after-tax profitability will redistribute wealth to those in higher income brackets – while monetary restraint constrains overall economic growth.

A tax reduction would not be useful under either of such macroeconomic circumstances.

Vietnam spending grew beginning in late 1965. The dollar's reserve position had by then somewhat stabilized from where it had been in 1961-1962, but remained precarious; unemployment and growth data were improving, and price inflation was mild. The macro-economic situation approached quadrant #3 conditions: danger of external reserve losses, combined with a strong domestic economy. Mundell observed that taxes should have been *increased* to prevent domestic over-heating in the face of a stepped-up war economy (Mundell, 1971; p.24); meanwhile, tight money conditions should have been maintained to protect US reserves. Instead, the US (via the central bank) resorted to money expansion; the money expansion led to an increase in the GDP deflator to about 3 percent in 1966 and to 5 or 6 percent in 1969-1970. The US policy mix of easy money/ easy fiscal was wrong in both dimensions. These 1965 decisions played a role in ending the post-WW2 gold exchange standard and stoking worldwide inflation a few years later.

To bring this reasoning forward, gains in economic growth from the second Reagan marginal tax cut, the Tax Reform Act of 1986 are hard to parse from the data, although there is evidence of shuffling of income from one group to another as a result of reforms (Bartlett, 2017).[11] As economic growth was largely restored, with much reduced inflation rates, by the mid-1980s, the conditions that would call for the quadrant #4 policy mix of tight money/ easy fiscal no longer held. And

[11] Bartlett (2017a) cites (Auerback & Slemrod, 1997).

consider the George W. Bush income and capital gains rate reductions of 2001 and 2003, which were also offered in the context of a fairly stable monetary situation – ie, with none of the exchange reserve or inflation pressures Kennedy and Reagan faced early in their tenures. By 2004 and 2005, the US economy was over-heating, in part because of the earlier tax cuts, which may have contributed to the gathering housing boom. The tax bills also contributed to what was a near-doubling of the US national debt during Bush's two terms (Amadeo, 2017). The macro-economic situation during Bush's first term did not call for a fiscal boost.

An even more interesting case is the capital gains tax cut signed in August 1997. Supply-siders have credited the rate reduction with stimulating the economic boom and strong stock market of the late 1990s. They were not wrong – but other factors were also in play. The Asian financial crisis hit in July 1997, and was followed by crises in Russia and Latin America the following year. Currencies were devaluing against the dollar, and systemic deflationary pressures were strong. The Greenspan Fed was right to provide international dollar liquidity; but a consequence was easy monetary conditions in the US, and without inflationary pressure. The best historical parallel to the late 1990s was the boom of the late 1920s – another period of international deflation combined with a strong US gold position, easy domestic monetary conditions, and a rising stock market. Both situations fit a quadrant #2 macro-economic scenario: strong external balance combined with a very strong domestic economy. The correct policy mix position, in both cases, would have been to continue with easy monetary conditions – but combined with a tighter fiscal stance to constrain over-heating.[12] The 1997 capital gains cut

[12] Regarding the earlier period, the US instead moved to tighter money by 1928, and maintained it until 1933. France, the other gold reserve-rich country at the time, became a source of systemic deflation as early as 1927. Meanwhile, US fiscal policy was quite easy, as the sharply-lowered tax regime introduced a few years earlier by Treasury Secretary Andrew Mellon remained in place. These factors, especially the monetary policies, played a determinant role in bringing on the Great Depression (Johnson, 1997).

did the opposite, it added fuel to the fire. It no doubt contributed to the subsequent run-up in technology stock prices, which some have called a "bubble".[13]

The 2017 Tax Act

Impressed by evidence from the Kennedy and Reagan tax cuts, some supply-siders have since wanted to deploy the tight money/ tax cut policy mix (quadrant #4) *all the time*: to wit, they implicitly assert that taxes can never be too low and the currency is never too strong. I believe that remains, in 2018, the view of, the *Wall Street Journal's* Editorial Page; and Forbes of *Forbes* magazine says "gold standard" and "flat tax" (at the lower possible rate) whenever the opportunity arises. (Erstwhile supply-sider and Reagan advisor Bruce Bartlett, in contrast, frequently appears on television to say that macro-economic challenges now are quite different from what they were in 1962 or 1980. He has been a scathing critic of the 2017 Tax Act (Bartlett, 2017a).

This facile supply-side view embraces much of what is in the 2017 Tax Act. The Trump Administration and Republican Congress have proceeded as though the domestic macro-economic position were weak. It includes significant corporate and high-bracket tax cuts, including expanded use of lower-rate pass-throughs. These are to be financed through additional government debt issue over the next decade – the higher fiscal deficit is usually a feature of an easy fiscal/ tight monetary policy mix.[14] As it shifts income to those in high tax brackets, it will also result in reduced federal and state government contributions to infrastructure, health, and

[13] I am not aware that Mundell ever offered this policy mix analysis for the late 1990s. I do recall a comment at the AEA convention in January 2001, during a session recognizing Mundell's Nobel award – a combination *Fest* and roast. A past colleague (whose name I have lost, unfortunately) remarked that, while Mundell was best known for advocacy of the easy fiscal/ tight money policy mix, the post-financial crisis situation appeared to call for the opposite: tight fiscal policy and easy money. So the observation above is not original with me.

[14] If lower tax rates were indeed to generate higher tax revenues, then fiscal deficits might not be part of the package.

education budgets.[15] (The package also includes higher standard deductions intended to benefit middle income earners; these are to some extent offset by reduced deductions for home mortgage interest and state and local tax payments for those able to itemize. There is also a case for some reduction in corporate marginal tax rates to equalize after-tax rates of return with lower tax foreign jurisdictions, regardless of where we are in the business cycle. These changes perhaps have some merit as "reforms" – but they are apart from the macroeconomic policy mix logic that energized support for the supply-side policy mix[16]). In fact, however, the macro-economic situation in 2017 very likely did not call for such a policy mix. Consider three competing diagnoses.

1) By 2017, domestic US unemployment was low, the stock market strong and rising, and the dollar steady in the $1.15 - 1.20 per euro range, a level higher than during much of the last several years. This depiction resembles quadrant #2, an economy with nearly-stable prices but never the less low unemployment and over-heated financial markets. The correct policy mix for quadrant #2 is steady, or perhaps easier, monetary policy, combined with fiscal constraint to prevent overheating. A strong macro-economy does not call for deliberately raising fiscal deficits!

2) An alternative diagnosis is that both external and internal balances look fine, and sustainable. In this case, equilibrium best describes the macro-economic situation; no change is required in either fiscal or monetary policy. This diagnosis is probably most likely to be accurate for the US in 2017. (It might be the case, of course, that the economy would benefit from other policy changes, eg, an improved legal or regulatory environment). Under neither of these first two characterizations is the macro-economy underperforming; both domestic inflation and

[15] Tax Policy Center (2017), Scott & Chang (2017), and Matthews (2017).

[16] The House GOP put out a paper in June 2016 outlining details of a tax reform plan – one that appears not to use the term "supply side" and is intended to be revenue-neutral (US House of Representatives, 2016). It is outside the scope of this study to evaluate the Republican blueprint, but for a favorable review, see Goodman & Kotiloff (2017).

unemployment and inflation are well-behaved by historical standards.

3) A contrasting diagnosis of the 2017 macro-economy acknowledges that the dollar is strong and inflation is controlled, even below target – but looks at falling work force participation level (as opposed to the improved unemployment rate or soaring stock market) to conclude that the domestic real economy remains weak.[17] If we accept this diagnosis, we are closer to quadrant #1, for which the appropriate policy mix would then be easier money combined with fiscal loosening. *This is the only diagnosis of the 2017 macro-economic situation that can support the case for supply-side tax cuts or, indeed, for any fiscal stimulus.*

But even here, the case for tax cuts is weak. First, unlike the stronger supply-side scenario depicted in quadrant #4, where the policy mix demands monetary constraint, the policy response for quadrant #1 includes monetary expansion. Second, a soft economy combined with a persistently rising stock market suggests that corporate profits are driven at least in part by redistribution upward -to shareholders - rather than by strongly expanding aggregate demand. A tax cut under such circumstances would aggravate regressive distributional consequences. A preferable policy response -in the somewhat unusual event of a weak economy combined with a strong stock market (particularly where inflation is under control and the currency is stable)- might be to emphasize the role of monetary expansion in boosting aggregate demand.

Considerations of policy mix and where we are in the business cycle aside, a defense offered for the sharp corporate tax reduction – from 35 to 21 percent – is that some of the new cash flow will finance higher wages. That is doubtful. From a static consideration, both S&P 500 and Dow Industrial stock

[17] (BLS, 2017). The US labor force participation rate reached a high point of around 67 percent during 1999-2000, then dropped steadily from about 66 percent in 2007 to about 62 ½ percent in 2015; it has since steadied, and has even risen slightly to about 63 percent.

indexes are up 20x (nominally) since 1980, indicating healthy growth in profitability and expectation of more. But below higher bracket incomes, wages and salaries have risen much less; many earnings categories have been essentially flat.[18] This pattern suggests that corporate profits have not much correlated with wage levels; in the face of immigration and foreign out-sourcing, the effective supply of labor has been fairly elastic, and the market price for it fairly stable. Whatever the theory, we know that wages did not increase after enactment of the 1986 tax cuts: on balance, they seem instead to have fallen over the subsequent decade (Bartlett, 2017b).

A more dynamic argument is that higher corporate cash flows might boost investment and hence bring more innovation and higher productivity. Maybe -but the economics of productivity are complicated, and their conclusions disputed. Despite lots of access to finance, profits, and gains in higher income brackets since the 1980s, there has been relatively little payoff in terms of productivity gain. Indeed, according to Robert Gordon's recent study, productivity- measured by total factor productivity – increased by historic proportions during the 1930s and WW2 not because of high returns on corporate investment, but rather as what appears an effort to reverse downward pressure on them (Gordon, 2016; Ch.16).

Arguably, government support for education and for R&D spending can also contribute to productivity improvements; but the Tax Act implicitly intends to discourage such discretionary spending -through both the constraint of higher fiscal deficits and deliberate squeezing of state budgets. US data indicate a decline in US high school graduation rates since 2000, as well as poor US secondary school achievement rankings relative to those in other countries. Meanwhile, tuition inflation and growing tuition debt, alongside very much reduced state-level spending on higher education, have made it harder for those of lower and middle income backgrounds to complete college. Gordon (2016; pp.624-627)

[18] *Inter alia*, see charts in (Mishel, Gould & Bivens, 2015).

concludes that problems with US education, including under-investment, have become a "headwind" against productivity improvement.

Still another hypothesis (contrary to the view that productivity improvements follow mostly upon greater after-tax profits) points to the role of labor organization in stabilizing work forces, and hence in improving work conditions, compensation, and productivity. According to one explanation:

> The shift to the eight-hour day must have had a direct effect in boosting productivity... However, the main upward stimulus to productivity must have come from the impetus of higher hourly wages, particularly during the late 1930s, that led firms to economize on the use of labor. This helps us to understand the explosion of productivity during World War II. (Gordon, 2016; p.543)

By extension, the relative decline of labor unions in the private sector, and the expansion of contract and part-time work suggest a lessening of such earlier practices.[19]

It is possible, of course, to agree that the above policy mix quadrants accurately describe policy choices, but to argue also that even in macro-economic equilibrium the US economy has too large a role (or too small a role) for the government in infrastructure, health and education.[20] Indeed, the best way to understand the position of Moore, Laffer, Kudlow and Forbes, despite their invoking of Kennedy- and Reagan-era parallels, is that they believe the government's present role in these areas is too large. From a policy mix consideration, 2017 has more in common with circumstances of the later years of the 1980s and the second Bush's first term. If a general case is to be made for smaller government and less taxation, it should be made without overlaying it with policy mix macroeconomics.

[19] For one interpretation of evidence, see (Eisenbrey, 2007).
[20] One could also conclude that the role of government is too small.

Takeaways, and looking forward

As the gold-linked post-WW2 standard broke down and systemic inflation took hold in the 1970s, Mundell played an important role in thinking through the limitations of Keynesian, monetarist, and rational expectations models and responses. A portion of that response was to use aggressive fiscal stimulus in situations where monetary policy was constrained – the supply-side policy mix. There is some evidence that fiscal expansion, including tax rate cuts aided economic recovery in situations where monetary expansion was impractical – that is, for the 1964 and 1981 tax cuts. Evidence for the economic growth impact of tax cuts is weaker where they have has been implemented in other macro-economic environments.

Circumstances in the US have not called for a quadrant #4, easy fiscal/ tight money remedy since systemic inflation was diminished during the early years of the Volcker Fed.[21] It is ironic that monetary policy, which Mundell proposed should be used to secure external balance, is now directed mostly toward stabilizing internal variables of growth rate and unemployment level. Fed Chairmen Greenspan and Bernanke wrote memoirs that scarcely mention the dollar's foreign exchange value.[22] But exchange rate management has a higher priority in economies that have linked their currencies to an outside standard. Under such currency frameworks, the supply-side policy mix may come to have unexpected applications. It has played an important role, even if it is scarcely acknowledged, in improving economic performance in the Eurozone.

[21] Volcker was appointed Federal Reserve Chairman in 1979 and served into 1987.

[22] Greenspan (2007); Bernanke (2017). For an argument that exchange rate management should have been a higher priority in US policy during the financial crisis and recession of 2007-2009, see Johnson, (2017), Section 3: Financial Crisis.

Policy mix in the Eurozone

The Eurozone macro-economy since 2009 points to suitability of combining inevitable monetary rigidity with an easy fiscal stance, particularly in euro-periphery countries (beginning with Greece) that have experienced sharp contraction and depression-level unemployment. The Eurozone's stagnation trap has often been attributed to the single currency zone – that is, to the inability of periphery economies to escape contraction through devaluation. In fact, improved Eurozone performance since about 2015 suggests that earlier stagnation might better be attributed to 1) overall restrictive ECB monetary policy; and 2) resistance by the ECB and the European Commission (sometimes endorsed by the IMF) to authorizing sovereign debt write-downs.[23]

Roll-over of un-serviceable debt kept affected economics locked for years into primary fiscal surpluses. As summarized by the *Financial Times'* Martin Sandbu:

> Europe had embraced fiscal austerity with unseemly enthusiasm in the crisis. The motivation had been the fear of public debt stocks rising from already high levels. The turn to austerity was the logical twin of the taboo on default: an obsession with squeezing the flow of new debt rather than cutting the stock of outstanding debt. The result was to kill off the recovery, worsening debt burdens further and straining the financial integrity of the Eurozone as a result (Sandbu, 2015; p.155).

Write-down of sovereign debt would allow affected countries to move from contractionary primary fiscal surplus to an "easier" primary balance or even deficit – either through increased public spending or tax cuts. Aggregate demand and capital inflows would then begin to recover. Indeed, this shift to debt write-down has permitted an easier fiscal stance to be (slowly) implemented since 2012, and it has been an important factor in improving economic outcomes in the Euro-zone periphery. While unrecognized as such publicly, it is an almost-textbook use of the policy mix Mundell

[23] For detail, see Sandbu (2015).

advocated in his 1962 paper, and which led to the Kennedy tax cut – where externally-driven monetary constraint should be paired against fiscal expansion (Mundell, 1968).[24]

Political context of 2017 Tax Act

In 1960, there was much public concern about how to adopt a policy mix that would allow the US to prosper without inflation, and especially without losing international reserves. By 1980, the burden of price inflation had risen, likely by enough to have contributed to Reagan's election. More than three decades later, inflation is no longer a pressing concern. The most visible public economic issue has instead become increasing domestic income and wealth disparity in the context of a world economy of growing inter-connectedness. While voting patterns are complicated, it seems a safe inference that resentments resulting from increasing income dispersion contributed to Trump's election in 2016. Further, reflecting growing inequality and structural rigidity, a recent United Nations report noted "the US now has the lowest rate of social mobility of any of the rich countries." The report goes on to estimate that budgetary consequences of the 2017 Tax Act are likely to weaken what there is of any American safety net. (United Nations, 2017) Of the trimming of public benefits likely to result from the Act, Pulitzer Prize-winning historian Joseph Ellis comments: "This is a repudiation of the social contract that Franklin Roosevelt announced at the New Deal." (Goodman, & Cohen, 2017).

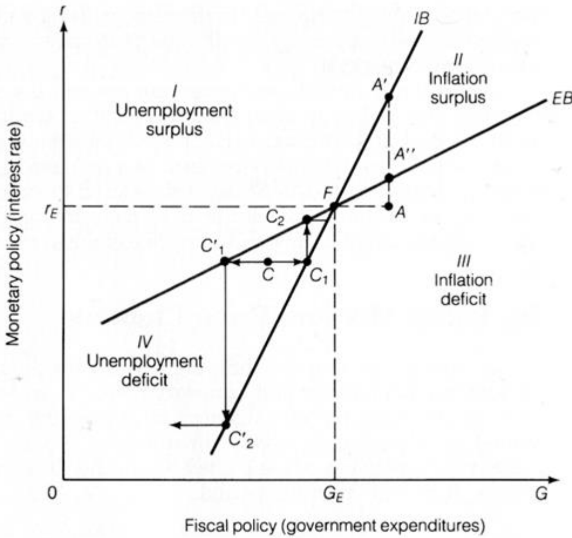
These are adequate grounds for caution about introducing tax policies likely disproportionately to benefit those in higher tax brackets – *especially absent a compelling macro-economic policy mix rationale for doing so.* Perhaps the US should look for a different sort of policy mix to boost economic growth

[24] Mundell has been called the "father of the Euro", which correctly suggests his embrace of fixed-exchange rate frameworks. My conclusion that the Euro-Zone periphery needed a tight money/ easy fiscal solution draws on analysis in Mundell (1968 and 1971); but I am not aware that Mundell himself has linked his earlier work to the more recent Euro-Zone issues in the way presented here.

while *reducing* inequality. For example, it may be time to consider deregulation of entry barriers, zoning practices, intellectual property and patent law, and occupational licensing – all of which have created rigidities in the working of the market economy.[25] Any tax changes required to implement such deregulation would not require the regressive changes implicit in the 2017 Tax Act.

[25] Consider Lindsey & Teles (2017).

Appendix



Effective Market Classification and the Policy Mix

Moving to the right on the horizontal axis refers to expansionary fiscal policy, while moving upward along the vertical axis refers to tight monetary policy and higher interest rates. The various combinations of fiscal and monetary policies that result in internal balance are given by the *IB* line, and those that result in external balance are given by the *EB* line. The *EB* line is flatter than the *IB* line because monetary policy also induces short-term international capital flows. Starting from point *C* in zone IV, the nation should use expansionary fiscal policy to reach point C_1 on the *IB* line and then tight monetary policy to reach point C_2 on the *EB* line, on its way to point *F*, where the nation is simultaneously in internal and external balance. If the nation did the opposite, it would move to point C_1' on the *EB* line and then to point C_2' on the *IB* line, thus moving farther and farther away from point *F*.

Source: (Salvatore, 1993).

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3 Tight money, high wages: Sumner on the Great Depression *

Scott Sumner's *The Midas Paradox: Financial Markets, Government Policy Shocks and the Great Depression* (Independent Institute, 2015) seeks to understand the Great Depression through combining economic history, macroeconomics, and the history of economic thought into a seamless whole. By wide agreement, the roots of the 1929-1932 depression lay in a shortfall of aggregate demand – which was a consequence of systemic monetary constraint. Sumner uses the world's quantity of monetary gold and ratio of gold-to-money (a "gold market approach") to determine the stance of monetary policy at different times and to identify lost opportunities. The more usual indicators of interest rates and the quantity of money turn out to be misleading.

He then moves beyond the roots of the downturn to the reasons weak economic conditions persisted for years after the underlying monetary problem was solved by Roosevelt's

* Earlier versions of this paper were published in the *Journal of Economics and Political Economy*, March 2016, and a few months earlier in *The Market Monetarist* blog.

early decision to depriciate the dollar against gold. He argues that the US saw a supply-side depression that began in late 1933, one driven in large part by New-Deal-linked interferences in labor markets. Sumner's conclusions contribute much to understanding what succeeded and failed during the Roosevelt Administration – which was, as concerns economic results, perhaps the most consequential US Administration during the twentieth century.

Sumner is best known for his advocacy of nominal GDP (NGDP) targeting as an approach to macroeconomic management, and especially for his blog themoneyillusion.com. *The Midas Paradox* text was completed in 2011, but reflects development of his monetary frame work over a period of a decade or more.

Monetary origins of the Great Depression

Sumner credits what he calls the Mundell-Johnson hypothesis, according to which the roots of the depression were in the post-WWI undervaluation of gold, as a precursor to his study (Mundell, 2000; Johnson, 1997). As its junior placeholder, I summarize the hypothesis here. According to British data, the purchasing power of an ounce of gold changed little from the middle of the seventeenth century to the middle of the twentieth. Gold convertibility was typically relaxed during wars to facilitate military spending and borrowing – and thereby allowing inflation of paper currencies. But English deflation restored prewar price levels as convertibility was restored in the years after the Puritan wars of the seventeenth century and again after the Napoleonic wars of the nineteenth; a similar deflation occurred after the 1861-1865 Civil War in the US. Another fall in price levels was likely after the 1914-1918 World War, as major economies of Britain, France, and Germany expected to deflate in order to restore gold convertibility during the 1920s.

The low postwar real (commodity exchange) value of gold affected monetary reserves in two ways: 1) it depressed the value of outstanding gold stocks; and 2) it lessened the price incentive for new gold production. In the US, France, and

Germany, which had traditionally had large gold coin circulations, gold was mostly taken out of circulation during and after the war, which lessened confidence in previously co-circulating paper money. Economist Gustav Cassel drew attention to the "gold standard paradox," by which a gold-based monetary system would require ever-increasing gold production to accommodate economic growth while maintaining reserve ratios. Yet world gold production during the 1920s was below what it had been in the decade before WWI; and given the postwar decline in gold's purchasing power, the real value of new gold produced in the mid-1920s was just over 50 percent of what it had been in 1914.

Ralph Hawtrey and John Maynard Keynes hoped in the early 1920s to avoid deflation by supplementing gold with foreign exchange – sterling and dollars – as monetary reserves; other economists, including Cassel and Charles Rist, doubted that a "gold exchange" standard would be viable. The doubters turned out to be correct. The viability of the gold standard was tied to its mystique; it provided a cultural and emotional link to the prewar *status quo*.

In proposing a hypothetical increase in the gold price, perhaps at the time of the Genoa Conference in 1922, Mundell and Johnson intended a counterfactual through which subsequent deflation might have been prevented. Almost no one suggested changing the gold price at the time – in my research the only advocacy I was able to find for a price increase came from a gold producers' association. In 1934 the US raised the price it would pay for gold from the prewar level of $20.67/ oz. to $35/ oz. – which removed the gold standard as a cause of weak systemic demand.

Sumner raises the objection that increasing the price of gold in the early 1920s would have risked significant inflation unless central banks raised their demand for gold in the short run. I believe he overstates the threat of inflation. As Sumner acknowledges in his theoretical chapter, prewar gold reserve ratios fluctuated considerably; central banks did not generally act as though bound to monetize new gold to satisfy "rules of the game" – nor did central banks of the US, France, or Germany show much inclination to monetize excess reserves

as deflation took hold a few years later. Also, only the US among major economies was on a gold standard during the early 1920s, so there would have been no central bank coordination requirement had the price then been increased.

Sumner argues that what mattered for monetary policy was the world's gold reserve ratio, not the amount of flow of gold from one central bank to another. This is a distinction without much difference: as conditions tightened in the late 1920s, gold tended to flow away from countries seeking expansion – for example, the sterling area – to gold bloc countries, including France, or at times to the US, where the gold-to-money ratio was already relatively higher. The consequence of such gold movements, especially during 1928-1932, was hence to raise the world's gold reserve ratio. The potentially expansionary (or contractionary) systemic impact of gold movements was diagnosed by Henry Thornton in the early 19th century.

The economists most concerned about the inadequate supply of gold reserves were the first to notice pressure from central banks' stepped-up accumulation. Cassel and Hawtrey were early critics as the Bank of France converted a portion of sterling reserves to gold during 1927. Movement of gold to Paris accelerated with adoption of the French Monetary Law in June 1928, which stabilized the franc, specified that all French required reserves be held as gold, and (significantly) prohibited addition to its substantial stock of foreign exchange. Robert Mundell made nearly the same observation about French monetary policy and the Monetary Law in his 2000 Nobel lecture.

Sumner suggests that the Depression started with the stock market crash in October 1929, intensifying in 1930, rather than with French gold conversions in 1928. The rise in liquidity demands following the Wall Street crash mirrored the tightening of gold ratios in 1930. The key policy error, he writes, was "the failure to accommodate Britain's need to rebuild gold reserves in 1930, as it had [under NY Fed President Benjamin Strong] in 1927." Sumner notes that the US money supply did not collapse in 1930, and that the banking sector was stable until late in the year -- yet both US

prices and real GDP fell considerably. Post-Strong leadership at the Federal Reserve (Strong died in October 1928) deserves criticism for re-asserting the pro-cyclical real bills doctrine, and for not making expansionary use of the large US stock of gold reserves. Also, the Smoot-Hawley tariff, which President Hoover signed in June 1930, made it harder for the rest of the world to balance accounts with the US.

Although liquidity preference rose in the US only after the October 1929 stock market crash, it is a reasonable inference that deflationary signals coming from France, as well as from tightened Federal Reserve policy in the US beginning in -1928, played a role in chilling sentiment that led to the crash itself.

In any event, the world had changed between 1927 and 1930. At the earlier date, French Prime Minister Raymond Poincare still intended for the franc to appreciate toward its prewar exchange value – which would have slowed or ended the gold inflow to France. But the strong-franc faction lost, the franc was formally stabilized in June 1928 at the deliberately undervalued level of one-fifth of prewar parity, and the movement of capital and reserves to France became a flood. While the world's monetary gold stock rose from $9.2 B to $11.3 B from December 1926 to June 1932, for a $2.1 B increase, the Bank of France's gold holdings alone rose by $2.5 B over the same period. Other gold bloc countries Belgium, the Netherlands, and Switzerland, all of which followed Paris' lead on monetary matters, added an additional $900 M to their reserves during the same period. The world outside the gold bloc thus saw a net loss of $1.3 B in gold. The share of the world's gold reserves held by these gold bloc countries, including France, rose from 11 ½ to a staggering 38 ½ percent, over this 5 ½ year period.

From December 1929 to December 1930 alone, roughly the period Sumner highlights, the share of the world's total of monetary gold held by France and the other three gold bloc countries rose by 5.5 percent, while the US share rose by only a smaller 1.0 percent. France in 1928 also held $1.4 B in foreign exchange, more than half of it in sterling; Bank of France officials made clear repeatedly in 1927 and 1928 that they considered the use of sterling as a reserve to be inflationary;

and Bank Governor Emile Moreau wrote in his diary in May 1927 that he could force an end to sterling convertibility at any time – and hence an end to the gold exchange standard. Even without actual withdrawal of gold, French pressure made the use of British pounds as a reserve untenable. Had the US attempted to inflate in 1930 (and it would have been worth an effort), much outgoing US gold would have gone to France rather than to the reserve-short Bank of England.

Looking forward, Sumner accepts such reasoning, as he indicates the likelihood that continued US efforts to inflate in 1932 would have led to an outflow of gold to France or other gold bloc countries, where most of it would have been sterilized. Sumner observes that the Federal Reserve's open market purchases (OMPs) in the spring of that year did little to boost the US economy, in large part because expansion led to fears of dollar devaluation. Coincident private gold hoarding reduced central bank reserves, hence offsetting expansionary effect from the OMPs. Sumner concludes that, far from demonstrating the US was in a "liquidity trap" (where additional liquidity would be hoarded rather than spent) in 1932, the failure of expansion efforts illustrated the constraint of the international gold standard on liquidity expansion.

Sumner has told me that he wanted to title his book "The Midas Curse" (rather than "Paradox") – but his publisher rejected the more portentous word as off-putting. The author's meaning would have been clear: a Midas-like demand for stockpiling monetary gold led to higher systemic gold-to-money ratios, which gave rise to systemic deflation. Evidence from the interwar years suggests the advantages of using gold quantities and gold reserve ratios rather than interest rates or changes in money stock as indication of the stance of monetary policy. Sumner comments that even Friedman and Schwartz understated the downturn by looking at money supply data rather than at rising gold reserve ratios. In the 21st century, gold ratios are no longer relevant – but money, interest rate, and even inflation indicators have often provided misleading signals. (US monetary authorities nevertheless continue to target interest rates and, to a lesser extent, inflation.) Market monetarists, led by Sumner, have

embraced nominal GDP (NGDP) targeting as a kind of Chicago School monetarism updated to incorporate market expectations. The object in setting monetary policy should be for each central bank to target, and thereby stabilize, expectations in NGDP growth. Mundell, who usually focuses on international monetary conditions, has prefered to look at movements in exchange rates to indicate when a particular central bank has become too expansionary or contractionary. More than most monetary indicators, exchange rates automatically incorporate expectations about growth and inflation.

A supply-side depressions?

Sumner's largest contribution in *Midas* is in explaining why the depression persisted – or, as he sees it, why the US had a second, supply-side depression beginning after July of 1933. The Great Depression should have ended with Roosevelt's decision to float the dollar in March 1933 and then to establish a new gold price at $35/ ounce in February 1934. Sumner traces daily and weekly press reports on market reactions to monetary and exchange developments, and isolates data to show an explosive, one-off 57 percent increase in industrial production from March to July 1933, immediately after Roosevelt took office. A few conclusions from that event:

1. The heart of the depression was deflation; when deflationary expectations were decisively countered, aggregate demand and economic activity quickly recovered.
2. Inflation -- in this case via dollar devaluation -- injected into a deflationary environment boosts economic activity despite the existence of large-scale unemployment; price inflation need not be a consequence of full employment of resources. (Sumner comments that this evidence contradicts much modern business cycle theory.)
3. As Sumner observes, the level of interest rates and changes in the money supply were irrelevant to this process; what mattered were expectations of future activity. Anticipation of higher prices affected activity immediately, without a time lag.

4. The fact that the monetary depression was compounded from late 1930 by a banking crisis did not prevent recovery in 1933, or even do much to slow it.

5. Fiscal stimulus, or deliberate deficit financing of government-directed projects, appears to have made at best a minor contribution to the demand boost during the four month period. Roosevelt came into office calling for a balanced budget, and took immediate steps to reduce government salaries. His Administration soon after moved otherwise to introduce the job-creating Civilian Conservation Corps, distributed $550 M to the states for relief, and funded various public works. Total federal spending rose from $5.1 B (nominal) in Hoover's fiscal year 1933 to $5.9 B in Roosevelt's FY 1934, while the fiscal deficit rose from $1.8 B in FY 1933 to $2.1 B in FY 1934 budget (usgovernmentspending.com). These numbers could explain the March-July 1933 recovery only if we were to posit extraordinary spending "multipliers"!

The revaluation of gold comprised Roosevelt's best moment in recovery policy. Its lead advocate was Professor George Warren, an agricultural economist who had long observed correlations between value of gold and the price of agricultural commodities – but who tends to get little respect in historical accounts of the New Deal. Sumner gives Warren his due as a macroeconomist; in contrast, both Keynes as a contemporary and Friedman and Schwartz in their historical account underestimated the impact that a higher gold price could have on expectations, and hence its immediate impact in boosting demand. Support for reflation came from many in Congress, especially from members representing farmers, but also from such New York bankers as J.P. Morgan Jr. and Russell Leffingwell. The decision to go off gold, implemented through the US Treasury, deliberately circumvented conservative orthodoxy at the Federal Reserve and in much of the financial community (Smith, 2007; pp.328-330).

Unfortunately, devaluation was soon followed by New Deal-driven negative supply shocks that offset much of its benefit. Sumner's most dramatic evidence is for the impact of labor market policies in five times aborting recovery in the US during 1933-1940. The first of these was in adopting the

National Industrial Recovery Act (NIRA), which led to average nominal wage increases of over 20 percent during July-September 1933 and in turn to a fall-off in industrial production that wiped out over half of the gains of the previous four months. NIRA was ruled unconstitutional in 1935, which gave stock prices a boost; but passage of the Wagner Act the same year encouraged build-up of labor unions. The American Federation of Labor and the Congress of Industrial Organizations then led successful unionization drives in 1936 and 1937, and minimum wages were increased sharply in 1938 and 1939. Each of these events generated expectations of rising production costs that were reflected almost immediately in stock market declines. Keynes' commented on NIRA in the same vein in January 1934:

> …rising prices caused by deliberately increasing prime costs or by restricting output have a vastly inferior value to rising prices which are the natural result of an increase in the nation's purchasing power… [It is] hard to detect any material aid to recovery in the National Industrial Recovery Act (Keynes, 1934).

Keynes returned to labor costs in his discussion on "money-wages" in the *General Theory*, where he noted the inter-changeability of nominal wage decreases (increases) and money supply increases (reductions) in influencing aggregate demand (Keynes, 1936; p.267). Sumner reduces causality of the Great Depression to two types of shocks: 1) gold market shocks, positive and negative, which influenced nominal aggregate demand; and 2) wage shocks, which impacted the way nominal changes in demand would be separated into changes of real output and of price. To underline the role of wage shocks, he continues:

> Can we simplify any further? Surprisingly, the answer is yes. As we saw in Figure 1.2, the seventeen high frequency output fluctuations [during 1929-1939] discussed in Chapter 1 can be explained with a single variable, real wage rates (p.418).

The data also reveal a crucial before-and-after distinction. Before mid-1933, real wages rose when prices declined – making wage trends statistically dependent upon, or endogenous to, ongoing monetary contraction. After that

date, higher real wages rose to reflect public policy initiatives – so that wage increases became an exogenous driver of dampened economic growth. (If this seems a conclusion that would please a GOP advisor, consider that evidence of an inverse link between wage levels and expected profits would also reinforce convictions of most Marxist economists.) The US unemployment rate stayed in double-digits well into 1940.

Sumner's conclusions counter a frequent view during the New Deal years, as well as that of many populists and "socialists" of various stripes even today, that the Depression was a consequence of unregulated financial capitalism. According to that view, recovery from the Depression required public-private partnerships, top-down coordination, and stepped-up regulatory oversight, especially of the financial sector. Historian James MacGregor Burns, for example, attributed the sharp increase in industrial production during March-July 1933 to NIRA and job-creation programs – which, as we saw above, gets it backward (Burns, 1956; pp. 181-182). But it would be a mistake to interpret the New Deal as conceptually cohesive. Demand for top-down partnership, welfare and jobs relief, and for labor organization, often came from populist factions in the Democratic Congress. Roosevelt himself led not by policy blueprint but by balancing competing demands. Burns noted that Roosevelt "hated abstractions," and described his "intellectual habits" as "staccato." He liked to punch holes in other people's theories (Burns, 1956: p.334).

What of recovery outside of the US? Britain and Germany, seeking to maintain reserves, had moved toward autarky as early as 1931 – Britain by concentrating on trade within the sterling bloc, Germany by advancing barter deals, most often in eastern Europe. France remained an active international trader, and should have benefited from devaluation in 1936 and the surge in international gold supplies; but, as Sumner reports, this advantage was largely offset by Popular Front redistributionist measures that constrained recovery of profits and investment, much as New Deal changes had in the US.

Sumner deploys both the gold market and the labor market arguments to explain the 1937-1938 depression, during

which US real GDP fell by 11 percent and industrial production by 30 percent, and which is often described as the second worst American depression of the twentieth century. He cites a rise in the world's gold-to-money ratio, caused by both official sterilization in the US and – what he emphasizes more -- a sharp increase in private gold hoarding. Also, wages rose rapidly in early 1937 in response to unionization drives and also, perhaps, to expectations raised by Roosevelt's landslide re-election victory in 1936. Uncertainty was heightened by frequent union-related violence.

As in 1933, many New Dealers in 1937 incorrectly thought wage increases should provide a boost to aggregate demand, and hence to output. When economic indicators turned downward, Roosevelt's advisers were divided between those who wanted "more New Deal," including more farm and labor legislation and more deficit spending, and those, including Treasury Secretary Henry Morgenthau, Jr., who wanted less. Roosevelt choose items from each side, attacking "trusts," but calling for a balanced budget. Then Keynes himself wrote to Roosevelt in February 1938 urging a sharp boost in public spending to rekindle demand (Keynes, 1989; Vol. 21, pp.434-439). Federal Reserve Chairman Marriner Eccles similarly encouraged spending, but like Keynes was oddly passive about what the central bank could accomplish with monetary policy. The President resisted the advice to expand the fiscal deficit. New Dealers seem not to have understood the central role that devaluing the dollar had in boosting production four years earlier, and neither Keynes nor Eccles called it to their attention. Apparently the President did not ask advice of Warren this time around – who anyway died later in 1938. Roosevelt was discouraged, and felt his economic policy had failed (Burns, 1956; pp.335-336); surely his advisers deserve a share of the blame.

Doug Irwin's 2011 paper on gold sterilization during 1937 and 1938 appeared after Sumner's *Midas* text was completed. In what counts as a serious policy mistake, Irwin notes that the Treasury responded to rising wholesale prices in 1936 by deliberately sterilizing new gold inflows from December 1936 until February 1938, most of it by August of 1937 when the

heavy pace of gold inflows slowed. In this process, dollars issued against new gold were drained by sales of other central bank assets. Where Treasury had championed price inflation and circumventing the Fed in 1933, by 1937, under Morgenthau's direction, it had become deflationist. At least 10 percent of what would have been the new monetary base was cancelled by the sterilization. A money supply measure (M2) that increased by 12 percent annually during 1934-1936, turned flat and even slightly negative from about January 1937 through July 1938 (Irwin, 2011). The monetary evidence suggests that 1937 saw a true-to-form deflationary squeeze – differing from that of 1932 mainly because national reserves were so abundant by the later date that the US faced no gold standard constraint. Irwin credits Roosevelt with the official decision to end sterilization in April 1938, and economic growth resumed by that summer.

Private gold movements, as Sumner describes them, were baffling and somewhat contradictory – first driven by fear of a revaluation of the dollar and gold dishoarding, then by fear of a devaluation and renewed gold hoarding. The second makes little sense: with new gold piling up at the Fed, and no deflationary pressure coming from abroad, US monetary authorities would have had no reason to devalue in 1937. Trends in the volume of private gold hoarding nevertheless provide a window into expectations. Sumner has elsewhere formalized this insight with the argument that central banks should introduce NGDP futures markets to obtain growth forecasts, and then intervene through money and capital market operations to adjust the forecast to match the policy goal. In short, "target the forecast."

Industrial production rose by about 40 percent from the post-devaluation, pre-NIRA-shock peak in July 1933 to the pre-crash peak in July 1937 – at which time it was higher than it had been at its peak in 1929 (St. Louis Fed). This was a disappointing rate of growth for what should have been a rebound after the worst depression in US history, but growth it was; it is not convincing to roll this four-year period into a longer 1933-1940 "supply-side depression." A monetary, demand-side depression (thankfully short) struck again after

July 1937; it was made worse by the negative unit-wage shock that occurred while aggregate demand was already falling. But what made the 1937-1938 downturn a “depression” was not rising wages but the burst of reserve sterilization, and the sharp braking of monetary expansion. It remains correct to say that depressions usually have monetary causes.

Sumner’s emphasis on the damage of exogenous wage increases holds a couple of ironies. Higher wages did macroeconomic damage by depressing investment functions (squeezing profits and raising unempoyment) repeatedly during the 1933-1940 period; stock market performance was generally lackluster. But according to Robert Gordon’s recent work, there is little evidence that such weakness hindered productivity growth – measured as total factor productivity (TFP) (Gordon, 2016; eg, Figure 16-1.) By the same metrics, and in contrast, during the first two decades of the 21st century, when wage growth was slower, private sector unionization was in decline, and unemployment benefits lagged behind price increases, profits were strong, and stock market performance was robust. Perhaps surprisingly, strong capital productivity was not matched by TFP gains during the more recent period.

Almost by accident, Sumner demonstrates that public policy could redistribute income away from capital and toward wage labor; the shifts correlate closely with specific measures in support of unionization and for minimum wage increases. The social policy effects of the the New Deal are often described as transformative – toward extending material benefits more broadly. According to Gordon’s evidence, this transformation was not a drag on the longer trend of productivity improvement. The thrust of *Midas,* in juxtaposition, provides striking evidence that exogenous boosts in labor’s share did delay recovery from the Depression. But the mosaic of the New Deal’s impact should include a legacy of social transformations, and room for different expectations about economic mobility.

Back to monetary issues, evidence from the 1930s suggests that the worst policy combination for recovery from contraction is a mix of tight money and rising wages – as for

example during the 1937-1938 depression. Somewhere there might have been a Goldilocks mix of slower redistribution efforts combined with steady monetary expansion. This suggestion is speculative, and does not follow directly from Sumner's data.

Keynes and other economists

Sumner moves from the 1932 evidence to ask what Keynes contributed to understanding the macroeconomics of depression. He notes that John Hicks and Milton Friedman emphasized the role of a liquidity trap as the pivotal concept in understanding the *General Theory*. Sumner is not quite convinced, but agrees that the concept of "monetary policy ineffectiveness… occupied a central position in the Keynesian revolution." I agree, provided we can extend the concept to include other themes from Keynes' most influential book. One of these was the instability of the investment function (reflecting the instability of the schedule of marginal efficiencies of capital, or MEC), the topic of Chapter 12 on "long-term expectations." Another was concern about stagnation and a declining rate of profit (that is, declining MEC), a frequent topic in later chapters of the book. In my past effort to collect historical instances in which Keynes thought monetary expansion could not be implemented, *none* of them derived from a liquidity trap – that is, from zero-bound interest rates (Johnson, 2016[2]). In 1929 and during the next few years, Keynes frequently recommended public works spending to boost demand, in part because of constraints on monetary expansion in a deflation-bound international system. But with the *General Theory* in 1936, Keynes moved beyond public works to advocate stabilizing the broader volume of investment, which he argued would be necessary even in a closed economy (that is, even without the complication of international capital flows.)

Keynes' analysis of monetary policy has more dimensions than most "Keynesians" understand, and more than anti-Keynesians acknowledge. It is misleading shorthand to

[2] A revised version of that paper is included in this book.

imagine that interest rate targeting comprised the whole of Keynes' intended monetary instruments. Drawing on his earlier writings, Keynes in the *General Theory* advanced a quasi-Wicksellian analysis setting MEC against the market interest rate – and *both* were suitable objects for monetary policy. Keynes frequently noted that changes in prices and in the quantity of money could affect MEC directly, rather than work through interest rates. In his chapter on the "marginal efficiency of capital," Keynes noted that a rise in prices can raise the investment-demand schedule. (We saw an outstanding illustration of this in the March-July 1933 recovery.) In the same chapter, he comments that an expected *fall* in the rate of interest – if it presages a decline in future investment prospects -- can *reduce* present investment outlays (Keynes, 1936, p.143). This was a penetrating critique of interest rate targeting, "Keynesian" or otherwise, as an instrument of monetary policy.

In his chapter on "the theory of prices," Keynes noted that an increase in the supply of money can affect expectations of future prices, which then affect MEC. In his discussion of saving and investment, he touted the "fundamental proposition of monetary theory," according to which the relationship between the supply and demand for money determines national income and securities prices (Keynes, 1936; pp.84-85). An economist who consistently doubted the effectiveness of monetary policy would be unlikely to write this way about using money or prices to boost investment!

In his earlier *Treatise on Money*, Keynes recommended boosting prices as a mechanism for raising demand and investment, and hence for rapidly moving past a downturn. His caution on interest rate targeting suggests a critique of the more recent innovation of negative-interest rate policy. In at least some passages from the *General Theory*, Keynes implicitly advocates boosting money supply directly, rather than counting on ever-lower interest rates to re-start spending and investment.

Nevertheless, Keynes is better known for expressing doubts about monetary intervention – and he went on to develop two policy visions, both drawing on the premise of monetary

policy ineffectiveness, that have had long-term resonance. The first is that fiscal pump priming (rather than monetary expansion) can best boost demand in a depressed economy, especially when interest rates approach zero. To this day, such lights in the economics profession as Paul Krugman and Larry Summers emphasize government borrowing and spending as the straightforward path to recovery under such circumstances. But the Keynesian argument against monetary stimulus does not succeed – for reasons Keynes himself spelled out. The question remains as to whether fiscal expansion can also boost demand, or at minimum be part of a demand-boosting policy mix. Sumner's focus in *Midas* is on monetary and wage policy, and he views demand-side fiscalism as an unnecessary distraction. But because of the prominence of the issue in literature on the New Deal, he would have done well to include more detail on efforts to expand or contract public spending during 1933-1941, and on whether or how they reinforced or contradicted monetary and wage policy efforts.

Almost in passing, Sumner observes (p.341) that a major increase in US military spending from August 1940 through December 1941 generated economic recovery that had been elusive for over a decade. This conclusion appears to supports the claims of fiscalists, and recalls what an older Keynesian once told me of that period: "We saw a miracle!"[3] Sumner says he can explain all changes in industrial production during 1929-1939 by looking at gold market and real wage shocks; does fiscal policy have a separate impact when we get to 1940 and 1941?

A second policy vision developed in the *General Theory* concerned what Keynes saw as the tendency of "present day capitalist individualism" to lead into stagnation. He put forth such concepts as that of an "average marginal efficiency of capital" falling to zero, and the "euthanasia of the rentier, of the functionless investor." These concepts drew on the premise that monetary policy could not prevent the collapse of MEC. Keynes wrote in the 1930s, an era of depression,

[3] Columbia University Professor Donald Dewey, probably in 1990.

fascism, socialism, and wide popularity of Marxism among intellectuals. The New Deal's NIRA was a fruit of a similar impulse, and led to comparisons with Mussolini's Italy. The thrust of NIRA was to move past what was understood as the "aimlessness and wastefulness of free competition and rugged individualism" by building a "partnership" of industry, labor, farmers, and government (Burns, 1956; pp.153, 197, 198). Keynes sought an alternative, relatively liberal vision for an expanded future state. The world since the 1930s, however, has tended to move away from centralized economic control, and has embraced more "capitalism," especially in Asian and other "emerging" markets. Keynes' forecast of capitalist stagnation has proved off-target.

Sumner writes in this spirit of what is now "the growing awareness of the sophistication of pre-Keynesian business cycle models."

Conclusions and a caution

Sumner's discussion of the causes of the 1929-1932 depression points to an important difference between that downturn and the 2007-2009 "great recession." The earlier depression was monetary in origin; bank failures and financial crisis did not kick in until late in 1930, when they amplified demands for money and for gold relative to supplies. The 2007 downturn, in contrast, began with a financial crisis, the heart of which was widespread and often hidden exposure to low-quality mortgage debt. US monetary policy was not an initial trigger of the downturn, and probably did not become contractionary until the dollar started to rise sharply in July 2008; at that point the recession entered a harsh, and unnecessary, new phase. Understanding of the more recent events has been delayed by the pattern of economists (and others) tending to focus either on the financial sector collapse or on the monetary contraction, without adequately integrating the two.

Midas reinforces the frequent conclusion within the economics profession that the Great Depression was caused by monetary contraction, and that the workings of the

international gold standard prevented most national economies from reflating. Sumner illustrates that Roosevelt's decision to revalue gold during 1933 led quickly to a recovery of prices and production. This should have meant the end of the deflation in the US and elsewhere. Even without the gold standard constraint, however, depression can be induced by inept monetary policy, as in the case of the 1937-1938 contraction in the US. Looking ahead, another near-depression was caused post-2008 by the European Central Bank, which, according to Eurostat data, held NGDP growth in the Eurozone to less than half of one percent annually for a five-year period beginning from the second quarter of 2008.

If rising unit-wage costs did not quite cause a New Deal depression, they certainly hindered recovery and contributed to creating a milieu of economic stagnation. Indeed, we have surprising agreement across the ideological spectrum that capitalist growth is most predictable with steady real unit wages – and we have robust evidence that exogenous influences pushed up unit wage growth, kept unemployment high, and slowed recovery from 1933 onward. Sumner's data may discomfit many economists, although they will be hard-pressed to deny his conclusions. His evidence should contribute to arguments over the distributional consequences of recovery and growth in the 1930s, and perhaps more generally. Suggestively, he determines that government policy on wages and union organization can substantially affect income distribution. Sumner indeed sees macroeconomic consequences during the 1930s of such intervention as almost entirely negative. But some readers will welcome his analysis – in combination with Gordon's history of productivity and living standards cited earlier -- as evidence that income distribution can be made more equal without damaging capitalism or snuffing out TFP gains.

In the shorter interval, Sumner's discussion of monetary and labor market factors suggests caution for prospects in in the last years of the second decade of the 21st century and forward. Economic growth requires a combination of monetary expansion and labor cost increases in line with improvements in productivity. The Federal Reserve in 2016

appeared ready to put some brake on monetary expansion, despite NGDP growth since 2008 that continued to fall farther below pre-2008 growth trend, ongoing economic weakness in Europe and Japan, and a slowdown in China. The post-recession recovery in the US since 2009 has added lots of jobs – 14 million, according to President Obama – but by most measures, wages and salaries have remained nearly flat, for which reason income inequality has become a potent political issue.

Post-script. Krugman has argued that the recovery of profits and stock prices since 2009 owes much to wage compression; if so, this pattern was likely/ accentuated during the Trump years, including with the 2017 Tax Act. If this argument is correct, it is the mirror-reverse of the pattern Sumner describes for the New Deal era, where wage expansion depressed profits and stock prices. It is reasonable to expect that an incoming Democratic administration in 2021 might want to use administrative measures to boost compensation – possibly through a higher minimum wage, mandatory home leave provisions, or encouraging re-unionization (in addition to pandemic supplemental checks). If monetary expansion were to slow while salaries and unit-wages increase, the post-pandemic expansion will face an uncertain future – and look something like portions of 1933-1940. The Powell Fed has been right to avoid adding tighter money to policy-driven redistributive measures.

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4 A different cold war? European settlement of 1963 and afterward *

By 1946, hopes for post-WW2 cooperative settlement of differences between the US and the Soviet Union were fading. Premier Stalin's goals were expansionist, even to establish hegemony over Europe. Prominent realist on international affairs John Mearsheimer has written:

> [The Soviet Union] had been invaded twice by Germany over a thirty-year period, and each time Germany made its victim pay an enormous blood price. No responsible Soviet leader would have passed up an opportunity to be Europe's hegemon in the wake of World War Two (Mearsheimer, 2017, 198).

Stalin mused to French Communist leader Maurice Thorez in 1947, "Had Churchill delayed opening the second front in northern France by a year, the Red Army would have come to France. We toyed with the idea of reaching Paris" (Gaddis, 2005, 14). He attempted expansive moves in Iran and at the Turkish Straits in 1946; both were thwarted by the threat of

* An earlier version of this paper appeared in *Journal of Economic and Social Thought*, March 2022.

US military action. In September of that year, Clark Clifford – who was to be a prominent advisor to Democratic presidents from Truman through Carter – wrote a secret memorandum calling for a global US security mission to oppose the USSR wherever it might menace "democratic" countries. He argued that it was not a matter of clashing security interests, but of moral shortcomings of Soviet leadership. The goal was not, for example, to maintain the balance of power in Europe, but instead to transform Soviet society (Kissinger, 1994, 450). Dean Acheson, as President Truman's advisor in early 1947, presented the case for aid to Greece and Turkey as part of a global struggle between democracy and dictatorship; such packaging was effective for securing US political support, and anticipated future themes. In March of the same year, Truman spoke of the Truman Doctrine in Wilsonian terms about giving effect to the principles of the Charter of the United Nations (Kissinger, 1995, 452).[2]

The longer source document of containment policy was State Department's George Kennan's 1947 essay in *Foreign Affairs*, anonymously authored as "X", "The Sources of Soviet Conduct." The concept was that Soviet domestic governance structure was formidable, but fragile. Under relentless pressure, it might implode. An insight from the paper was that communist ideology served the domestic function of legitimizing an illegitimate Soviet government (Gaddis, 1982, 34). Kennan anticipated a scenario for collapse. He called for:

> a policy of firm containment designed to confront the Russians with unalterable counterforce at every point where they show signs of encroaching upon the interests of a peaceful and stable World (Kennan, 1947, 575).

The goal, similar to what was outlined in Clifford's memorandum, was to *convert* the Soviet Union to a different kind of system, one that would cease to challenge world peace and stability. For Kennan, this was not an effort to be

[2] "Wilsonian idealism" refers to a policy asserting a collection of goals to include self-determinism, democratic government, collective security, and the rule of law. Conceptually, it stands against a policy based on advancing the national interest.

compartmentalized for diplomats and perhaps military leaders to address. It would require a society-wide engagement. As he wrote in the same essay:

> The issue of Soviet-American relations is in essence a test of the overall worth of the United States as a nation among nations... [T]he thoughtful observer of Russian-American relations will find no cause for complaint in the Kremlin's challenge to American society. He will rather experience a certain gratitude to a Providence which... has made their entire security as a nation dependent on their pulling themselves together and accepting the responsibilities of moral and political leadership that history plainly intended them to bear (Kennan, 1947, 582).

Kennan defined an extraordinary task, one he asserted to be entrusted from Above. It recalls President Woodrow Wilson's quasi-religious appeal to "make the world safe for democracy" after the First World War, but it goes beyond Wilson in its call for transformation of *American* society. Henry Kissinger comments in *Diplomacy* (1994), his *magnum opus*, that Kennan "had defined a task so complex that America would nearly tear itself apart trying to fulfill it" (Kissinger, 1994, 456). Churchill, leader of the Opposition in Parliament in the late 1940s, already warned against a Western policy following Keenan's concepts that would bring the psychological strain of endless strategic stalemate (Kissinger, 2011). Looking beyond diplomatic events, it is easy to speculate that the demands of Containment affected other aspects of American culture during the 1950s. The image of a militarized economy with accompanying oppressive social norms was reflected in, for example, C. Wright Mills' *Power Elite*, or in Herbert Marcuse's *One-Dimensional Man*.

Kennan was not effective as a senior diplomat, perhaps because he found it hard to focus on what Kissinger calls the "immediately feasible" (Kissinger, 2011). Kennan became critical of the way Containment was implemented – especially in a militarized form – and over subsequent decades he perhaps felt remorse for his role in introducing it. It was left to Dean Acheson, Truman's Secretary of State from 1949 to 1953, to take the lead in applying a containment framework as

policy. The North Atlantic Treaty Organization, established in 1949, was explained in the US not as defending territory, and not as directed against an enemy, but as defending principle, and directed toward preventing aggression from whatever source it might arise. That is – it was different from a European-style military alliance. Acheson no doubt suppressed a smile, but these formulations smoothed Senate approval of the Treaty. In fact, none of Containment's advocates were optimistic about the potential of the United Nations to resolve disputes, especially those between great powers. As a matter of political culture, NATO was thus an odd combination of a military alliance intended to advance power interests of its members while packaged in language of League of Nations-like collective security.

Containment, as outlined by Clifford, Kennan and Acheson, disdained East-West negotiation, left initiative to the other side, and hence prescribed that US policy be (in Kissinger's word) "reactive" (Kissinger, 1994, 455-456). Kissinger described three alternatives to Containment's long-range strategy. The first he associates with journalist Walter Lippmann, who argued that Containment would drain American resources and bring psychological and geopolitical over-extension. Lippmann proposed more limited objectives, but combined it with recommendation for an assertive diplomacy with the Soviets. The second was from Winston Churchill, who wanted to use what he thought a strong Western strategic position to negotiate, or to demand, a settlement – while the US had an atomic bomb and the Soviets did not. We can link Lippmann and Churchill together as "realists." They wanted to co-exist with the Soviet Union, and to establish a balance of power to constrain it in Europe and perhaps elsewhere, without trying to transform it (or the United States!) in the process (Kissinger, 1994, 463ff). Implicit in this realist argument was that a Soviet effort to achieve hegemony in Europe could have been prevented by Western power at the time. Realists would not welcome the "psychological strain of continuous stalemate" embraced by some early cold warriors, and they generally give short shrift to discussion of legal principles or ideological preferences. By

the time he returned to power in 1951, Churchill's objective had adjusted toward making Containment less rigid, hence toward what Kissinger writes anticipated his and President Nixon's policy of "détente" in the 1970s (Kissinger, 1994, 512). Kissinger's partiality to the realist critique of Containment policy is evident. The critique is also, he says, the position least conformable to American culture, which is marked by geographic isolation, hence relative security, from other great powers; and – perhaps until recently -- by almost messianic idealism about transforming the world.

The third objection to Kennan's Containment came from left "moralists," led at the time by Henry Wallace, Franklin Roosevelt's third-term Vice President and 1948 third-party presidential candidate. Their view was that America should improve its own moral standing before intervening against Soviet action in Europe or elsewhere. Wallace advocated something close to League of Nations style collective security, which he believed had also been Roosevelt's intention. (In fact, Roosevelt hoped Stalin would cooperate after the war. But his likely backup plan was to bring American and British military power to bear, were that to become necessary (Kissinger, 1994, 409).[3] Wallace held the silly view that Russian political freedom and religious toleration were expanding in Stalin's Soviet Union in 1945. His political position collapsed in the face of the communist coup in Czechoslovakia and the Berlin blockade, both in 1948. But Kissinger notes that the Left moralist critique of US foreign policy had strong resonance in the following decades, and that it has deeper roots in American thought patterns than does any kind of realism (Kissinger, 1994, 467-469).

Containment, as offered in the late 1940s, was a set of axioms often without clear policy applications. An exception was the Marshall Plan, soon implemented in part on Kennan's recommendation (Gaddis, 2005, 31-32), toward preventing collapse of western economies that might leave populations open to Soviet blandishments. Containment's founders were not always rigid. Kennan embraced diversity among

[3] Kissinger cites a speech on topic by Arthur Schlesinger Jr.

governments and multipolarity in the world order as relatively stabilizing; Acheson wanted the State Department to encourage Tito's Yugoslavian breakaway from the Soviet bloc (Gaddis, 1982; 42-43, 67; also Brands, 1989, 141-180). But in the years ahead, two items, with Acheson's involvement, became emblematic of Containment policy. One was "multilateral force" (MLF) arrangements for nuclear weapons – to provide for European policy input, but while denying national control even to close allies. This grew out of Acheson's conviction by July 1951 that America should keep a major troop presence in Europe, including in Germany, almost indefinitely. The troop presence became a point of agreement among the US, Soviet Union and Germany; Stalin did not want an independent Germany, and was amenable to having the western part of it under US direction. Various plans for a European Defense Community, independent of the US, were put forward but never became viable. The alternative took shape: keep NATO forces under a US Supreme Allied Commander – Europe (SACEUR) (Trachtenberg, 1999, 119-120). A second item, represented by National Security Council document 68, which was drafted by State Department Policy Planning Director Paul Nitze and presented to Truman in April 1950, laid out a proto "domino theory" as basis of a Cold War strategy. A defeat anywhere – eg, in Czechoslovakia – was a defeat everywhere; this reasoning was extended already to developing world venues, including Indochina. And NSC-68 emphasized that aggressive behavior could be changed only through conversion of the Soviet Union, which in fact should *precede* serious negotiations (Kissinger, 1994, 462, 624, 755).

As Kissinger tells it, Containment remained the default position of American diplomacy vis-à-vis the Soviet Union until the early 1970s, if not longer. At that point, he as National Security Advisor, and President Nixon (1969-1974), opened "triangular diplomacy" with China and the Soviet Union, then used new geopolitical fluidity to relax tensions (hence, "détente"), and to break locked-in positions involving Germany, Vietnam and elsewhere.

> ...the Nixon Administration's approach to containment differed from that of Acheson and Dulles

> in that it did not make the transformation of Soviet society a precondition to negotiations. Nixon parted company with the fathers of containment and chose a path reminiscent of Churchill, who in 1953 had called for talks with Moscow after Stalin's death (Kissinger, 1994, 713).

In fact, as we will see, Containment as a policy framework was largely abandoned a decade earlier during the Kennedy administration (1961-1963); this happened vis-à-vis European and Soviet issues and again regarding intervention in Third World hostilities. Rigidity was alas reintroduced during the subsequent Johnson (1963-1969) and Nixon administrations, especially regarding the developing world. Kissinger's omissions were matched by others: an important part of the story of the Cold War – the Berlin settlement of 1963 – is often neglected, with resulting confusion about policy choices during the following quarter-century.[4] The US-Soviet rivalry continued, but within understood boundaries. We concentrate here on the Berlin Crisis and its resolution, some developments in post-colonial Africa, and how the US expanded its role in southeast Asia.

NATO and the Berlin crisis

Soviet First Secretary Nikita Khrushchev (1953-1964) announced in November 1958 that the Soviet Union would sign a peace treaty with East Germany that would end the rights of the US, Britain and France in Berlin. He added the ultimatum that Western powers had six months to reach settlement with East Germany, otherwise – the expected outcome – they would have to leave Berlin. Kissinger narrates that Khrushchev sought to convert new Soviet prestige from their Sputnik launch the previous year into diplomatic coin by demanding an end to Berlin's four-power status (Kissinger, 1994, 570). The Soviets' stated focus in launching the Berlin ultimatum in November 1958 was to burnish East Germany's sovereign credentials. In domestic politics, Khrushchev had

[4] Eg, Gaddis (1982, 1997, 2005), Morgenthau (1969, 1970), and Brands (2022) do not mention the 1963 settlement.

been challenged by a hardline group, led by Stalin's one-time foreign minister Vyacheslav Molotov, mostly for leading what they considered a feckless foreign policy. Khrushchev was also sensitive to Chinese ally's saber rattling around the Taiwan Straits, and did not want to look weak vis-à-vis NATO by comparison (Zubok, 1993, 2-5, 7). But the NATO powers essentially refused to budge. The six-month ultimatum was extended repeatedly.

The Soviets were concerned about more than access to Berlin or about East Germany's sovereign status. The broader issue was the military power of West Germany, whether it would develop nuclear weapons, and whether NATO would continue to absorb its power into their multilateral defense structure (Schlesinger, 1965, 347; Dobrynin, 1995, 52; Trachtenberg, 1999, 246-247, 252, 344; Brinkley, 1992, 94). The Repacki Plan, endorsed by Foreign Minister Gromyko in December 1957, already called for a nuclear free zone in central Europe. Lippmann interviewed Khrushchev in October 1958 and found him in "a cocoon of pre-1941 fears" – with US policy pushing Germany against the East, and with Adenauer as Paul Hindenburg, the aging President of the Weimar Republic who elevated Hitler to power in 1933 (Zubok, 1993, 8).[5] But NATO policy fell into disarray in the middle 1950s, and afterwards created gridlock against advancing negotiations. US President Dwight Eisenhower (1953-1961) wanted to spend less on conventional defenses, and intended for NATO to rely more directly on nuclear weapons. This New Look doctrine, outlined in a JCS report dated August 8, 1953, called for "redeployment" of US forces back to the continental US. It gave impetus to North Atlantic Military Committee Decision 48 (MC-48), in November 1954, which called for early first-strike nuclear response to Soviet provocation (Trachtenberg, 1999, 158-176).

Eisenhower was likely haunted by the human implications of official strategy (Thomas, 2012), and quietly wanted an exit. In July 1955, he and Secretary of State Dulles indicated during

[5] Zubok cites interview notes in the Walter Lippman Papers; Series 7, Box 239, F.27.

an NSC meeting their objective of "getting out of Europe" (Trachtenberg, 1999, 145). By 1957 and 1958, Eisenhower wanted to leave nuclear decisions to NATO's west European allies, including West Germany (Trachtenberg, 1999, 210, 262); and the US administration quietly but directly supported France's development efforts (Trachtenberg, 1999, 208-209). This was a reversal of the Truman-Acheson policy, under which a strong American SACEUR would anchor the US commitment to Europe. Indeed, Eisenhower's intention to disengage from Europe raised security fears for the Soviets, and did much to trigger their ultimatums over Berlin (see also Mearsheimer, 2014, 51). The US State Department stayed closer to a Containment script, hence wanted to keep US forces in Europe at capacity. State also wanted multilateral arrangements to control nuclear weapons, and floated MLF schemes reminiscent of Acheson's several years earlier. It was cool to British and French demands for national control, as such demands might also require empowering the Germans. As the Berlin crisis continued, NATO allies lacked plausible answers about how to reconcile Soviet demands regarding control over Germany, Western national demands and US commitments in Europe. Moving past the crisis required addressing, or in some cases revamping, negotiating positions of different countries, as well as different domestic arguments (especially in the US) regarding national defense and the role of NATO.

By 1959-1960, Eisenhower had cooled on national nuclear control, and his preference moved instead back toward MLF arrangements (Trachtenberg, 1999, 214-215). Correlated with this vision, USAF General Lauris Norstad, SACEUR, wanted NATO to operate multilaterally, and independently of direct US political control. In line with nuclear strategy, NATO military officials were prepared to respond to pressure in accord with military planning documents in place, not allowing Soviet sequences (or US political directives) to interfere in the escalatory process (Trachtenberg, 1999, 289-290, 301-302). This situation was indicative of civil-military tensions in US at the time.

German Chancellor Konrad Adenauer (1949-1963), and head of center-right Christian Democratic Union (CDU) to 1966, was committed to rebuilding Germany after WW2 as a West-integrated power. His role was essential in bringing West Germany into NATO, and in resisting any Soviet blandishments toward unification through neutrality. As Eisenhower put it in July 1953, "our whole political program in Europe [is based on] Adenauer's continuation in power" (Trachtenberg, 1999, 132; Gaddis, 2007, 134). Adenauer was always cool to talk of re-unification, in part because of skepticism about East German voters as left-leaning, also because he saw them as less inclined politically and even culturally to side with the West. But by 1956, he actively wanted Germans to have an independent nuclear force, and by 1961 he saw this demand as not negotiable (Trachtenberg, 1999, 232-238, 280, 330). Aware of potential opposition among allies, and concern about stirring old ghosts, Adenauer usually offered his views outside of public settings (Trachtenberg, 1999).[6] He vocally objected to US-Soviet negotiations over-the-heads of Europeans, hence opposed US-led détente initiatives.

French President Charles DeGaulle (1958-1969) continued earlier French demands for independent national control of nuclear weapons. More broadly, he wanted to expand France's and Western Europe's presence in a world dominated by two superpowers, a domination he thought against nature, and certainly against his vision of France in the world. DeGaulle did not want Germans to have nuclear weapons, but was even more dismayed by possible neutralization of Germany, which might pull it away from the West. As the Berlin Crisis evolved, France made itself the public defender of West German rights and eventual reunification. DeGaulle intended that a French-German combination would undermine superpower dominance, reinforce Germany's ties to the West, and raise France's power profile.

[6] online Appendix 6, "The US Assessment of German Nuclear Aspirations." [Retrieved from]. Trachtenberg cites Schwarz (1986).

Acheson, who resurfaced in a quasi-official role as advisor to the Kennedy Administration during 1961 and 1962, usually advanced a view common among many in the European section of the State Department. He had advocated ongoing conventional US military presence in Europe through the Eisenhower years, with a US control over nuclear weapons, perhaps via an MLF arrangement –to avoid sharing with West Germans, which he thought a non-starter (Trachtenberg, 1999, 284, 304-305, 309, 311, 356). Acheson argued that US and other Western powers could offer nothing on Germany that Soviets would accept, hence – in line with Containment axioms -- he opposed East-West negotiations (Schlesinger, 1965, 380; Kissinger, 1994, 588; Brinkley, 1992, 100, 140, 147). Subsequent to policy arguments over the French loss in Dienbienphu and at Geneva in 1954, he doubted the usefulness of nuclear weapons, hence he wanted to respond with non-nuclear force to Khrushchev's challenges over Berlin (Brinkley, 1992, 96-98).

British Prime Minister Harold Macmillan (1957-1963), in opposition to Eisenhower and other American officials, much preferred to avoid steps that might make military action over Berlin more likely. He and other British officials were aghast following a hard-line briefing from Acheson in April 1961 (Brinkley, 1992, 125). But Macmillan moderated opposition in order to maintain a common front with US positions (Trachtenberg, 1999, 266-267). Like France, Britain preferred national control over nuclear weapons, not MLF. Indeed, US efforts to promote multilateral control over nuclear forces – in line with Acheson's concept and with Eisenhower's later vision -- had a corrosive effect within the NATO alliance. Ongoing negotiations following the initial US agreement in 1957 to sell the Skybolt missile to the UK became a microcosm of broader strategic tensions.

Goaded by East German leader Walter Ulbricht, who faced a rising outflow of residents to West Berlin – roughly 2.7 million by 1961 (Gaddis, 2007, 114) -- and unwilling to risk military action to change Berlin's legal status, the Soviets in August 1961 erected the Berlin Wall. This move lessened tensions, as it was perceived as an alternative to military

action regarding the city's status, although without resolving most underlying security issues. Meanwhile, US President Kennedy already in 1961 offered the outline of a European settlement to include: 1) US forces stay in Europe, and West German forces remain under NATO command; 2) US tightens control over its own nuclear weapons in Europe, de-emphasizing MLF schemes; 3) Britain and France move closer to national control of their nuclear development; 4) West Germany does not get nuclear weapons, and is to be blocked from developing them; 5) *status quo* is maintained in central Europe: there is no change in West Berlin's status or access, and no Soviet peace treaty with East Germany. Kennedy's roving ambassador Averell Harriman had in fact tightened the US position on the last items with the explanation to Khrushchev in March 1961 that "all discussions in Berlin must begin from the start" (Schlesinger, 1965, 348).

The agenda took shape. The first two points would mean moving past Eisenhower's intention to disengage from Europe, and hence required reining in the SACEUR. The third meant moving past the public Skybolt and MLF controversies and in its place offering Britain the more advanced Polaris missiles, and with escape clauses that assured it of greater national control. Doing so would ruffle expectations of the Acheson-aligned group at the State Department, and elsewhere, that the US would maintain a weapons monopoly. The fourth, getting German agreement not to go nuclear, would be more complicated for as long as Adenauer was in command; by April 1962, the US had supplied the more co-operative Foreign Minister Gerhard Schroeder with a "principles" paper, apparently through a separate diplomatic channel. The Americans hoped to get DeGaulle on board, better to isolate Adenauer. Point 5, recognizing the status quo in central Europe, came implicitly to include leaving the Wall in place. During talks in early months of 1962 and afterward, and via such signaling as stopping harassment of US flights to West Berlin, Khrushchev indicated interest in a proposed settlement (Trachtenberg, 1999, 346).

What happened next on the Soviet side is a puzzle. Author Marc Trachtenberg summarizes in his Preface that we do not

know why Khrushchev did not agree to a settlement in 1961 when Kennedy offered diplomatic steps toward securing a non-nuclear Germany (Trachtenberg, 1999, ix-x). Soviet Ambassador to the US Anatoly Dobrynin tells us in his memoirs, 30 years later, that Khrushchev was mistaken in not being receptive to the offer (Dobrynin, 1995, 64). Or as Kissinger later put it, "It is difficult to comprehend why Khrushchev never explored any of the innumerable negotiating options that were offered, debated, and so often hinted at" (Kissinger, 1994, 592). Khrushchev instead raised new demands regarding Berlin, specifically for an end to all Western military forces in the city. Kennedy read it as a test of wills rather than as a serious negotiating position. He told French Foreign Minister Couve de Murville on October 9, 1962, that he expected an imminent showdown with Khrushchev, and that NATO forces should be prepared to move down the Autobahn toward Berlin with one or two hours of notice (Trachtenberg, 1999, 350). The expected showdown did occur a week later, not however in Berlin but with the Cuban missile crisis. Cold War historian John Lewis Gaddis suggests that Khrushchev "understood more clearly than Kennedy" during that period that the Soviet Union was losing the Cold War. Strategic "Potempkinism," effort to reassert control over heretofore allies Mao and Tito, pressures on Berlin, megatonnage nuclear tests – all had failed to reverse the trend. Khrushchev wanted another roll of the dice to turn things around (Gaddis, 1997, 261-262).

Kennedy guessed from its onset that the Soviets might use the Cuban crisis as a cover for a move on Berlin; but Khrushchev apparently ruled that out early in the confrontation. According to Dobrynin, indeed, the Soviets never contemplated military confrontation with the US (Dobrynin, 1995, 45). Kennedy decided early that he would have to trade removal of US missiles in Turkey for removal of Soviet missiles in Cuba, but he anticipated both opposition from his advisors and a negative reaction from NATO allies. So he cut advisors and allies out of discussion, and delivered an ultimatum – which included the Turkey trade -- directly to Soviet leadership. The Soviets accepted the trade (with the

understanding that they must not publicly link Cuba with Turkey), and were seen to have backed down; power relations were hence reshuffled. The Soviets never again threatened violence over Berlin (Trachtenberg, 1999, 345-355).

Kennedy then sought to reassemble the settlement as initially formulated in 1961. General Norstad was out as SACEUR by July 1962, as nuclear strategy moved from quasi-independent NATO headquarters in Brussel back to Washington's direct control (Trachtenberg, 1999, 301-302). Acheson himself was critical of Kennedy's handling of the Cuban missile crisis, as he thought the president too willing to negotiate with Khrushchev – rather than put the Soviet Union in a corner, damage its prestige in the world, and perhaps force a national implosion as envisioned by Kennan's 1947 formulation. (Keep in mind that the Soviet Union did not yet have nuclear weapons at the time of the X-article.) (Brinkley, 1992, 172-174). Following the October crisis, Acheson's brand of Containment was fading, and his days as a senior advisor in that administration were over; and there was less talk of multilateral decision sharing (Trachtenberg, 1999, 329-356). Kennedy and Macmillan did some public posturing over the sale of Skybolt missiles before reaching the Nassau Agreement in December 1962: Macmillan wanted to show British voters that he could stand up to the US; and Kennedy wanted to demonstrate for the "MLF clique" at the State Department the intensity of British demand for sovereign control of weapons. Quietly, the two leaders had already agreed that the Skybolt transaction would be scrubbed, and Britain instead would get the more advanced Polaris missile, with effective national control. Kennedy's intent was that Polaris also be offered to France, a step aborted by unauthorized State Department intervention (which asserted the otherwise discarded Acheson-MLF framework) by the beginning of January 1963. DeGaulle may also have seen the Polaris sale as linking Britain too closely to the US, and hence sought a different path to nuclear independence (Jackson, 2018, 591; Trachtenberg, 1999, 368). But, with Soviet concerns in mind, the advanced missile would not be offered to the Germans (Trachtenberg, 1999,

365-368). The last step required reaching out to Germans other than Adenauer.

As Adenauer was unhappy with the turn in US policy on nuclear weapons, and with US-Soviet détente, he turned to a receptive DeGaulle for an all-European combination. The upshot was the Franco-German friendship treaty (Elysee Treaty) in January 1963, with the implication that West Germany would gain access to nuclear technology. Washington was caught off-guard; and the Soviet reaction to the Treaty was furious.[7] The US ambassador to Germany soon advised German leaders that they would have to choose between France and the US. Before the German Bundestag ratified the Treaty with France, a preamble was added that made clear the priority of German relations with the US (Trachtenberg, 1999, 374-377). And James Reston at the *New York Times* ran a well-sourced column on January 22 – the day the treaty was signed -- that relayed official US displeasure. Adenauer, keeping channels open to the US, pursued last-ditch efforts to revive MLF talks, as a back-door way for Germans to get access to nuclear weapons, to no avail (Jackson, 2018, 594). By October, Adenauer was out as chancellor, and Ludwig Erhard was in. Erhard and Foreign Minister Schroeder, both of the CDU, were willing to cooperate with US and Soviets to keep Germany non-nuclear. These Germans chose close US relations, as French and Soviet alternatives were unattractive or unavailable (Trachtenberg, 1999, 344, 346, 397). US forces would stay on the ground in Germany, a turn of events surprising in 1963 to then-retired Eisenhower (Trachtenberg, 1999, 401). The center-left Social Democrats were mostly amenable, and hoped that improved relations with the Soviets, and de-escalation of Berlin tensions, would over time enhance prospects for German re-unification. When JFK spoke in front of the Berlin Wall in June 1963, the crowd reception was almost rapturous. They apparently took the message that America was reliable as Germany's most important ally, and peace would be

[7] US reaction, Trachtenberg (1999, 371-374). On Soviet reaction, *New York Times* (1963); also, Trachtenberg (1999, 381).

preserved. It may also be that Germans were too-much taken with Kennedy's public allure.[8]

In April 1963, Harriman met with Khrushchev, who twice linked the test-ban negotiations with the German question, and then asserted flatly that Berlin was no longer a problem between the superpowers (Trachtenberg, 1999, 387-388). But Kennedy did not want directly to single out Germans for non-proliferation attention, so that part of the plot was wrapped in the soft velvet of the Limited Test Ban Treaty, which would apply to all signatories. (It applied most urgently to Germany. Kennedy, for example, turned a nearly blind-eye to Israeli nuclear development during 1961-1963.[9]) Kennedy and Khrushchev agreed in principle on the Treaty in 1961, but it was not signed until August 1963, and ratified by the US Senate in September. The US compelled Germany to sign the Treaty, as a price for German reliance on the US, by a then-weakened Adenauer (Trachtenberg, 1999, 394). Meanwhile, the Soviets understood that any challenge to the German status quo would be likely to stir nationalist sentiment that might bring renewed pressure for nuclear development.[10] The settlement was self-reinforcing. We can take it a step further: the settlement could be reached only because it was implicitly understood that the Soviet Union would never achieve hegemony over Europe.

DeGaulle would not sign the test-ban treaty, despite US offers to help with underground testing or with the sort of data that atmospheric testing might provide. But the outline of the settlement was consistent with French interests: West Germany remained linked to the West, even without nuclear weapons; and the status quo in central Europe would be maintained. Trachtenberg suggests that DeGaulle's decision

[8] Morgenthau (1970, 345), suggests the last explanation. "The Problem of Germany," Sept. 1963.

[9] Trachtenberg (1999), on-line Appendix 8, "Kennedy and the Israeli Nuclear Program." [Retrieved from]. Trachtenberg cites declassified correspondence between Kennedy and Israeli Prime Ministers Ben Gurion and Eshkol.

[10] Eg, *FRUS* (1996). Kennedy's private letter to Khrushchev, October 16, 1961; p.40.

was driven by resentment, in part because the Kennedy Administration had forced Germany to choose between the US and France a few months earlier (Trachtenberg, 1999, 393). Perhaps it was more strategic than that. Foreclosing of the German option may have been a blow to DeGaulle's "grand national ambition" for France; but he would live to pursue it another way (Jackson, 2018, 594). DeGaulle considered a bipolar world to be temporary and that it "paralyzed and sterilized the universe;" nevertheless, he was bound to support his US ally during tense moments of the Berlin crises. As tensions cooled – coincidentally with progress toward a European settlement – DeGaulle began to downgrade relations with NATO (Jackson, 2018, 673-675). In June 1963, he withdrew French Atlantic and Channel fleets from NATO command; in June 1966, remaining French armed forces were withdrawn from the integrated military command. Days later, recognizing relaxation of European tensions – and the fizzling out of his opening to West Germany three years earlier -- DeGaulle traveled to Moscow to test different diplomatic waters. He wanted détente with the USSR, but led by Europeans (preferably French), rather than arranged by a US-Soviet combination. It was easier for DeGaulle to test the limits of the European settlement for having stood aside while it was constructed.

Aside from some notice for the Test-Ban Treaty, which has usually been understood (incorrectly) as not related to resolving the Berlin Crisis, the settlement was reached with little public fanfare. Indeed, the achievement appears to have been opaque to no less an observer than Hans Morgenthau, who wrote in December 1963 that the Franco-German treaty in January of that year represented a sort of dead end for Kennedy's NATO diplomacy. Morgenthau reported that the Kennedy Administration was "associated with the disintegration of the Atlantic Alliance;" he indicated that Kennedy had offered multilateral force proposals to NATO allies right to his end in November – the Acheson, MLF clique formula, which Morgenthau accurately described as "political

evasion" (Morgenthau, 1970)[11]. In fact, such proposals had been quietly abandoned over the previous two years. Perhaps more puzzling, Kissinger, writing 30 years later, made similarly incomplete comments regarding the Berlin Crisis and the subsequent settlement:

> ...[N]either side was in a position to substitute diplomacy for power. Despite the mounting tension, the arguments in favor of the status quo always seemed to outweigh the impulse to modify it. On the side of the democracies, an allied consensus proved impossible to achieve; in the communist side, Khrushchev's boasting may have raised the expectations of his colleagues to such an extent that even the major concessions the West was prepared to make seemed inadequate to the Kremlin hard-liners.
>
> ...Any concession conceivably acceptable to Khrushchev would weaken the Atlantic Alliance, and any settlement tolerable to the democracies would weaken Khrushchev (Kisssinger, 1994, 586-587).

Then Kissinger added:

> Through [the Berlin Crisis], the allies preserved their position on all the most essential matters – albeit with many a vacillation. For his part, Khrushchev had achieved no more than to build a wall to keep East Germany's unwilling subjects from bolting the communist utopia (Kissinger, 1994, 591).

To the contrary, Khrushchev and the Soviets achieved their most important requirements: the Germans would be bound by multilateral international treaty not to conduct nuclear tests, and hence not to develop nuclear weapons; and West German defense would be subsumed under a NATO structure. It is indicative of Kissinger's account that he nowhere in his discussion of the Berlin crises mentions multi-lateral force schemes or the 1963 Test Ban Treaty. The status quo was maintained regarding Berlin, even without a formal peace treaty. The NATO allies agreed that Britain and France would have access to or develop their own nuclear deterrents; for the US to accept this freedom for close allies was itself a step away from the Containment pattern of MLF arrangements.

[11] to (Morgenthau, 1970) "The Problem of Germany," September 1963; p.345.

One prospect was foreclosed by the settlement: that of a reunified nationalist or neutralist Germany that might become "a loose cannon on the European boat." Such a Germany might have sought Rapallo-like cooperation with Russia, as had occurred during the 1920s (Zubok, 1993, 3); it might also have turned against the eastern neighbor, as it did during both world wars. Morgenthau wrote in mid-1963 of the possibility of "a drastic change in the world balance of power through an Eastern orientation of a united Germany" (Morgenthau, 1970)[12]. Russian leaders were mostly disquieted by such a prospect, in the 1960s and later. As Mikhail Gorbachev, Soviet leader during 1985-1991, told US Secretary of State James Baker in 1990:

> We really don't want to see a replay of Versailles, where the Germans were able to arm themselves... The best way to constrain that process is to see that Germany is contained within European structures. What you have said to me about your approach is very realistic"[13]

The 1963 settlement included ongoing US military deployments in Germany; the neutralist Germany scenario was blocked. Kissinger concludes that "Containment had worked after all"(Kissinger, 1994, 593). In fact, what happened in 1963 was more like the anti-Containment, realist negotiation that Churchill had wanted during the middle and late 1940s, and again as British prime minister in 1952 and 1953. *Once a self-enforcing agreement was in place to prevent Soviet hegemony in Europe, rationale for a Containment framework should have dissolved.* The Soviets felt the ongoing US deployments from 1963 as a form of détente, as they allayed fears regarding a resurgent Germany. Soviet expansion beyond eastern Europe satellites would not happen. And US troop deployments continued on a smaller scale after the Cold War ended, after any rationale for converting the Soviet Union had vanished.

[12] to (Morgenthau, 1970) "The Problem of Germany," September 1963; p.345.

[13] Gorbachev-Baker meeting, February 9, 1990; in Zelikov & Rice, (1995, 184). Also, Trachtenberg (1994, 401-402).

Kissinger notes the role of the Quadripartite Agreement of 1971 (adopted while he was US National Security Advisor) in formalizing the recognition of East Germany, the status of the four powers in Berlin, and in creating "ironclad" access procedures. Kissinger reasonably notes that the Berlin Crisis ended as it did because of "latent Soviet weakness." (Kissinger, 1994, 593). But the Quadripartite Agreement would not have been realized without the prior Berlin settlement of 1963, which reflected the power relations among the US, its NATO allies and the Soviet Union. Going forward, the threat of nuclear brinkmanship faded, and the Cold War became a different, less intense conflict.

A different cold war?

Eisenhower, committed early in his term to a NATO strategy that relied on nuclear weapons, including the New Look and MC-48, believed East-West relations in Europe (and Korea in the Far East) to be frozen, with potential hegemony still in doubt. The only place the Soviets could expand was in the developing world. In line with Containment reflexes, Eisenhower shifted his Cold War battlefield to meet that challenge, indeed, to respond almost wherever provoked. From 1954, he popularized the concept of the "falling dominos." This was a bad idea, which reflected the focus of Truman-era planners on European recovery and defense. In a postwar world of decolonization, adoption of the domino theory frequently made the US the enemy of gathering nationalisms. In an era of East-West confrontation, it might have worked better to look for ways to tap down developing world tensions, to take countries off the global chessboard. And whatever Eisenhower's reasoning for policy in the developing world, his intended drawback from Europe would destabilize what had been implicit agreement among the US, Germans, and the Soviet Union, and raise the prospect of a nuclear-armed Germany. In a chain reaction, destabilization of the Cold War balance in Europe then contributed to carrying the same conflict, including its threats of nuclear force, into what had been, as far as great power diplomacy,

peripheral parts of the world. But the post-Berlin peace of 1963 tamped-down the European standoff, which, had it been better understood, should have implied diminishing need to draw developing world conflict into East-West brinkmanship.

At about the same time the European settlement came together, Kennedy delivered his "peace" speech at American University in June 1963. Where Containment doctrine urged vigilance and fortification for battle, Kennedy at American University urged critical self-examination and international reconciliation. In the months ahead, beyond a nuclear test ban treaty, Kennedy took the first steps toward normalizing relations with Cuba and toward reducing US force levels in Vietnam (Johnson, 2016, 91-93). He and Khrushchev were discussing a state visit to Moscow for the following year. Khrushchev's son Sergei, noting the end of the Berlin confrontation in 1963, told the *New York Times* in 2001:

> ...[T]here was much that President Kennedy and my father did not succeed in seeing through to the end. I am convinced that if history had allowed them another six years, they would have brought the cold war to a close before the end of the 1960s. I say this with good reason, because in 1963 my father made an official announcement to a session of the U.S.S.R. Defense Council that he intended to sharply reduce Soviet armed forces from 2.5 million men to a half a million and to stop the production of tanks and other offensive weapons. [He then indicates that his father wished to shift resources from military spending to agriculture and housing construction.]
>
> ...But fate decreed otherwise, and the window of opportunity, barely cracked open, closed at once. In 1963 President was killed, and a year later, October 1964, my father was removed from power. The cold war continued for another quarter of a century (Khrushchev, 2001; Quoted in Douglass, 2008, 53-54).

This is hypothetical; but it is interesting commentary that Sergei Khrushchev believed his father was removed from his post because he had invested too much in making peace with Kennedy – and because cold warriors were again in charge in the US after Kennedy's assassination in November 1963.

Back in real history, there would never again be another cold war confrontation involving major industrial powers on both sides. The multilateral force concept did reappear during the Johnson years, as German leaders continued to seek some route to access nuclear weapons; but that bottle stayed corked, as officials on both the US and Soviet sides were determined to prevent such access (Trachtenberg, 2012, 161-162; Dobrynin, 1995, 147-148). (With the French-German combination closed in 1963, DeGaulle also turned more decisively against West German possession of nukes (Jackson, 2018, 676)). Following the Berlin settlement, remaining venues for confrontation shifted to the developing world: the Middle East, Southeast Asia, Africa, Latin America.

Kennedy rejected the Containment framework of much of Eisenhower's foreign policy – the preoccupation with communist designs, military pacts, Soviet maneuvers, and anti-neutralism. As he put it in a 1958: "Less and less have we and our allies been concerned with our own capacities, our own positive objectives, and our own ability to reach new goals consonant with our own values and traditions" (Mahoney, 1983, 19).[14] Relations with newly and soon-to-be independent African countries were an emblematic, sometimes under-emphasized, aspect of the Kennedy record. Following his call for Algerian independence in a 1957 speech, he became the "man to meet" for African visitors to Washington. During his presidential run leading into 1960, Kennedy emphasized African issues as a way to attract black voters in the North without putting-off white Democratic voters in the South. In three months of campaigning, he mentioned African issues 479 times (Mahoney, 1983; 30). As a diplomatic strategy, Kennedy coincidentally thought encouraging nationalism in African former colonies to be the best way to counter Soviet inroads or communist enticements (Mahoney, 1983, 108).

The issue of the newly-independent Congo and the break-away Katanga province was boiling as Kennedy took office in January 1961. On January 17, three days before inauguration,

[14] Quoted from a US Senate speech, March 25.

the democratically elected leader Patrice Lumumba was assassinated with involvement of the CIA; based on testimony to the Church Committee in 1975, Eisenhower himself authorized US participation in meetings on August 18 and 25, 1960 (Newman, 2017, 224ff). Moreover, Eisenhower had become involved in Congolese events through a tacit agreement with NATO member Belgium to go along with his plan for regime change in Cuba (Newman, 2017, 406). Also, Katangan leader Moise Tshombe – a favorite with Belgian mineral extractors and white regime leaders in southern Africa -- was implicated in the murder in a UN report released late in 1961. Lumumba had been dealing with the Soviets mostly because Belgian, French, British and Eisenhower's US governments had isolated him -- Europeans usually because of commercial interests in Katanga, and both they and the US because of Lumumba's suspected communist sympathies. Harriman, however, had traveled to Africa and reported back to Kennedy during the campaign, in September 1960, that Lumumba was a genuine nationalist, not a communist; he urged further that the US continue to support the UN's role in the Congo, which to that point had been a barrier to Soviet intervention. But Harriman also opined that Lumumba's Soviet dealings and hostility to the UN role would be problematic for US strategy (Newman, 2017, 202-263). Kennedy only learned of Lumumba's death a month after his inauguration, but in the meantime had brushed aside entreaties from other African leaders to act in support of Lumumba's political interests.

Kennedy took a cautious middle road: he would support the UN presence in the Congo, championed by Secretary General Dag Hammarskjold, with the intent of preventing Katangan secession. Rather than endorse Lumumbists, Kennedy supported what was perceived as the more moderate Cyrille Adoula, which he intended could be acceptable both to Lumumbists concentrated in the northeast and Katangan secessionists, led by Tshombe, in the southeast. Kennedy continued the Eisenhower administration's dealings with Colonel Joseph Mobutu, who had led the coup (with CIA collaboration (Newman, 2017, 265-266)) to bring down

Lumumba in September 1960, and who continued as the key figure in the central government's army. Kennedy's premise, shared by Hammarskjold, was that without the Katanga province, the Congo would be deprived of resources, lapse into tribal rivalries, and descend into civil war (Mahoney, 1983, 94, 124, 131, 155, 245). Hammarskjold died in a suspicious plane crash in September 1961; (some evidence, including what were intended as secret communications between them, pointed to culpability for Tshombe and Rhodesian white-regime Prime Minister Roy Welensky (Mahoney, 1983, 103)). Kennedy at that point became more active in reasserting a role for the UN in suppressing the breakaway, and obtained US funding to support it; for a moment in late 1962, a tentative coalition of Congolese factions and other African and European governments in a supporting role held together. Katanga was seized by UN forces and Tshombe was forced into exile as the US administration's effort appeared to have succeeded (Mahoney, 1983, Ch.5). The UN had been deployed not to maintain collective security among great powers – a task beyond any international body's capacity -- but instead to aid small powers in remaining neutral, and in staying out of great power fights. But by the summer of 1963, the Congo again fell into chaos. Lumumbists challenged and weakened Adoula's position, and the Western "safety catch," Mobutu, was activated. Forces under Mobutu's command, but perhaps not his full control, rampaged in Katanga. Kennedy again, and against odds, pushed a UN funding bill through the US Congress, which was enough to keep UN forces in-theatre; Kennedy's objective all along was to use the UN "to keep the Cold War out of Africa," so as not have to deploy US forces (Mahoney, 1983, 225-226).

Kennedy's Congo policy, measured though it was, faced stiff US counter-currents. Tshombe became a darling of Republican politicians for his anti-communism, was lauded by the John Birch Society and what was left of the China Lobby, and the Luces put him on the cover of *Time*. Former and future GOP presidents and candidates, including Herbert Hoover, Barry Goldwater and Nixon, embraced him (Mahoney, 1983, 135-136). From the Democratic side, Acheson

(his Containment reflexes intact) tried to reassure European leaders that US support for UN activity in central Africa should not be mistaken for real US security interests – which, in his mind, nearly always lay in siding with NATO allies. Acheson was in 1968 to begin a frequent and enthusiastic correspondence with the same Welensky on post-colonial governance, race, and other African matters (Brinkley, 1992, 132, 324, 325). Johnson, Kennedy's vice president and successor, was a "not-so-secret admirer of Tshombe" (Halberstam, 1972, 292). In the face of a provincial rebellion in 1964, Johnson did not even try to extend Congressional funding to keep the UN in place. Instead, turning to the right, he had the US join Belgians in intervening with arms, airplanes and military advisors. In some desperation, white mercenaries from South Africa, Rhodesia and parts of Europe were also deployed. Mobutu, breaking away from what had been Kennedy's effort to build an enduring center, brought Tshombe back from exile to became prime minister the same year (Mahoney, 1983, 230). The optics of white intervention in central Africa were terrible, and made for a durable political setback to the US. Mobutu went on to become a quintessential corrupt African dictator, who would hold power into the 1990s. Kennedy had sought to provide training for Mobutu's Congolese army, preferably in coordination with the UN, intended to turn it from a marauding band to a professional military; but the effort never quite got off the ground (Mahoney, 1983, 226-228).[15] An un-knowable of Kennedy's demise is of whether, or how, that African history would have been different had he lived.

Back in the Americas, there was much speculation in the press in early April 1961 about an imminent effort to overthrow dictator Fidel Castro in Cuba. Covert action had been approved by Eisenhower at the White House, probably on March 17, 1960, for CIA planning and direction; meeting notes indicated that what was otherwise intended as an invasion by mercenaries and Cuban exiles would if needed be

[15] Mahoney's book is also useful for understanding Kennedy's initiatives elsewhere in Africa, including Ghana, Mozambique, and Angola.

reinforced by US forces (Newman, 2017, 61-65). Kennedy, in a direct break with that expectation, stated on April 12, 1961, that the US would not use military force to overthrow Castro (Kaiser, 2000, 47). The Bay of Pigs invasion took place during April 17-20 – and failed, in large part because Kennedy would not authorize military deployment in the heat of crisis, despite much pressure from the CIA and military to do otherwise. The fiasco, as it came to be known, was followed by two years of efforts to assassinate Castro by one method or another (essentially as extension of CIA-Mafia collaboration begun during the previous administration (Newman, 2017, 331ff, 406). All of the assassination efforts failed, and have stained the Kennedy legacy. The relevance of Bay of Pigs events to the account here is twofold. First, Kennedy tried to step back from Cold War-driven plans left over from Eisenhower (although in Cuba, he did not step back enough.) Second, he never wavered from his commitment not to deploy US troops, despite more than 100 of the CIA's ragtag force being killed on the beach and 1200 surrendering.[16] The pattern would appear again in events in Laos and Vietnam.

Eisenhower's administration also left a legacy of intervention in southeast Asia. On the day before the January 20 inauguration, Eisenhower advised his successor that a fall of Laos to communists would mean "writing off" the whole region, hence that Kennedy should be prepared to intervene militarily to prevent that from happening (Newman, 1992, 9). In September 1956, NSC 5612/1 set US policy against allowing pro-communists into an otherwise neutralist Laotian government. In 1958, the CIA intervened heavily against neutralist Prime Minister Souvanna Phouma (already in coalition with the communist Pathet Lao) in a Laotian election, but Souvanna won anyway (Kaiser, 2000, 22). In December 1959, without Eisenhower's authorization, CIA under Director Dulles arranged a *coup d'etat* in favor of anti-communist Phoumi Nosavan; the US president was apparently led to believe that coup was directed by other Laotians. A few months later, in August 1960, Souvanna

[16] Kennedy Presidential Library.

Phouma regained power, this time with Soviet support. In December of the same year, Phoumi regained power, again with CIA help (Newman, 2017, 371-373). Both of these coup interventions were carried out against the advice of US ambassadors to Laos, Smith in 1959, Brown in 1960 (Kaiser, 2000, 24-26). The US military led Kennedy to believe in February and March 1961 that Souvanna's forces were weaker, and Phoumi's stronger, than was the case; more accurate military intelligence had been gathered, but was internally suppressed. Kennedy agreed to troop movements around Laos in March reflecting the inaccurate information; some senior military officials took the message that Kennedy could be manipulated. By late March 1961, with Souvanna aided by North Vietnamese and Soviet forces, pro-American Laotians were in full retreat. The US military wanted a sizeable intervention; Defense Secretary McNamara mentioned the figure 11,000 troops (Newman, 2017, 375-380; Kaiser, 2000, 48).

The collapse of the Bay of Pigs invasion on April 20 had a profound effect on Kennedy, who henceforth became much more skeptical about whatever intelligence he got from the CIA or the military. A couple of weeks later, he told house intellectual Arthur Schlesinger Jr:

> "If it hadn't been for Cuba, we might be about to intervene in Laos." Waving a sheaf of cables from [Joint Chiefs Chairman] Lemnitzer, he added, "I might have taken this advice seriously" (Schlesinger, 1965, 316).

With that background, intervention advocates were put on the defensive. An important meeting was held on April 27 with the National Security Council to brief Congressional leaders. The military, led by Admiral Burke (standing in for Lemnitzer), made a case for intervention, which included the expectation that a war with China would likely follow -- and lead to the use of nuclear weapons. Congressional leaders, including Senators Mansfield, Dirksen, Humphrey, Fulbright, Russell, Saltonstall and others, and House Speaker Rayburn, were underwhelmed, and unanimously rejected Burke's case (Kaiser, 2000, 48-49). Kennedy advisor Rostow called the meeting the worst he knew of during the Kennedy administration (Schlesinger, 1965, 315). Newman writes that

the meeting was the beginning of a series of events that "opened a breach" between the president and the Chiefs (Newman, 1992, 18). Kennedy decided against intervention, if he had not previously. Year-long negotiations began the following month, attended by 14 countries, which led to the Geneva Accords of July 1962. The Accords established a three-part government of pro-communist, pro-American and neutralist factions; it was mostly honored in the breach in the years ahead.

A few items from the Laotian story merit highlight. First, while Eisenhower was prepared to act unilaterally in Laos, Kennedy from the outset wanted to coordinate with Britain, DeGaulle's France, Nehru's India and others (Newman, 1992, 9; Kaiser, 2000, 42-45). Second, US advocates of intervention showed little interest throughout in what Laotians thought, or specifically in whether they were prepared to fight under Phoumi Nosavan against the Pathet Lao; for interventionists, it was all about the global military balance (Kaiser, 2000, 40, 49-50). Third, shocking to those examining the period decades later, was the readiness of some intervention advocates, led by the Joint Chiefs and joined by McNamara, to use nuclear weapons over the fate of a small, landlocked country in southeast Asia. In fact, that readiness reflected US military doctrine during the Eisenhower administration, including NSC 5809 (April 1958) and NSC 6012 (July 1960) (Kaiser, 2000, 17-19). Take this as emblematic of the then-prevailing Containment premise that the US must treat every confrontation in the world as potentially decisive for the East-West standoff. Fourth, in an anticipation of things to come -- including a post-Kennedy policy shift on Vietnam -- only Vice President Johnson, among April 27 civilian attendees, spoke out to support the military's case for intervention (Kaiser, 2000, 49-50; Newman, 1992, 16-18).

Historian David Kaiser shares a memorandum by Robert Komer (better known for his later role as pacification advisor in Vietnam) to National Security Advisor MacGeorge Bundy in February 1964 that pointed to the strategic issue of support for neutralism. Komer raised an alarm about the deterioration of US relations with neutrals, including Indonesia, Egypt, and

India, noting that the Johnson Administration was apparently "reversing the Kennedy line." He wrote:

> A hard line [against neutrals] now may increase the chances that – in addition to Vietnam, Cuba, Cyprus, Panama and other current trials – will be added come summer Indonesia/Malaysia, Arab/Israeli, India/Pak crises which may be even more unmanageable.

Kaiser noted that within a few years the three crises had mutated into civil wars. He adds that in 1964 the US refused a conference intended to reaffirm Cambodia's status as a neutral. He infers that Johnson himself took little interest in the matter at the time – the decision reflected the bureaucracy falling back on "its own instincts" (Kaiser, 2000, 314-315). Perhaps bureaucratic instincts included the Containment reflex that nationalism and neutralism somehow aided the Soviets? As Morgenthau summarized: "After [Kennedy's] brief and inconsequential interlude, the routines of the 1950s were continued with renewed vigor" (Morgenthau, 1969, 84).[17]

Kissinger supported the logic of the Vietnam engagement as early as 1955; he agreed a decade later that General Suharto should be supported against Indonesian communists. Kennedy sought to collaborate with DeGaulle and Nehru on a neutralist strategy in Indochina almost from the beginning of his term in 1961 (Kaiser, 2000, 44); Kissinger, in contrast, scarcely acknowledged neutrality-intentioned initiatives. Kissinger wrote 30 years later, approving Eisenhower's advice to Kennedy on Laos, that he would have preferred to intervene militarily there in 1961 or 1962 – with no mention of previous US interventions in that country, and without discussing arguments then advanced against a military role (Kissinger, 1994, 647).[18] Kissinger and Nixon a decade later were ill-disposed toward Indira Gandi, then the prime minister of India, the world's leading neutralist state. Kissinger's policies were reactive to communist or hostile

[17] Morgenthau again misses what would be the lasting success of the 1963 settlement.

[18] Kissinger's (1979) discussion of Laos begins with the 1962 Accords, with no mention of previous US interventions. pp.448-457.

provocations in the way anticipated in earlier Containment axioms. His strategic approach to Vietnam as national security advisor in 1969 departed little from what it had been during the Johnson administration following the troop commitments in 1965, or even what it had been during the Eisenhower years.

Containment as a *strategy* gave scant attention to nationalism as a force in developing countries. Mearsheimer noted a few years ago:

> A brief analysis of how American policymakers thought about interacting with smaller powers during the Cold War shows that they not only failed to appreciate how nationalism limits Washington's ability to intervene in other states, but also did not understand how that ism works to America's advantage. If the United States had to run the Cold War all over again, or had to engage in a similar security competition in the future, it would make good sense to pursue containment in a markedly different way (Mearsheimer, 2017, 223-224; also Rosato & Schuessler, 2011).

Kennedy embraced neutrality as a diplomatic solution, thereby allowing nationalisms to bloom without US opposition, and as a way to take emerging countries off the cold war battlefield. His Administration reversed the Eisenhower-Belgian policy of allowing the Congo to break up, and instead supported the UN in holding the new country together. Kennedy at the end of his term wanted to deal with Castro in Cuba if the latter would dissociate from Soviet subversion efforts in the western hemisphere (Mahoney, 1999, 287; Schlesinger, 1965, 999-1000). Laos faded to the left for years following the 1962 Geneva Accords, although this narrative should recognize that Eisenhower-era interventions to make that country an ally against Hanoi likely backfired. Neutrality between the West and the Communist-bloc did not provide immunity against civil wars, or against communist take-over through internal factions or even external invasion. Sukarno was a card-carrying neutral, but always dealt with the Indonesia communist party; his turn to them for support in 1964 led in phases to his removal from power – but the turn was in part a response to the post-Kennedy shift from the US

against neutralism (Jones, 1971, Ch.10). The context for most of these cases was that the US had no pressing national security interest in bringing such geopolitically peripheral countries to the anti-Communist ledger.

In a realist framework, it would matter that no other power become a hegemon in its region – as the US was in the western hemisphere -- but the US might better have elsewhere adopted an off-shore posture of intervening only where such imbalance was threatened (Mearsheimer, 2014, especially Ch.2.). The purpose of NATO was to prevent a European power from achieving regional hegemony; toward that end, the US engaged directly. Given the importance of oil to the world economy, the US had an interest in preventing any country – perhaps the Soviet Union or Iran – from gaining hegemony over the Persian Gulf; indeed, this became the Carter Doctrine. Similarly, the US would have reason to prevent an Asian power from acquiring hegemony in the Far East – although that should not have been a major concern during the 1960s or 1970s (See Morgenthau, 1970, "The Far East", 1968; 396-397). Essential geopolitical dynamics were conflated with concern about communism, which was perceived as automatically advancing Soviet – and later, Chinese – power interests. Indeed, such reasoning was built into early Cold War national security documents, and it was implicit in Containment axioms. Those premises often set an unfortunate presumption against neutralist policy choices. Foster Dulles said in 1956 that a policy of neutralism was "indifferent to the fate of others... immoral and shortsighted (Kaiser, 2000, 20). Dulles' sweeping language went beyond US policy; in fact, the Eisenhower administration often dealt constructively with such "Bandung generation" neutrals as India and Nassar's Egypt (Brands, 1989, 4-5).[19] But a wave of post-colonial new countries triggered Eisenhower-era anti-communist reflexes, in Africa and especially in southeast Asia. Morgenthau credited Kennedy in retrospect with having moved beyond such a mindset, noting:

[19] on Dulles' statement; throughout on India and Egypt.

> ...the intellectual recognition on the part of the Kennedy administration that Communism could no longer be defined simply, as it could in 1950, as the "spearhead of Russian imperialism." Thus the crusading spirit gave way to a sober differentiating assessment of the bearing of the newly emerged, different types of Communism on the American national interest (Morgenthau, 1969, 18).

Here is a picture, a blurry negative, of what a different Cold War strategy – one using nationalism to US advantage -- might have been, especially after the 1963 European settlement.

Adifferent course in Vietnam?

There is a direct policy line from containment of the Soviet Union to the US commitment in Vietnam, initially in support of the French recolonization effort during 1950-1954, then as a US-supported anti-communist effort from the middle-1950s into the 1970s. Kissinger several times links early US commitments to supporting French forces in Vietnam during 1950-1954, and subsequent US intervention, to the domino theory (advanced in NSC documents 64 and 68, both from 1950). The requirement to prop up potentially falling dominoes was a variation on Wilsonian tenets, which, as Kissinger put it, "permitted no distinction to be made among monsters to be slain" (Kissinger, 1994, 621ff; Goldstein, 2008).[20] Such tenets dictated confrontation over principles – international law, self-determination, democratic governance, and collective security – rather than over national interests.

It became Eisenhower's policy that the US must resist Communist expansion wherever it appeared. NSC 5429/5 of December 1954 committed the US to defend the SEATO (southeast Asia) area without help from allies, if necessary. NSC 5612/1 of August 1956 provided a framework for intervention, again independently of treaty requirements (Kaiser, 2000, 11ff). In his writings, Kissinger often tries to link

[20] Kissinger (1994), pp. 621ff. Goldstein (2008) summarizes the view linking US commitment in Vietnam to seldom-questioned policy of containment over two decades; p.240.

Kennedy's policy choices to a Containment framework. He notes the universalist language of Kennedy's Inaugural Address; and he surfaces a statement by then-Senator Kennedy in 1956 in support of US policy in Vietnam as the "keystone of the arch" of security in Southeast Asia (Kissinger 1994, 639). (Kissinger does not mention differently-directed speeches Senator Kennedy made on Indochina, Algerian independence, Eisenhower foreign policy, black Africa, or later as president at American University.) He says Kennedy's comments at a press conference on March 23, 1961, were consistent with Eisenhower's advice a couple of months earlier to intervene in Laos on behalf of Phoumi Nosovan; in fact, during the same press conference, Kennedy had shifted emphasis to seeking a neutralist solution, with as small a US military footprint as possible. Indeed, as early as a press conference on January 25, five days after inauguration and six days after Eisenhower's counsel of vigilance, Kennedy had said he wanted Laos to be independent of control from either side in the Cold War (Kissinger, 1994, 646; Kaiser, 2000, 38; Newman, 1992, 9, 14). Kissinger says, again inaccurately – see below -- that "more [US] troops were in the pipeline" for Vietnam when Kennedy was assassinated (Kissinger, 1994, 653). He then argues that it would have been difficult for incoming President Johnson to reverse the policy of a popular assassinated president, especially given that almost all members of that president's administration supported the war policy.

Kissinger notes that Eisenhower's anti-communism was to some extent softened by his traditional American anti-colonialism, and he calls the decision to avoid intervention on the French exit in 1954 "wise." (Kissinger, 1994, 636). In fact, the sweeping generalities of Containment often contrasted with policies actually pursued by Truman and Acheson, and again by Eisenhower and Dulles, as both administrations trimmed pronouncements down to some version of what they thought compatible with the national interest (Morgenthau, 1969, 17-18).[21] But whatever their private reasoning, Truman

[21] see Brands (1989) on dealing with established neutrals.

and Acheson publicly justified the Korean intervention in 1950 according to moral and legal generalities that easily blended with Containment logic. Consequently, the Cold War battlefield was expanded, which helped to bring China into the war, so to protect what communist leaders feared might be a US incursion against their territory, and against their revolution (Kissinger, 1994, 478-479).

Some of Kissinger's defenders point to private situations in which he challenged the case for escalation in Vietnam (Gewen, 2020, 249; Ferguson, 2015, 583-584). In fact, Kissinger acknowledges in the first volume of his memoirs that he was part of the "silent majority" in support of the decision to commit combat forces in Vietnam in 1965. He notes a page or so later that no one on the US side at the time had any idea how to win or how to conclude such a war (Kissinger, 1979, 231-232). (Wouldn't that be reason enough to withhold support?) Kissinger notes that Churchill rejected Eisenhower's effort to win him over to a more supportive position on Vietnam in 1954 (Kissinger, 1994, 632). Lippmann, the other realist Kissinger likes to cite, was consistently and publicly critical of US commitments in Vietnam. In late 1963, Lippmann – along with Senators Mansfield and Russell – endorsed DeGaulle's proposal to neutralize all of Southeast Asia, the better to save the area from Chinese domination; the advice was presented to the newly acceded Johnson, who rejected it (Logevall, 1999, 106). A year later, Lippmann met again with DeGaulle, and brought a similar message back to the White House – with the same result (Logevall, 1999, 280). Kissinger notes in *Diplomacy* that a "geopolitical approach" to Vietnam would have distinguished between what was significant in terms of national interest and what was peripheral (Kissinger, 1994, 621). But I can find only one sentence in Kissinger's memoirs on the topic of South Vietnam's negotiations with North Vietnam in 1963 (Kissinger, 1979, 231) and similarly one sentence in *Diplomacy* on DeGaulle's initiatives during 1963-1966 (Kissinger, 1994, 666). Rather than grapple with Lippmann's or DeGaulle's arguments, Kissinger preferred to define the debate as between idealists who "thought we could bring democracy to

Southeast Asia" and moralists who thought the US role reflected some "moral rot at the core of the American system" (Kissinger, 1994, 666). He notes the diplomatic and bureaucratic pull of containment and domino logic toward US commitment in Vietnam, including such overwrought themes as preventing "the collapse of non-communist Asia" and "Japan's accommodation to communism." Apparently taking such themes as plausible, he describes them as "too geopolitical and power-oriented" for Americans, who are inclined to "Wilsonian idealism" (Kissinger, 1994, 658). Kissinger then notes less cogent objections from Henry Wallace-style moralists. In this vein, he cites Senator William Fulbright's legal and moral reservations about intervention in 1961, while tut-tutting that a more cogent diplomatist – "a Richelieu, Palmerston, or Bismarck" -- would ask about the national interest (Kissinger, 1994, 650). Kissinger's framing of the Vietnam debate allows him to emerge, misleadingly, as a savvy advisor guiding his country through corridors filled with extremists or naifs on both sides.

Many from the Kennedy Administration did endorse the military buildup in 1965, as Kissinger noted, but there were exceptions. Kennedy-appointed State Department officials Bowles and Ball and Ambassador-at-Large Harriman opposed the buildup (Parker, 2005, 366). Kennedy National Security Advisor McGeorge Bundy was open in 1964 to neutralization of the region as a possible solution (Kaiser, 2000, 295). Kennedy-linked intellectuals Schlesinger and John Kenneth Galbraith were resolute opponents of the Vietnam commitment from the beginning. More to the point, based in part on John Newman's research, we know that Kennedy was in the process of ending the US commitment to Vietnam before his assassination in November 1963. National Security Action Memo 263, issued without public announcement on October 11, directed withdrawal of 1,000 soldiers from the Vietnam theatre by the end of the year (Newman, 1992, 407-411). Subsequent to Newman's 1992 study, additional relevant documents were declassified. We have General Maxwell Taylor's memorandum of October 4, 1963, written under Kennedy's direction: "All planning will be directed towards

preparing RVN forces for the withdrawal of all US special assistance units and personnel by the end of calendar year 1965" (Galbraith, 2003).[22]

Some, notably Noam Chomsky, have argued that any withdrawal plans by Kennedy were contingent on US military victory; inasmuch as the US was nowhere close to winning at the time, Chomsky says, such plans were empty of content. He adds that that Newman "never suggests" that Kennedy had reason to believe optimistic reports on battlefield progress were inaccurate (Galbraith, 2003; Galbraith quotes Chomsky, 1999). Chomsky is wrong. Newman argues that Kennedy well knew of deliberately misleading military assertions of progress by March 1963, if not earlier. By that time, Newman concludes, Kennedy resolved to get out *even if the war was lost* (Newman, 1992, 320-321. Italics added). In tune with the "deception" in Newman's subtitle, Kennedy reasoned in early October:

> ...The irony of the elaborate deception story [from some in the US military], begun in early 1962, was this: it was originally designed to forestall Kennedy from a precipitous withdrawal, but he would now use it – judo style – to justify just that. The original architects of the deception had feared a collapse on the battlefield would bring about a U.S. pullout, but they had been careful to paint a picture of cautious "success" to prevent a claim of victory and a bring-the-boys-home routine to justify increased U.S. military participation in the war. Kennedy's plan was indeed more imaginative and brilliant than [US Embassy Chief of Mission] Mecklin first realized – and duplicitous. He was using the [September 1963] McNamara-Taylor trip to hold the fiction of success in place while he engineered a withdrawal (Newman, 1992, 410).

At about the same time, the State Department Request for Evidence 90 (October 22, 1963) summarized findings with this Abstract:

> Statistics on the insurgency in South Vietnam, although neither thoroughly trustworthy nor entirely

[22] Also, Jones (2003), on Taylor's memorandum; p.383.

> satisfactory as criteria, indicate an unfavorable shift in the military balance. Since July 1963, the trend in Viet Cong casualties, weapons losses, and defections has been downward while the number of Viet Cong armed attacks and other incidents has been upward. Comparison with earlier periods suggests that the military position of the government of Vietnam may have been set back to the point it occupied six months to a year ago. These trends coincide in time with the sharp deterioration of the political situation. At the same time, even without the Buddhist issue and the attending government crisis, it is possible that the Diem regime would have been unable to maintain the favorable trends of previous periods in the face of the accelerated Viet Cong effort (FRUS, 1963; Newman, 1992, 454).

On the morning of November 22, Kennedy's last day, he commented publicly in Fort Worth, "Without the United States, South Vietnam would collapse overnight" (Newman, 1992, 427). Also, the Diem assassinations of Nov 1 – which some have argued committed to US to remain in-theatre (Ferguson, 2015, 590-592) -- did not change the quiet momentum toward withdrawal. In a November 16 press conference, Kennedy indicated that he wished to permit "democratic forces within the country to operate," a formulation only a step away from the neutrality language used the year previously in Laos. Two days later, the troop withdrawal was announced publicly. Within a day or two of Kennedy's funeral however, troop withdrawal orders were effectively canceled, a decision directed by Joint Chiefs Chairman General Taylor – but no doubt with concurrence of Kennedy's successor (Newman, 1992, 433-434).

The planning baseline for Vietnam during the Kennedy years was rejection in November 1961 of advice to introduce ground troops, when Defense Secretary McNamara requested 205,000 in a secret memorandum (FRUS, 1988). Kennedy had taken what were understood to be political loses over Cuba and Laos earlier that year, and he faced nearly unanimous demands from military and national security leaders to make a large commitment in Vietnam. The decision instead to send

16,000 advisors was an attempt to buy time, in the context of electoral politics. The essential choice was not "kicked down the road," it was made: there would be no US ground troops in Vietnam under the Kennedy administration. Deceptions and counter-deceptions, at the highest levels of the US government, were made to break or to implement that choice. Kennedy made a decision against Containment as it had been practiced, in favor of neutralism and nationalism. It has obvious echoes with choices made at about the same time on the Congo, Cuba and in Laos – which offers some of the best corroborative evidence on where JFK's Vietnam policy was headed. And, as was true of the other choices, Kennedy's directions on Vietnam scarcely survived his death.

There is much irony in Chomsky and Kissinger both sidestepping evidence that Kennedy was taking US forces out of Vietnam; both have been committed to almost opposite Cold War narratives that such evidence contradicts. Chomsky's hard left critique holds that US policy prizes capital over people, so he rejects evidence that any US leader – especially a popular one – could have embraced nationalism to avert war. And inclusion of such evidence undermines Kissinger's account of US options in Indochina as narrow and limited by prior commitments during most of the 1960s. Kissinger (and Nixon) did not acknowledge, even in 1968 and 1969, what Morgenthau and others had by then emphasized for the better part of a decade: by one route or another, Communists were going to rule in South Vietnam.

Evidence of the step away from Containment policies in Europe, Africa and Southeast Asia suggests a weakness – more than a time lag -- in Kissinger's geopolitical analysis, especially regarding worldwide commitments. Morgenthau wrote of the Truman Doctrine (almost co-sourced with Containment), for publication in 1969:

> ...[T]he Truman Doctrine transformed a concrete interest of the United States in a geographically defined part of the world [Greece and Turkey] into a moral principle of world-wide validity, to be applied regardless of the limits of American interests and or American power (Morgenthau, 1969, 17).

Even at the point of maximum concern about Soviet intentions – during the 1950s and early 1960s – Morgenthau (in common with Lippmann and Churchill) drew limits on the scope of US interests and the extent of its plausible power. Morgenthau also indicated that fighting a war like the one in Vietnam that inevitably brought major damage to civilian populations would undermine the international prestige, and the domestic cohesion, of the country fighting it (Morgenthau, 1969, 137-138). In contrast, Kissinger during the same years had a Containment-driven concern with opposing the Soviet Union at every turn, even in venues of the Soviets choosing. Niall Ferguson's biography describes a meeting Kissinger attended in April 1961 with his patron Nelson Rockefeller:

> …[T]here is little doubt that Kissinger did most of the talking. Three clear themes emerge: first the return of limited nuclear war as an option; second, the need to stand up to Soviet encroachments anywhere and everywhere; and third and most important, the need for idealism in American foreign policy.
>
> …[T]he second Tarrytown argument – for treating "Cuba, Laos, South Viet-Nam, Berlin and Iran as testing points of national purpose" – was hardly likely to resonate with the writers of protest songs. Yet the notes make clear that, to Kissinger, losing such places to Communist governments would be a greater evil than fighting back.

Kissinger's third theme of "idealism" had a Wilsonian echo, or a Containment one, that the US must "play the part of the global policeman" (Ferguson, 2015, 471-472).

During the 1960s, DeGaulle was the Western leader who best understood the dynamics of neutralism in Asia. As Lippmann put it in the *Washington Post*, February 11, 1964, "DeGaulle has proposed a line of policy and a mode of thinking which we cannot afford to dismiss lightly" (Logevall, 1999, 106). Regarding Laos, DeGaulle advocated that the US seek a neutral solution, which he encouraged also for all of Indochina, and beyond. He offered several general advantages to accepting neutrality rather than seeking military victory.

1) DeGaulle told Kennedy in 1961, "the worst thing that could happen to the West would be a military defeat" (Kaiser, 2000, 54). And he told Lippmann in December 1964, in an accurate diagnosis, that it would take a million Americans to pacify South Vietnam, and that a lasting military victory could never be achieved (Logevall, 1999, 280).

2) Intervention by one side provokes intervention from the other side. DeGaulle added during the same conversation with Kennedy, "Southeast Asia, and that applies to Laos, Vietnam, Cambodia, and even Thailand, is not a good terrain for the West to fight on. The best thing to do is encourage neutralism in that area, the more so that the Soviets themselves do not have any strong desire to move in. They will, however, tend to follow every time the West moves in" (Kaiser, 2000, 539). The Vietnam historian William Duiker made a similar observation about the "dialectics of escalation" in the region:

> The new Soviet leadership [Brezhnev and Kosygin, who acceded to top positions in October 1964] apparently less fearful of the United States and anxious to prevent a closer Vietnamese relationship with Peking, promised to increase military assistance to Hanoi and pledged to support [North Vietnam] if it were attacked by the United States. One source notes that Moscow agreed to support a general offensive in the South if the United States continued to refuse meaningful negotiations (Duiker, 1981, 231).

3) DeGaulle argued in February 1964 that for the US to fight in Southeast Asia would make national leaderships there more dependent on China. Better, he said, to encourage neutrality (and nationalism), which would increase Indochina-Chinese friction (Logevall, 1999, 106). On a related point, the Soviets saw a re-convened Geneva conference to advance neutralism as a way to reassert their influence in the region, perhaps at the expense of China (Logevall, 1999, 191). France formally recognized China in January 1964, and DeGaulle sought ways to profit diplomatically from intra-bloc tensions – most of a decade before the Nixon-Kissinger

opening to China. Howard Palfrey Jones, the US ambassador to Indonesia during 1958-1965 observed a few years later:

> ...I was repeatedly approached by Ambassadors from other bloc countries, who deplored the escalation of the war in Vietnam, urged us to get out, and stressed that we were playing into the hands of the Communist Chinese by forcing North Vietnam into their arms. The Soviet concern at the time seemed clearly to be directed toward keeping Southeast Asia quiet for the all-too-obvious reason that the Chinese had the more advantageous position for exploiting a chaotic situation there (Jones, 1971, 338).

4) DeGaulle also told Kennedy that the US would be able to maintain influence in Indochina countries even when they were neutral. He added that France was able to regain some influence in Indochina – following its 1954 departure – only when it renounced future military action, "which seemed equivalent to Asians to a desire to rule them" (Kaiser, 2000, 54).

Not surprisingly, DeGaulle was unpopular with such Containment-driven US leaders as Lyndon Johnson and Dean Acheson (Brinkley, 1992, 189ff). But DeGaulle's counsel on Vietnam reads very well decades later. Kissinger often showed a diplomatist's respect for DeGaulle as a practitioner of their common craft. But he scarcely gave DeGaulle's views on Vietnam policy, or his Vietnam peace efforts during the Kennedy and Johnson years, more than a stray sentence.

Some inferences

Trachtenberg's *Constructed Peace* describes in detail a usually overlooked European settlement patched together during 1961-1963. The peace was based on implicit recognition by stakeholders that the Soviet Union would achieve no hegemonic objective in Europe. Had that outcome not been clear, the Soviets would not have agreed to leave the more productive three-quarters of Germany so openly aligned with the US, Britain and France. But Kennedy and his sometime collaborator Khrushchev were soon removed from the scene. Prominent academic observers, including Morgenthau at the

time and Kissinger later, seem not to have understood what happened. DeGaulle, who presumably did understand, for the moment stood aside. Yet the 1963 settlement endured, diplomatic pressures cooled to something closer to normal, and nuclear threats became less frequent and much less strident. It became easier for DeGaulle's France to challenge what had been a rigid East-West division in Europe, and subsequently easier for West Germans to pursue *Ostpolitik*. But the argument here goes a step further: had the construction of a settlement at the end of the Berlin crisis been better understood, the Western side might have pursued different policies over the following quarter-century. The settlement effectively replaced Containment's full-court pressure framework with East-West détente. Looking back over the subsequent decades, the message should have been heeded that reduced East-West tension meant that independence struggles and civil wars on the world's periphery could have stayed on the periphery. With the settlement, in a variation on what Lippmann and Churchill had advocated a decade and a half earlier, western strategy no longer required conversion of the Soviet system. In most cases neither US nor Soviet spheres of influence were being challenged. The Cold War might have faded away. That was evidently what Kennedy intended, and perhaps Khrushchev would have gone along with it.

A recent argument holds that "containment required abandoning a beautiful dream – collective security and global integration – for the ugly reality of rivalry…. Yet it is now seen as one of history's great strategies because its key traits were well suited to protracted struggle" (Brands, 2022, 238). Or as Kissinger wrote later of Kennan's "X" article: "No other document forecast so presciently what would in fact occur [more than four decades later] under Mikhail Gorbachev" (Kissinger, 2011). It is true that collective security through the United Nations was not going to prevent Soviet hegemony in Europe after the Second World War, any more than the League of Nations was able to prevent a German attempt at hegemony after the First. US policy in the years after 1945 also included large-scale assistance to European economic

recovery, and a military alliance to block future hegemonic efforts. These usefully separated early Cold War US policy from the isolationist turn during the interwar period. But we are left with a puzzle Ferguson sets up in his study of Kissinger, without quite resolving. Given US wealth, technology, impact of popular culture, relatively attractive governance, and abundance of allies, the central question should not be self-congratulatory about how the US won, but almost the opposite: why did the Cold War last so long? (Ferguson, 2015, 23-24).

Containment, as outlined by Kennan, and in part implemented by Acheson, Eisenhower, Kissinger and others, was less a response to protracted conflict than a contributor to it. Containment made sense as policy, if at all, when the outcome of the confrontation over hegemony was in the balance; by 1963, it should have been clear to all that Europe would have no regional hegemon. Despite Kissinger's claim, it was not Kennan's 1947 proposed strategy of avoiding East-West negotiation that led to the implosion of the Soviet Union by 1991. Kennan's suggestion that the Soviet Union would have to be "converted" before European settlement negotiations could begin offers no insight into the 1963 Berlin settlement, which was based on East-West dialogue; its essence was to lock West Germany, without nuclear weapons, into a NATO structure so that it would relax (not heighten) pressure on Soviet interests. And Nixon-Kissinger détente initiatives a decade later sought to link foreign policy issues in different parts of the world, but again not -- by Kissinger's own account -- to "transform" the Soviet system.

As practiced, Containment required subordinating regional and local conflicts to the logic of great power confrontation, or even to a great ideological struggle. That framework made it harder to resolve conflict, not easier. Moving away from the central European flashpoint of the Cold War, Kennedy's sometimes fitful approach to Africa was intended to hasten decolonization, and to invite nationalism and neutralism as the path for their future. He saw this mix, co-incidentally, as the best buffer against Soviet encroachment in Africa. In Indochina, Kennedy's developing strategy was to neutralize

the region, to remove it as an item of conflict with either Communist China or the Soviets. Frequent assertions that the US followed a containment policy for 45 years conflate different meanings of the word. Do post-1991 tributes to Containment's success mean to include most of US policy as having contributed to it – including nuclear brinkmanship, overthrowing elected leaders in different parts of the world, intervention in Vietnam? Or is it a more specific tribute to the narrower axioms from Kennan, Acheson, Nitze, or others during the formative years of the late 1940s and early 1950s, and as carried forward in subsequent decades? If the first, the term is so vague as to explain little. If the second, it is not accurate. What brought the Soviet Union down was a mix of inept central planning, corruption, generally declining economic growth, lack of innovation, and weak oil prices during much of the 1980s. Surely pressure to stay up with US military spending during the Reagan years strained a failing system, but that strain largely reflects the same economic weakness.

The onset of war in Ukraine in 2022 is evidence that the 1963 European settlement should have been updated during the previous two or three decades. The earlier peace was reached after years of nuclear ultimatums, and following a US reserve call up of more than 200,000 in July 1961. It was self-reinforcing even through the break-up of the Soviet Union, as it was in all sides' interest to keep it in place. The settlement did not touch the Warsaw Pact; for that moment, the destinies of East Germany, Poland, Hungary, Czechoslovakia, Romania, Albania, and Bulgaria were locked into the Soviet sphere. The settlement brought no conversion, no liberation, no rollback. In 1968, the Soviets suppressed an insurrection in Czechoslovakia, comparable to what had happened in Hungary in 1956 or East Germany in 1953. Following the break-up of the Soviet Union and the collapse of the Warsaw Pact in 1990-1991, Russian leaders were "led to believe" by US, German, French and British officials that NATO would not expand eastward (National Security Archive, 2017). (The Budapest Agreement of 1994, under which Ukraine returned nuclear weapons on its territory to Russia, is sometimes cited

as evidence of US security commitment to the Ukraine. But anyone in the West who took that agreement as consent for Ukraine to join a potentially hostile military coalition, reversing what had been implicit in discussions three years earlier, was surely mistaken.) Through negotiations beginning in 1996 with the new member states – while excluding Russia -- all of these formerly Warsaw Pact countries were nevertheless absorbed into NATO. By Western design, Russia was left on the periphery of a post-Cold War Europe (Sarotte, 2014). Even the three Baltic states, formerly part of the Soviet Union (via the 1939 Hitler-Stalin Pact), have joined NATO. More recently, in the 2008 Bucharest Summit Declaration, former Soviet Republics Ukraine and Georgia were advised they would become NATO members in the future. In November 2021, US Secretary of State Anthony Blinken and his Ukrainian counterpart Dymetro Kuleba signed the US-Ukraine Charter on Strategic Partnership, which refers back to the Bucharest Declaration as authority. Russian President Putin and Foreign Minister Sergey Lavrov immediately denounced the new framework, and demanded that NATO remove military assets it has deployed in former Warsaw Pact countries since 1997 (Mearsheimer, 2022).

NATO expansion eastward was a byproduct of the unipolar American moment, emblematic of the spirit of those years according to which the rules of great power politics no longer applied. But as Chinese wealth and power grew rapidly in the early 21st century, and Russia recovered somewhat from its historic weakness during the 1990s, multipolarity returned (Mearsheimer, 2019). The 1963 European settlement faded further from diplomatic memory. It should have been anticipated that a decision to expand NATO would not be self-enforcing, as it hardly served Russians' security interest – perhaps raising a military threat, and certainly by undergirding an alternative political model immediately on Russia's border. It violated the logic of the post-Berlin peace. NATO and Secretary Blinken have defended their action on legal and moral grounds (both of which are strong), and they – indeed joined by non-NATO countries -- have been

surprisingly assertive and unified in supporting such action.[23] But given current Russian leadership, NATO's messaging led directly to war in Ukraine. More than any time since the Berlin and Cuban missile crises, a scenario leading to armed conflict between one or more great powers is plausible, and the threat of nuclear war again influences policy choices (Ignatius, 2022).[24] From a cold *realpolitik* view, Russia in the 21st century does not present a threat to achieve hegemony in Europe, unlike the Soviet Union following the Second World War, or Germany twice during the first half of the 20th century. Whatever its *revanchist* intentions, Russia today is a declining power, without the economic heft, cogent governance, or growing population of the earlier challengers. From a US perspective, and perhaps from that of western Europe's great powers, the hegemonic threat now comes from China in the Far East. Accordingly, the US and western Europe should have focused in the new millennium on Asia and avoided war, or its provocation, in Europe.

In the face of evidence of large-scale Russian war crimes emerging in April 2022, willingness of Ukraine and its western allies to reach a peace agreement, or even limited compromise, has narrowed. Some sort of provisional armistice in the Ukraine is more likely, perhaps following a *de facto* Ukrainian victory. Any updating of the broader 1963 settlement will have to wait, and will depend in part on the role China choses to play, or not, in the war's aftermath. An overall settlement with China, comparable to the post-Berlin peace with the Soviets, is unlikely: China is in a stronger international position now than the Soviet Union was in the early 1960s. As China seeks regional hegemony in Asia, it will be disinclined to negotiate a settlement with the US, or with any combination of powers, that would hinder such an

[23] Another dimension of the Russia-Ukraine war is its role the 21st century's worldwide confrontation between authoritarianism and liberalism. That topic is obviously important, but is not addressed in this paper.

[24] Mearsheimer (2014b) noted that the path toward NATO's inclusion of the Ukraine threatened a "major war." Cohen (2019) commented that US Democrats' efforts to provide military materials to Ukraine were making theirs the "war party."

outcome. It will be in China's interest to keep the US distracted with European disputes; on the other hand, the Ukraine war has energized NATO countries as a more coherent geopolitical force – one that might become a counter-weight to Chinese objectives. Plausibly, the last could provide reason for China to encourage a new Europe-Russia détente.

Kaiser observes at the end of his study that the Vietnam War was "essentially" without effect on duration or outcome of the Cold War (Kaiser, 2000, 493). Kissinger has suggested that everything from Soviet support to Cuban activity in Africa, to the Vietnamese invasion of Cambodia in 1978, to the collapse of the Shah of Iran in 1979 and the Soviet invasion of Afghanistan the same year, were somehow a consequence of the way the US departed Vietnam in 1975 (Kissinger, 1994, 763). That is surely a stretch, and it misses the point. The more important evidence is that such Soviet activity scarcely affected the collapse of the Soviet Union and the end of international bipolarity just over a decade later. With the balance in Europe essentially stable after 1963, hence with the Soviet Union no longer a hegemonic threat, the linkages among events in different parts of the world that Kissinger usually emphasized became less important. The enemy-based, Containment reflex that the Soviet Union had to be countered at every turn became strategically misguided – certainly from the time of the European settlement in 1963, and probably before that. Nothing about national security requirements required that the US become an enemy of nationalism, or even of revolution.

Kissinger's sketches of Containment's early realist critics – Lippmann and Churchill – suggests that he wants to be associated with them. He observes that Kennan himself later reached a view closer to Churchill's, and suggested that the West might have successfully negotiated with the Soviets in 1944 or 1945 (Kissinger, 1994, 512). Kissinger argues that his and Nixon's approach to the Soviet Union was, he says, similar to Churchill's in that their administration did not seek transformation of the opposing power (Kissinger, 1994, 713, 813). But in several ways, his arguments during the 1960s were

anything but realist. One of these was Kissinger's ideological, or emotional, objection to revolution in general, and to communism specifically; in a world emerging from generations of colonialism, this tended to make him an emblem of outdated *status quos* – eg, in the Middle East, the western hemisphere, southeast Asia, or at times in Africa. Next, realists from geopolitical island powers, including the US and Britain, should stay out of on-shore fights, unless the regional balance is clearly at stake. As DeGaulle and Kennedy understood, Vietnamese unification (even under a communist auspices) would have added little to China's regional power position, hence war there was a fight to be avoided. A third not-very-realist position was the importance Kissinger assigned to keeping commitments, even where commitments locked the US into policies that were domestically or reputationally damaging.[25] It is unlikely that Kissinger would have convinced Richelieu, Palmerston or Bismarck of the wisdom of his approach to Vietnam. Many have the impression that Kissinger was a foreign policy realist; but a portion of his legacy was to give realism a bad name, especially in the US, often by malpractice of it.

Eisenhower's impulse in the mid-1950s was to reduce the US presence in Europe, but without first stabilizing the European framework of US-Soviet confrontation; more than anything else, those plans lit the fuse that led to the Berlin crisis and the threat of nuclear war. Eisenhower then left ill-informed interventions, and the prospect of larger wars, in the Congo, Laos and the Caribbean. After his departure, the West and the Soviet Union constructed a settlement that would remove the prospect of a nuclear Germany, reduce uncertainty over the status of Berlin, and allow the US to step back from trying to control military postures of west European allies. The might-have-been is about whether that peace agreement could have become a platform for neutralization of Southeast Asia, of Cuba, and of portions of Africa. The puzzle is that the 1963 settlement was not better

[25] For discussion, see Stoessinger (1976, 216-219); Gaddis (2005, 164-165, 170-171).

understood after Kennedy and Khrushchev departed – both in real time and in historical accounts.

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5 Ferguson, Kennedy, Kissinger and Vietnam: A fresh look *

For many readers, the story of the US involvement in Vietnam carries more than academic interest. Aside from the War's impact on the Vietnamese, it left a legacy of division and alienation among tens of millions of Americans that lingered for decades. Henry Kissinger's involvement stands in the middle of related controversies. Niall Ferguson's biography includes surprising detail, and draws attention to the roles of those who came earlier, especially to John F. Kennedy's, and to the way Cold War choices were understood and made.

Ferguson's account of Kissinger self-consciously follows R.G. Collingwood's premise that history is "a re-enactment of a past thought, [e]ncapsulated in a context of present thoughts" (Ferguson, 2015; p.xvi).[2] The subject, Kissinger, sought historical and intellectual precedent for his arguments and his policies to an extent that makes him unusual among

* Earlier versions of this paper were published in the *Selected Topics in Humanities and Social Sciences Vol. 6*, Septemner 2021.

[2] Parenthetical page numbers in text reference (Ferguson, 2015).

foreign policy practitioners. Ferguson evaluates Kissinger's record in this context, and Kissinger presumably expects as much. Ferguson has requisite background in intellectual history and in past and present diplomatic complexities to attempt such a task. He has also devoured reams of archival evidence, and has taken in Kissinger's published and most of his unpublished writings. His descriptions of various settings from Kissinger's biography – including Nazi Germany in the 1930s, upper Manhattan before World War II, the US Army during and after the war, Harvard University as a student and faculty member, various official consulting roles, and Kennedy and Johnson Administration politics in Washington -- are colorful and absorbing.

Ferguson tells us that Kissinger was not always a foreign policy "realist"; indeed, his academic background included embrace of a very ethics-driven framework from German idealism. Ferguson's case is that such study was not merely an academic interlude, but in fact played a role in building his policy arguments for decades to come. A weakness in Ferguson's account rests in some of his own judgments about Kissinger's academic and public life; he has a tendency to defend Kissinger's role even where his own narrative points toward harsher conclusions. But these are quibbles, inasmuch as Ferguson opens new information and perspectives about diplomatic complexities Kissinger confronted and in turn influenced. This review highlights Kissinger's views on US policy in Vietnam in the years before he was named President Richard Nixon's chief foreign policy advisor at the end of 1968.

Idealism and realism

The title of Ferguson's biography is "Kissinger 1923-1968: The Idealist". An organizing theme for Ferguson is that Kissinger was originally a Kantian idealist and always retained a core of that idealism. This is unexpected, not least because Kissinger has called himself a realist, an advocate of unsentimental pursuit of the national interest, for as long as he has been on the scene. Kissinger has never viewed himself

as a Wilsonian idealist, who would want to bring democracy or self-determination as a policy priority. He also had no interest in conservative idealism, for example of the kind represented by Russia‘s Alexander I at the Congress of Vienna in 1815. Nor has he ever been receptive to Neo-Conservatism, whether of its anti-Soviet variety in the 1970s or to the transformative, anti-Islamist version post-2001.

As an undergraduate at Harvard during 1947-1950, Kissinger was enrolled in political science, but read widely in the history of ideas. Kissinger‘s advisor, Professor Bill Elliott, encouraged him to study Immanuel Kant, around whose ethical framework much of his 380-page thesis, *The Meaning of History* [2], would be organized. For Ferguson, the theme of Kissinger‘s idealism is almost new in the literature, and its near-absence has "vitiated severely, if not fatally, the historical judgments many have passed" (p.28), and it is important enough to include in the book‘s title.[3] It merits summary here.

Kantian idealism connotes that properties we discover in objects depend on the way that those objects appear to us as perceiving subjects, in space and time, and not as something they possess "in themselves", apart from our experience. This framework is sufficient to overcome Berkeleyan and Humean skepticisms, to restore contact with real objects, and to account for "causality" and "necessity" as they are recognized in modern science. German idealism then moved from reason in science to the activity of reason in human history. But Kant did not tell us how aesthetics, religion, and (especially) free moral action can be understood: that is, how can the same behavior be both scientifically determined and freely chosen? The answer is that we cannot know with certainty in a given instance whether free will is exercised, but we can posit that it might be, and we are therefore obligated as moral agents to try to exercise it.[4]

[3] Ferguson notes that (Dickson, 1978) also reviewed Kissinger‘s philosophical interests.

[4] On Kantian ethics generally, see (Wolff, 1973).

Given the potential for moral action - which Kissinger wanted to use to define meaning in history - what might realize it? Kant established that as moral agents we seek to act in accord with duty; and we can will that a maxim for carrying out such duty should become a universal ethical requirement (hence, a "categorical imperative") - thereby resolving the earlier puzzle by making the same act, driven now by an ideal, both determined and free. This conception is formal, hence it does not tell us what the specific, or substantive, imperatives might be - yet these latter are exactly what philosophers, including Kant, often want to find. Such maxims, if we could derive them, would be very helpful in making political and historical judgements. Kissinger butted up against the difficulty of identifying such substantive maxims in his thesis. He wrote, for example:

> The categorical imperative provides the framework for Kant's philosophy of history. If the transcendental experience of freedom represents the condition for the apprehension of the greater truth at the core of all phenomenal appearances, then its maxims must constitute norms in the political field… the possibility of the categorical imperative results from its very conception not from its relation to empirical reality (Kissinger, 1950; pp.262-263).

Much of Kissinger's thesis was devoted to explaining that such thinkers as Arnold Toynbee and Oswald Spengler, who were not working in a Kantian framework, did not succeed in finding imperatives (or maxims) that could inject judgements into history, or, as he put it, that could "expand the philosophy of history into a guide for guaranteeing the attainability of the moral law." Kissinger tried to find such a Kantian maxim – for example, in a requirement to work for eternal peace -- but concluded that Kant had not succeeded (Kissinger 1950; p.240).

Kant failed in that task because a categorical imperative lacks coherence if derived in the abstract, or in personal isolation. Kant's deeper argument was that such duty-driven imperatives had no status outside a community of moral agents through which maxims might be derived, selected, and

"made applicable" (Kissinger, 1950; p.123). Six decades later, in *World Order*, Kissinger again dismissed peace-seeking as a maxim that could be directly applied. He went on, for similar reasons, to reject proposals in Kant's 1795 essay *On Eternal Peace* for a "perfect civil union of mankind" as representing brashness to the point of *hubris* in the power of reason, and as violating Kant's own doctrine (Kissinger, 2014b, p.400).

While Kissinger could not derive specific political maxims from Kantian ethics, Ferguson argues that he gained from his study, first, the perspective that one can genuinely experience freedom in "inwardly confronting" options, or "as a process of deciding [among] meaningful alternatives" (p.869). For example, more than a quarter-century after *The Meaning of History*, Kissinger was still citing Kant to explain an opposition between two imperatives, the obligation to defend freedom and the necessity for coexistence with adversaries (p.28). Later, especially in the case of the Vietnam War, he would set domestic justice within contested countries against US geopolitical goals. Second, his experience of such inward freedom led him to emphasize the importance of discourse and "ideals". On this basis, he would choose a system that advanced the ideal of freedom even if curtailing it would increase material welfare and efficiency (pp.242-243). Ferguson at one point calls Kissinger a "dogmatic anti-materialist" (p.803).

A critic could say that his Kantian framework is where Kissinger went off-track. Ferguson comments that Kissinger showed "no interest whatever in the idealism of Hegel" (p.29), although he does not tell us whether Kissinger rejected Hegel after reading him, or whether perhaps Professor Elliott discouraged him from engaging Hegel in the first place. In fact, Kantian idealism's incomplete capacity to reconcile scientific necessity with moral freedom did much to incubate subsequent German idealisms. Kissinger wanted to understand freedom, and "meaning", in history, *inside Time.* Kant, finally, could not help much with that. As the French Hegelian Alexandre Kojeve explained in the 1930s:

> To the extent that there is [in Kant] … [an] act of freedom, the relation to time is accomplished "before"

> Time. The act of freedom, while being related to Time, is therefore outside of Time. It is the renowned "choice of the intelligible character." The choice is not temporal, but it determines Man's whole temporal existence, in which, therefore, there is no freedom.... Man, as historical being, remains inexplicable. The history he creates by temporal free acts is not understood (Kojeve, 1969; pp.129-130).

A much older Kissinger reached similar conclusions, but without linking them to an Hegelian framework. He wrote that we could not discover historical meaning through reflection or declaration - which is essentially what Kant wanted to do - but only by facing challenges as they arise in real events (Kissinger, 2014b; p.374). We can ask whether Kissinger's intellectual framework during his years in power would have been different had he grappled with such post-Kantian concepts during or soon after his student years at Harvard. A realist geopolitician-in-waiting might have learned more from reliving the dialectic of ideologies in history than from consideration of inner freedom and the juxtaposition of extra-temporal ideals.

Ferguson often sets Hans Morgenthau, the leading foreign policy realist of the post-WWII generation, and by some accounts the founder of the academic field of International Relations, as a counterpoint to Kissinger.[5] In contrast to Kissinger's Kantian influence, Morgenthau during the mid- and late-1920s read nearly every word Friedrich Nietzsche ever published. Reflecting Nietzsche's influence, Morgenthau wrote in his diary in 1927 that "genuinely strong characters" accept life as it is. He wrote in a 1931 letter, "only adolescents cherish ideas about making the world a better place." Quoting Nietzsche directly, he added that to ascertain "what is and how it is" seems vastly nobler and much more responsible "than any speculation about how it ought to be"

[5] In an odd mistake, Ferguson describes Morgenthau as "nearly ten years older" than Kissinger. (p.17) In fact, their birthdates were nineteen years apart --1904 and 1923 -- and some of Morgenthau's most important work, including Politics Among Nations (1948), appeared before or while Kissinger was an undergraduate.

(Morgenthau, 1936; p.5). He reformulated this a few years later as *"Je constate simplement ce que je vois"* -- I simply state what I see. Biographer Christoph Frei points to these aphorisms as the intellectual roots of a realist (Frei, 2001; pp.101-102)

But Ferguson's argument that embrace of Kantian ethics somehow anticipates a foreign policy framework does not work. In arguing that Kissinger was not a simple-minded realist, Ferguson knocks down a straw man: even Kissinger's many critics usually acknowledge his complexity – but criticize his decisions. While reading Nietzsche may indeed have intellectually prepared Morgenthau to embrace a sometimes bleak realism, nothing about Kantian idealism or ethics is inconsistent with a realist grasp of foreign policy choices. Kissinger understood that moral maxims have no standing outside of a community that has accepted them, and the point of his undergraduate thesis was that no maxims can be called upon *a priori* to explain the meaning of history. A realist starting point is that there is no international community that can deploy such maxims to compromise any country's national interests. Kissinger sometimes departed from views of Morgenthau and other foreign policy realists, but those departures have little to do with Kantian idealism.

Ferguson's case that Kissinger was something other than "realist" from the outset rests too much on drawing emotional and policy contrasts between him and the older Morgenthau. A more recent study by Barry Gewen, *The Inevitability of Tragedy: Henry Kissinger and his World* (2020) stresses the decades-long confluence of ideas and attitudes between Kissinger and Morgenthau, as well as each's personal esteem for the other. Both were much shaped by their experience as emigres from Nazi Germany, which set their worldviews apart from most of their US contemporaries. Gewen cites Morgenthau's judgement that Kissinger was an outstanding Secretary of State. But he carries his thesis too far when he argues that the two men had converging views on US policy regarding the Vietnam War. As we will see, they did not.

Ferguson's account of Kissinger's views on 19th century diplomacy is based on close readings of the latter's texts, and

draws unexpected inferences. Notwithstanding whatever philosophical idealism may have motivated Kissinger, his early writings reveal a framework steeped in a realist world view. Despite many impressions otherwise, Kissinger did not at all take Austrian Prince Klemens von Metternich as a role model, and while he admired Otto von Bismarck's diplomatic acumen, he also believed consequences of Bismarck's role on subsequent German history were quite mixed.

Kissinger published *A World Restored* (1957), based on his doctoral dissertation, as a work of history, not as a blueprint for the way he might exercise power a decade-and a-half later. The book's public reception emphasized the role of Metternich, Austria's foreign minister at the 1815 (post-Napoleon) Vienna conference and subsequently its chancellor. In *Diplomacy*, Kissinger (1994) explains that post-Napoleonic peace was maintained not through an arithmetic balance of power alone but also through shared values – even what proved to be a short-lived common acceptance of moral maxims. But Ferguson's evidence makes clear that, in Kissinger's view, Metternich's success was instrumental and manipulative; it was not creative, and (in Kantian language) was not based on the "superiority of its maxims" (p.302). Kissinger depicted Metternich as a rigid protagonist for "an illusory restoration of the old order," which meant a battle against nationalism and liberalism (p.307). To underline the point, he described Metternich's face as "without depth," and his conversation as "brilliant but without ultimate seriousness" (p.293). Restoration-era legitimacy, reflected in a "Holy Alliance" among Austria, Prussia and Russia, and directed against France, was backward-looking – pre-Revolutionary -- and European stability based on it was not going to last. Ferguson indicates that Kissinger intended to complete a trilogy on 19th century diplomacy, with a central theme that Metternich's stability carried the seeds of violent destruction a century later. He wrote that Metternich "lacked the capacity to contemplate an abyss, not with the detachment of a scientist, but as a challenge to be overcome – or to perish in the process" (pp.302-303).

A more impressive diplomatic figure from *A World Restored* was Lord Robert Stewart Castlereagh, the British foreign secretary at Vienna. Castlereagh urged Britain to play an ongoing role not as an active participant in Europe – a role left to continental powers – but as an offshore balancer. As a down payment on his concept, when he arrived in Vienna he discarded his instructions from London, dissolved the victorious wartime coalition, and demanded moderation toward post-Napoleonic France. Britain had fought against Napoleon "for security not for doctrine, against universal conquest not against revolution" (p.306-307). Kissinger saw Castlereagh's conception of offshore balancing as a framework for the US a century and a half later. Unfortunately for the future peace of Europe, Kissinger argues, post-Napoleonic Britain would play this role only fitfully. As early as the Aix-la-Chapelle conference of 1818, Britain had drawn back from Castlereagh's vision, setting a tone for what was to come; his diplomatic instructions indicated that Britain was to interfere only in "great emergencies", and otherwise to avoid "continental entanglements" (Kissinger, 1994; p.89). Looking forward, Kissinger (1994; pp.212-214) asserts that a forthright statement of British commitment in July 1914 might have dissuaded the German Kaiser from confrontation. Castlereagh became a tragic figure, as he killed himself in 1822, perhaps a casualty of disappointment over his thwarted European agenda.

Europe had changed by the time Bismarck rose to prominence in the 1850s and became Prussia's Minister-President in 1862. The revolutions of 1848 capsized the legitimacy of the restoration order nurtured by Metternich – who then resigned as the Austrian chancellor. The Crimean War of 1853-1856 allowed France to break out of its post-Vienna diplomatic isolation. The European order symbolized by Metternich could be represented metaphorically with an eighteenth century model of the universe as a great clock, tending toward harmony and balance. Bismarck's new order and the unification of Germany in 1871 looked more like Darwinian survival of the fittest. Bismarck indicated that any state should value its opportunities over its principles –

meaning it should relentlessly pursue its interests. However, as a superior practitioner of power, Bismarck also understood its limits, which distinguished him from many of his admirers and most of his successors (pp.697-698). While he preserved much of the traditional aristocracy in Prussia, he also introduced universal suffrage and social legislation – and the latter helped to stanch what had already been a millions-strong German emigration to America.

Because Bismarck was no longer constrained by an anti-revolutionary framework, Prussia under his direction could be closer to all of the contending European powers than any of the rest of them were to each other. This practice allowed Bismarck to maintain the peace of Europe for two decades following German unification. It was also to become a model for Kissinger as the Nixon administration reached for an opening to China and détente with the Soviet Union.

But Kissinger found something disturbing in Bismarck's legacy. The title of his *Daedalus* article – "The White Revolutionary: Reflections on Bismarck" -- published in 1968, but written a decade earlier, suggested much. As we will see again, Kissinger dreaded revolution because of extreme measures that would be necessary at some point to contain it. The obverse of Bismarck's facility with the calculus of power was disdain for Restoration concepts of legitimacy. Prussia's conservatives distrusted Bismarck from the outset. Ferguson unearthed some unpublished manuscripts from the 1950s from which we learn that Kissinger at that time saw Bismarck's *Realpolitik* as dangerously immoral. In portentous language, Kissinger wrote --

> … about the nature of the new world that [Bismarck] was conjuring up, a world in which only miscalculation was evil and only failure is a sin. It was a world without illusion in which only giants or nihilists could live. (p.700)… It was the essence of Bismarck's revolutionary quality that he drew the full consequences from his skepticism – that all belief became to him only factors to be manipulated. …Thus the more Bismarck preached his doctrine the more humanly remote he became. The more rigorous he was in applying his lessons the more incomprehensible he became to his contemporaries.

> Nor was it strange that the conservatives gradually came to see in him the voice of the devil (p.702).

Kissinger's unease continued. In *Realpolitik* terms, Bismarck failed because an effective successor would have to have similar skills in assessing power relations. Potential Bismarcks are always in short supply. Kissinger's study of Bismarck seems to have crystalized what he already considered in *A World Restored* – that a balance of power requires a leavening of legitimacy if it is to produce lasting stability. Kissinger did waver eventually from his early judgments, and Ferguson notes that at some point, probably during the 1960s, he deleted a particularly critical paragraph from his Bismarck manuscript (p.874). Writing in 2011, Kissinger acknowledged that Bismarck was less cynical than he had earlier believed, and was not indifferent to ideals:

> ...Bismarck dominated because he understood a wider range of factors relevant to international affairs — some normally identified with power, others generally classified as ideals — than any of his contemporaries.
>
> Bismarck is often cited as the quintessential realist, relying on power at the expense of ideals. He was, in fact, far more complicated. Power, to be useful, must be understood in its components, including its limits. By the same token, ideals must be brought, at some point, into relationship with the circumstances the leader is seeking to affect. Ignoring that balance threatens policy with either veering toward belligerence from the advocates of power or toward crusades by the idealists (Kissinger, 2011).

Ferguson does not consider this late judgement on Bismarck (at least not in Volume I); but his biography achieves much in calling attention to Kissinger's discomfort with unalloyed power-seeking. Where he misleads somewhat is in his implication that other realists, including Morgenthau (Frei, 2001; p.7), even including Bismarck, disdain ideals. But by the end of the current volume, Ferguson concludes that an effective statesman will find it possible to "zigzag" between the poles of idealism and realism. (pp.873-874) Good realists, including Kissinger, understand ideals. Ferguson's account is

more helpful as a narrative of choices faced and made than in providing a conceptual framework for idealism and realism.

Kennedy and Vietnam

Ferguson devotes many more pages to Kissinger's understanding of and activity regarding unfolding events in Vietnam during the 1960s than to any other foreign policy topic. And while Kissinger's record in the Nixon and Ford administrations is far-reaching, historic judgment already weighs heavily on his and Nixon's Vietnam decisions. Ferguson's account of the years before he became National Security Advisor provides much context.

Ferguson reports that Kissinger in private was a "scathing critic" of Vietnam policy of both the Kennedy and Johnson administrations (p.583).[6] Kissinger, seeking some policy distance, told *Der Spiegel* in 2014, "You have to remember that the administration in which I served inherited the war in Vietnam" (Kissinger, 2014a). In November 1968, he said, inaccurately, "I never supported the war in public" (p.822). In fact, Ferguson records at least four previous instances in which Kissinger *did* publicly defend the war: a letter to the *NY Times* signed by 190 academics; participation in a Harvard v. Oxford debate in December 1965; another debate, this time at the University of North Caroline in June 1966; and a *Look* magazine interview later that year (pp.670-672).

As an advisor to the Kennedy Administration, he challenged the effectiveness of gradual escalation in Vietnam during 1961 and 1962, and criticized the decision to continue assistance to the Ngo Dinh Diem government absent "substantial" reform (pp.588-589). Tactical criticisms aside, however, much of Ferguson's evidence reinforces the conclusion that Kissinger never challenged the strategic wisdom of the US intervention or troop buildup in Vietnam. In March 1965, for example, he wrote to assure MacGeorge Bundy, the National Security Advisor under both Kennedy and Johnson (and who had been Kissinger's dean at Harvard) that "I think our present actions in Vietnam are essentially

[6] Also, Ferguson, (2015b).

right and to express my respect for the courage with which the Administration is acting." Two weeks later, he wrote again to say "the carping of some of your former colleagues at Harvard may create a misleading impression of unanimity [against the Administration's policy]. I will look for an early opportunity to state my views publicly" (p.623). Ferguson describes Kissinger generally as an "idealist committed to resisting Communist advance and an advocate of 'limited war'" (p.587).

Ferguson backs up his not-very-robust defense of Kissinger as an insightful critic of Vietnam policy with a harsh depiction of then-President Kennedy. The latter, he tallies, was a philanderer, unscrupulous in his political ethics, who sat out the censure vote on Senator Joseph McCarthy, fought dirty in the Cold War (including, according to Ferguson, conniving in the 1963 coup and assassination plot against Ngo Dinh Diem in South Vietnam,) and ran an ill-coordinated administration (pp.514-515). Some of these ring true, but they miss what is essential, which were Kennedy's efforts to reverse the escalation in Vietnam and to change the dynamic of Cold War diplomacy – perhaps to nurture détente a decade ahead of time, or even to end the Cold War altogether. A younger Congressman Kennedy travelled to Vietnam in 1951 during the French war there, and drew the conclusion that it would be very difficult for any Western power to fight successfully there. In 1954, Vice President Nixon called for intervention, if necessary using tactical nuclear weapons, to support the imperiled French effort; Kennedy, by then a senator, argued publicly against intervention where he doubted even a "remote prospect of victory." In 1957, in what was criticized as almost reckless, Kennedy spoke in the Senate against the French war in Algeria (Mahoney, 1983: pp.5-10). As President, quietly but in a similar pattern, Kennedy maintained an extensive private correspondence with Premier Khrushchev beginning in September 1961 and initiated efforts

through a third party to open communication with Cuba's Castro beginning in October 1963 (Douglas, 2010).[7]

John Newman describes this key 1961 decision of the Kennedy Administration regarding Vietnam:

> Kennedy's final decision – NSAM (National Security Action Memorandum) 111, issued on November 22, 1961 – against intervention, was arrived at after all the arguments for it that could be made had been mustered: when the intelligence unequivocally showed the battlefield situation was desperate, when all his top advisors agreed that the fate of Vietnam hung in the balance, and when most of them believed that vital US interests in the region and the world were at stake. Clearly, then, it was *the major Vietnam decision of his presidency*, drawing, as it did, a line that he never crossed. One of the principal theses of this work, derived from that decision is that Kennedy would never have placed American combat troops in Vietnam (Newman, 1992: p.453). (Italics added.)

Prior to NSAM-111, Kennedy sent General Maxwell Taylor to Vietnam for a first-hand look in October 1961. Taylor's original draft instructions for the trip included considering whether to invoke SEATO provisions and whether to introduce US forces; Kennedy redrafted the instructions to remove both of these. Taylor's report on November 3, against the President's guidelines, called for deploying a combat force of 8,000; Defense Secretary McNamara followed up a few days later with a top-secret memo to the President calling for 205,000 troops – the demand for a large deployment was already there as early as 1961 (Parker, 2005; p.370; FRUS, 1988). NSAM-111 rejected these requests (Logevall, 1999; pp. 26f). Taylor acknowledged two decades later to Army historian Andrew Krepinevich that he went to Vietnam "knowing the President did not want a recommendation to send forces."

Taylor's proposals left Kennedy blindsided, and nearly isolated among senior national security officials (Newman,

[7] Also, (FRUS, 1996) on the Kennedy-Khrushchev correspondence; and Dallek (2003) on Cuba.

1992; pp.135-136; Parker, 2005; pp.369ff). In an effort to block the momentum in favor of escalation, he twice sent John Kenneth Galbraith, then his Ambassador to India, to Vietnam to prepare official contrary opinions. As Ambassador Galbraith sardonically explained to his family, "[the President] sent me to Vietnam because he knew I did not have an open mind." Kennedy told Galbraith during the latter's visit to Washington in November 1961:

> There are limits to the number of defeats I can defend in one twelve-month period… I've had the Bay of Pigs, pulling out of Laos, and I can't accept a third (Galbraith, 2003).[8]

Kennedy was also concerned about stirring a domestic replay of the "Who Lost China?" debate of a decade earlier (Reeves, 1993; p.261). But it is likely that Galbraith's April 4, 1962, memo and subsequent meeting with Kennedy reinforced the latter's doubts about the war and led to directing McNamara's instruction in May 1962 to plan for withdrawal of 1,000 troops from Vietnam (Galbraith, 2003).

Kennedy's evolving strategic outlook was closely held. We know, for example, from the slow drip of information releases on the 1962 Cuban missile crisis that Kennedy's decision to trade removal of Soviet missiles in Cuba for removal of US Polaris missiles in Turkey was shared only narrowly even within the crisis Executive Committee (and did not include EXCOMM member Vice President Johnson.) It was publicly denied, until acknowledged in 1982 by former Kennedy Administration figures in a *Time* magazine article. The other shoe dropped with the release of tape transcripts in 1987, which showed that the President was nearly alone in his decision, and that almost everyone else in the room – including McNamara and Robert Kennedy -- adamantly objected to the trade. Fred Kaplan more recently speculates that "JFK himself was departing from the views of Kennedy men" (Kaplan, 2012). This narrative offers some background

[8] James K. Galbraith, author of Galbraith (2003), is John Kenneth Galbraith's son.

for understanding both subsequent decisions on Vietnam and disarray in executing them.

Newman provides evidence that Kennedy in early months of 1963 shared his intention to disengage from Vietnam within a limited circle that included O'Donnell, Galbraith, Senator Mike Mansfield, and probably McNamara and Michael Forrestal, among others – but certainly did not include Rusk, Bundy, or Taylor (Newman, 1992; pp.321-324, 426-427) [9] Reasons for such guardedness included 1) accumulating evidence, persuasive to Kennedy by February or March 1963, that military and intelligence officials, led by Generals Taylor and Paul Harkins, were feeding him a deliberately optimistic picture of progress in Vietnam in order to force his hand (Newman, 1992; p.320); and 2) Kennedy's certainty that airing his doubts about Vietnam would be politically perilous going into the 1964 presidential campaign.

Kennedy endorsed National Security Memorandum (NSM) 263 on October 2, 1963, which called for withdrawal of 1,000 US troops by year's end. But the 1,000 troops were only a first step toward withdrawal of most US forces within just over two years. Kennedy also directed Taylor, by then Joint Chiefs Chairman, to send a memorandum to services' heads, dated October 4, indicating:

> The program currently in progress to train Vietnamese forces will be reviewed and accelerated as necessary to ensure that all essential functions visualized to be required for the projected operational environment, to include those now performed by U.S. military units and personnel, can be assumed properly by the Vietnamese by the end of calendar year 1965. *All planning will be directed towards preparing RVN forces for the withdrawal of all U.S. special assistance units and personnel by the end of calendar year 1965*. (Galbraith, 2003) (Italics added.)

Ferguson leaves the misleading impression that initiative for this directive came from McNamara and Taylor, and hence lacked the strategic import of a presidential decision to

[9] Also, (Parker, 2005; pp.364-377) regarding John Kenneth Galbraith's role (Galbraith 1969, 1982).

withdraw from Vietnam. (In fact, following Kennedy‘s assassination on November 22, Taylor and McNamara led the policy reversal *against* the withdrawal directives (Newman, 1992; pp.434-435)). Ferguson then argues that the *coup d'etat* of November 1, 1963, against South Vietnam President Diem tied the US to Diem‘s successors and hence left Kennedy implicitly responsible for the escalation of the US role even after his death (p.590-592). Ferguson‘s view puts him on a page with Kissinger, who, notwithstanding his previous harsh criticism of Diem, wrote in a memo to his political patron Nelson Rockefeller in late October:

> If we undermine the Diem regime, we are really doing the Viet Cong‘s work for them… A public announcement by Secretary McNamara that we would withdraw 1,000 troops by the end of this year and the remainder by 1965 must give comfort to the Vietcong (p.592).

The Diem coup showed the Kennedy Administration in disarray, with sharp differences among State, Defense, and CIA. But countervailing evidence indicates that the most important policy decisions lay in the future, going into 1965 (Logevall; 1995; pp.73-74, 376). Kennedy‘s planned troop withdrawal was intended to move ahead despite the Diem coup, and notwithstanding the continued deterioration in the military situation during November. Newman cites three public items to corroborate this case. 1) In Kennedy‘s press conference of November 14, he placed "bring[ing] Americans home" at the top of his objectives in Vietnam – the highest public priority he had ever given it. 2) In the same press statement, there was no provision for "winning the war" – a change from previous press conferences, including the most recent of September 12. He instead referred "to permitting democratic forces in the country to operate" – a formulation "only a step away" from that of the Laos neutrality agreement of 1962. And 3) the secrecy requirement was lifted from the 1,000-man withdrawal announcement (Newman, 1992; p.426).

Important studies of this topic, in addition to Newman‘s, include Howard Jones (2003), *Death of a Generation,* James W Douglass (2010) *JFK and the Unspeakable,* Gordon Goldstein

(2008), *Lessons in Disaster* (2008) and James Galbraith (2003) "Exit Vietnam" – this list is incomplete. Interesting corroborative evidence can be found in McNamara (1995) *In Retrospect* (1995), Peter Dale Scott (1972) *War Conspiracy*, Kenneth O'Donnell (1972) *Johnny: We Hardly Knew Ye*, Parker's (2005) biography of John Kenneth Galbraith, Ambassador Galbraith's (1969) memoirs, and in Arthur Schlesinger's interviews with Jacqueline Kennedy (2011) in the spring of 1964. Mrs. Kennedy emphasized a full year before the 1965 troop buildup that Lyndon Johnson did not share her late husband's views on Indochina, and she thought it likely that he (Johnson) would make a hash of it. Of these, only Goldstein's and McNamara's books are included in Ferguson's otherwise extensive bibliography, while James Galbraith's article is cited in a footnote (p.910, n128).

Ferguson also omits what may have been the most important consequence of the Diem coup. Diem's brother Ngo Dinh Nhu, who was also assassinated in the November coup, had been leading secret negotiations during the summer of 1963 with the Viet Cong and Hanoi, toward the goal of reaching an intra-Vietnam agreement that would include a US departure. French President Charles DeGaulle, bypassing Washington, directed his Ambassador Lalouette to build on efforts already underway in order to promote the concept of neutralization with the Diem brothers – who were receptive. There is plausible evidence that the Viet Cong and Hanoi did not launch an offensive that summer in the face of Buddhist agitation against Diem because they did not want to upset negotiations (Jones, 2003; pp.310-313, 344-346). On August 29, DeGaulle publicly announced the French initiative, which drew diplomatic support from India, Poland, Italy and the Vatican. Kennedy responded in a TV interview with Walter Cronkite a few days later that the US was not interested – an answer likely intended to deflect criticism from hardliners at home. The very credible Vietnam journalist and historian Bernard Fall, based on discussions with Ho Chi Minh and other DRV (Democratic Republic of Vietnam) officials, declared in late September 1963 that Hanoi was then amenable to a delay in reunification. The alternative

– war with the US – would have cost Hanoi its delicately sustained independence vis-à-vis China (Logevall, 1999; p.348).

Although some in Washington considered such an initiative to be a betrayal of trust, Ambassador Nolting wanted the talks to continue, and apparently persuaded the White House not to interfere. Galbraith, who was trying early in 1963 to advance the negotiations from his post in New Delhi, indicated in his memoirs that Kennedy encouraged his efforts (Galbraith, 1982; p.478). Interest in a settlement continued even after the assassinations of the Diems and Kennedy. Senators Mansfield and Richard Russell advised President Johnson to embrace DeGaulle's call for a neutral Vietnam (Logevall, 1992; pp.81-82). The influential journalist Walter Lippmann met with DeGaulle in December 1963, then endorsed the latter's plan in-person to Johnson on his return to the US (Logevall, 1992; pp. 97-98)[10]. Rejecting such advice, Johnson soon cast his lot with hardliners. In post-Dallas discussions with Rockefeller, Kissinger also encouraged a more aggressive posture in Vietnam, and appears not to have mentioned the DeGaulle initiative. In a disappointing pattern, neither does Ferguson mention it (pp.598-602).

DeGaulle's motives were mixed; even a failed effort to settle the Vietnam War would raise France's diplomatic profile. His efforts to bring about neutralization agreements continued during 1964 and 1966 (pp.704-705). Had the 1963 diplomacy succeeded, US forces might have been asked to leave Vietnam, thereby saving infinite trouble – but frustrating some American Cold Warriors. We may only speculate about what Kissinger's position would have been – he does not mention the Nhu-Hanoi talks in his memoirs or in *Diplomacy*. We know from his efforts to find negotiating partners on behalf of the Johnson Administration during 1966 and 1967 that Kissinger would have been receptive to efforts to use third- or fourth-party leverage to advance negotiations, and he was more sympathetic to DeGaulle's geopolitical revisionism than were most in Washington (Kissinger, 1965).

[10] Logevall cites the Pentagon Papers, Vol. II, pp.193-194.

But given his view of the dynamics of international communism, and his reservations about the earlier neutrality agreement in Laos, it seems unlikely that Kissinger would have embraced a neutrality solution in Vietnam in 1963. In the event, Kennedy replaced Ambassador Nolting with Republican Henry Cabot Lodge in August of that year – a switch made in part to give Vietnam policy a bipartisan cover. Based on cable traffic, Lodge and other US officials were suspicious about what the Diems might negotiate with Hanoi (Newman, 1992; p.384). the *NY Times* suggested that fear of a Gaullist neutralization of Vietnam lay behind US support for the ouster of Diem (Logevall, 1992; pp.85-86) [11] . This interpretation of events carries the implication that Lodge and his fellow coup plotters were acting without full awareness from Kennedy.

Kissinger's own writings years and decades after the events parallel Ferguson's incomplete account of the aftermath of the Diem and Kennedy assassinations. He leaves out complexities in Kennedy's position on Vietnam, and makes little effort to look behind public statements. For example, in Kissinger's account – contradicting discussion above -- the 1961 decision (NSAM-111) reinforced "momentum... clearly all in the direction of further [troop] increases, as Kennedy had not changed his assessment of what was at stake." As noted, he does not mention French-led negotiations for a neutral solution during the summer of 1963. And he asserts that when Kennedy was assassinated "more [US military personnel] were in the pipeline" (Kissinger 2003, pp.33-34). [12] – which contradicts official evidence of both October 1963 decisions to withdraw troops.

For two decades, the world was led to believe that Kennedy had gone "eyeball to eyeball" with Soviet Premier Khrushchev during the 1962 missile crisis – and *won*.

[11] Logevall cites NY Times, January 30 and 31, 1964.

[12] Kissinger's (2003) account was originally included in (Kissinger, 1994) – which predates some of the studies cited here. To my knowledge, Kissinger offers no revision in more recent writings, including in (Kissinger, 2014).

Kennedy nurtured that impression, and wanted the agreement over missiles in Turkey to remain secret, in part so as not to raise concerns about US commitments in NATO and elsewhere. The misleading impression would for years to come reinforce a case for a strong response in Vietnam and elsewhere. Indeed, Kennedy publicly made the case for holding the line in Vietnam, despite privately, almost secretly, planning for extrication. His vice president was not privy to his thinking on either the missile crisis or Vietnam (Kennedy probably intended to replace Johnson on the ticket in 1964 (Caro, 2012)). Hardliners in and outside the Administration were encouraged. For example, Deputy National Security Advisor Walt Rostow – who was not a member of the October 1962 EXCOMM – drew the incorrect lesson from the Cuban missile crisis "that the communists do not escalate in response to our actions" (p.587).

In his defense, and not mentioned by Ferguson, Kennedy did telegraph a shift in direction via his commencement address at American University in June 1963. In a substantial change from Cold Warrior themes of his 1961 Inaugural Address, Kennedy now asked that "every thoughtful citizen who despairs of war and wishes to bring peace, should begin by looking inward – by examining his own attitude toward the possibilities of peace, toward the Soviet Union, toward the course of the cold war and toward freedom and peace here at home." Its emotional thrust was to prepare for an end to the cold war – not to fight it, and certainly not to encourage Washington's hawks. This speech got more attention abroad than in the US; the Soviet Union allowed broadcast of the entire speech. In subsequent weeks, the US and Soviets reached agreement on the Test-Ban Treaty.

Kissinger surely understood stirrings toward a different direction in the Cold War, but he was unmoved regarding strategy in Vietnam. As Morgenthau tartly put it in 1969: "I opposed the war, while Kissinger supported it" (p.581). Why?

Kissinger's early views on Vietnam

For Kissinger, Vietnam was usually about the world's geopolitical chessboard. In a 1955 piece for *Foreign Affairs*, he speculated that, despite the Geneva Agreement and French departure the year before, an "all-out American effort might still save Laos and Cambodia." He added that we should make sure that countries at risk have "indigenous governments of sufficient stability" to prevent Soviet subversion (p.339). In memoranda to Rockefeller in February and April of 1962, Kissinger argued that failure to defend South Vietnam might have doleful consequences, and called for political and tactical measures to defeat the guerilla movement (pp.588-589). He remained forthright about his concerns over the advance of communist powers, and wrote after leaving office:

> Washington policymakers had good reason to be concerned about the conquest of Indochina by a movement which had already engulfed eastern Europe and the taken over China. Regardless of whether Communist expansion was centrally organized, it seemed to possess enough momentum to sweep the fragile new nations of Southeast Asia into the anti-Western camp. The real question was not whether some dominoes might fall in Southeast Asia, which was likely, but whether there might be a better place to draw the line (Kissinger, 2003; p.19).

Kissinger wrote in 1950 that the Soviet Union was "an uncompromising revolutionary power – a power with whom no kind of peaceful equilibrium could be attained." (p.316) John Mearsheimer, an academic "offensive realist" of a later generation, has made the related observation that "no responsible Soviet leader would have passed up an opportunity to be Europe's hegemon in the wake of World War II" (Mearsheimer, 2014; p.198). (A revolutionary power is one that will not accept limits, and that cannot be reassured of its security, hence is outside the constraints of normal diplomacy. For a power to seek regional hegemony, by contrast, does not necessarily imply loosening of such constraints.) Yet Ferguson tells us that Kissinger, even before Stalin's death in 1953, saw "mounting evidence" that the

Soviet Union was becoming less revolutionary, and more a status-quo power (p.309). He wrote to his Harvard colleague Schlesinger in 1954 that while he thought peace would never "break out... so that tensions would magically disappear," he nevertheless believed that it "would be [un]wise to fight any more Koreas" (pp.323-324).

Ferguson notes, citing Kissinger, that Austria's Metternich saw Restoration-era political crises in Spain, Naples and Piedmont as system-threatening menaces to his new order, demanding intervention. Foreign Secretary Castlereagh, meanwhile, understood Britain's role as that of an offshore balancer, and hence was to engage in an ongoing process of adjustment – shifting its weight in favor of or against one small or large power against another. Kissinger argued in 1953, and frequently since then, that the US also should act as a British-style balancer (p.321). Where Metternich worried about uprisings in the periphery, for the British the greater danger was that intervention in distant places could *itself* cause systemic unbalance (pp.307-308). There is no antecedent here for a large-scale intervention by America a century-and-a-half later in a location geographically removed from its vital interests!

Kissinger was also a critic of *military* containment against a revolutionary Soviet Union, which he felt was too demanding a strategy, as it forced the US to respond in settings of Moscow's choosing (pp.314-315). Kissinger came to prominence in the mid-1950s as an advocate of alternatives to general nuclear war, including under some circumstances, limited nuclear war – including such weapons "clean and for tactical use" (p.472). The psychology aspect of the nuclear standoff was much on his mind, including concern that the prospect even of limited nuclear war would lead US allies to re-calculate their interests and go over to the Soviet side. The need to calibrate threats, and to make nuclear threats credible, was paramount. Ferguson's account also shows that Kissinger's view of the Soviet Union had stiffened, so that he by 1961 saw a need to stand up to Soviet encroachments anywhere and everywhere – even, apparently, in settings "not of Washington's choosing." To meet such heightened

concerns, he told Rockefeller, the US needed to be prepared to go to general, rather than limited, war; "nuclear weapons," he reassured, "have preserved civilization" (p.472). For Kissinger, diplomacy almost everywhere was becoming subsumed under requirements of US-Soviet relations.

A televised December 1965 debate was revealing, and embarrassing. Teamed with two Harvard Law students against future Labour Party leader Michael Foot and writer and journalist Tariq Ali representing Oxford, Kissinger said, "It is my belief that the United States should accept the [1954] Geneva settlement as a basis for the settlement of the present war... and it is my impression that the American Government has indicated its readiness to do so" (pp.671-672). In fact, the 1954 settlement had called for the temporary division of Vietnam, with internationally supervised elections and reunification to follow. Because it opposed reunification, the US government had not signed the agreement, and the Johnson administration – which had blocked Vietnam neutralization talks in 1964 - was not about to reverse policy. Good high school debaters would have known this much in December 1965; Oxford's side won the debate. An inference is that Kissinger's support for the US war effort at that point had much to do with his geopolitical calculations elsewhere and very little to do with understanding of events in Vietnam. What makes his confusion more surprising is that Kissinger had made an information-gathering trip to Vietnam only a few weeks before the debate.

Kissinger cited Castlereagh's post-Napoleonic view of France as "against universal conquest not against revolution" (pp.306-307) – like many realists, Castlereagh treated ideology as much less important than hard power in security considerations. Somewhat against the realist mold, and despite his admiration for Castlereagh, Kissinger's was an historical conservative, with a dread of the disorder and chaos that revolution might bring. In *World Order* in 2014, he argued that internal upheaval could "shake the international equilibrium more profoundly than aggression from abroad." He added that "the more sweeping the change, the more violence is needed to reconstruct authority, without which

society will disintegrate" (Kissinger, 2014b, p.241). Ferguson describes him during the 1950s and 1960s as a Burkean conservative, who understood history to be driven by nations and peoples – hence statesmen would have to draw on such forces to prevent chaos (p.298).

In this context, Kissinger was also a reliable anti-communist, although he preferred to express it otherwise. From an interview with reporter Mike Wallace in 1958:

> I believe, for instance, that we reacted very wrongly to the riot in Latin America [an illusion to the protests sparked by Vice President Nixon's visits to Peru and Venezuela the previous May]. Rather than saying, "These are Communist-inspired and we must keep Latin America from going Communist," we should have said, "This recalls us to our duty. These are things we want to do because of the values we stand for, not because we want to beat the Communists" (pp.415-416).

The Kantian language of ethical decision echoes. According to notes from an April 1961 meeting with Rockefeller, and in similar spirit, Kissinger allowed that opposing communism was a moral duty – one that would justify taking tens of thousands of lives in order to save millions that would be lost in the event of communist victories. Noting that communists would often advance using infiltration and subversion, he said it "was not our moral concept to act against it, but it should be." And "We can't demand perfection before action... Let's face up to the question of who[m] we support: let's defend the bastards and reform them later" (pp.472-473). Kissinger's motivation regarding Vietnam rested significantly on concern about communism and insurrection – which, Ferguson argues, were out of synch with the cynical realism often attributed to him. Kissinger's commentaries on revolution and stability would be off-key coming from such less-ideological realists as DeGaulle, Morgenthau or Mearsheimer.

There is a larger question here that neither Ferguson nor Kissinger sufficiently answer. Did pressure from the Soviet Union require that every part of the world be drawn into superpower competition? Was it really in the US interest to pressure nonaligned countries to enter security agreements?

To take one example, under a Dulles initiative, the US entered a bilateral security pact with Pakistan against the Soviet Union. But as nearly every account of Pakistan‘s history makes clear, its leadership was obsessed about competition with India, including in the Kashmir, and agreed to align itself with the US in order to obtain material and diplomatic support against India, not against the Soviet Union. An important consequence of the Pakistan pact was to put US diplomacy at loggerheads with post-colonial India, heretofore the world‘s largest non-aligned power – which almost inevitably led India to seek military and diplomatic support from the Soviets. Senator Kennedy had again opposed the thrust of US cold war policy by calling in 1958 for closer and more extensive ties with India (Parker, 2005; p.379). His decision to send Galbraith to New Dehli in 1961 was a follow-up on his earlier interest in bringing about improved relations.

As further examples, US intervention against democratically elected governments in Iran in 1953 and Guatemala in 1954, and support for the assassination of similarly elected President Lumumba of the Congo at the end of the Eisenhower Administration, were all driven by opposition to neutralism (Mahoney, 1983) or by the premise that nonalignment was an implicit boost to Soviet interests. Other evidence indicates US efforts to support right-leaning, pro-US factions in Italy and France during the 1950s and into the 1960s, either officially or through covert channels (Talbot, 2015). This way of thinking -- the expectation that every government should be lined up either with the US or, by inference, against it -- lay at the heart of the urgency in US national security circles about supporting the Saigon-based government in Vietnam.

While Kissinger was inclined to draw most of the world into a superpower competition, his views were nuanced enough for him to be sympathetic to Gaullist re-assertion of an independent French defense policy during the 1960s (pp.704f, 717f). When the time arrived a few years later for triangular diplomacy with China and the Soviets, Kissinger proved adept at it. But Ferguson‘s evidence reinforces the

conclusion that Kissinger's thought-framework regarding the world's post-colonial periphery was implicitly bi-polar during most of the 1950s and 1960s. Ferguson's speaks of Kissinger in 1967 confronting the "absurd predicament of the US in Vietnam" (p.727) – as though Kissinger had not himself argued in favor of deeper involvement at almost every turn.

Kissinger and sometimes Ferguson depict Kennedy as a straightforward Cold Warrior, perhaps doing so as a buffer to soften the hardline nature of Kissinger's own preferences. But where Kissinger (and other US leaders of that era) saw conflicts almost everywhere as linked to US-Soviet power competition, Kennedy's strategic thrust was to seek "neutral" status where possible, to "take pieces off the board."[13] This was the approach in Laos, Indonesia, India, the Congo and Egypt; as noted above, it would become the goal in Vietnam and Cuba. Screening out Kennedy's new directions, and his decision to implement the first stage of withdrawal from Vietnam – and omitting any mention of the multi-lateral 1963 initiative to negotiate an intra-Vietnam settlement -- leaves an impression that Kissinger faced a narrower set of choices when he came on board in 1969, and was a more resourceful geopolitical thinker, than were in fact the case.

Kissinger, Morgenthau and negotiations

Morgenthau blasted the premises of official strategy, which were similar to Kissinger's premises. Like most realists, Morgenthau intended to navigate the world with its human flaws, and did not share Kissinger's fear of contagion from chaos and revolution. He noted:

> If one probes beneath the rationalizations for our military presence in South Vietnam, one finds as the dominant motivation the fear that if South Vietnam should go Communist, [then] no nation threatened by Communism would entrust its protection to us… This theory… is unsupported by any historic evidence. The Soviet Union went Communist in 1917 and China in 1949, but no other nation followed suit. In 1945, Poland

[13] I owe the phrase to Richard Mahoney, in a December 15, 2021, email.

> and Hungary went Communist, but Finland did not, and all the Balkan states went Communist, but Greece did not. In 1948, Czechoslovakia went Communist, but no other nation did. In 1954 North Vietnam went communist all by itself, and in 1960 or so Cuba went communist without being followed by any other Latin American nation. Social and, more particularly, revolutionary change is not a mechanical result of imitation and prestige but of objective conditions peculiar to individual nations (Morgenthau, 1965: pp.77-78).

Morgenthau wrote of telling South Vietnamese President Ngo Dinh Diem during a visit in 1955 that his governance was driving the population to political frustration and indifference, and that the only organized opportunity for opposition would be through the Communist underground. That is, it was Diem – not some congeries of international forces – that was making South Vietnam into a potential communist "domino" (Morgenthau, 1965; pp.29-30). Diem's draconian Decree 10/59, issued in May 1959, expanded the scope for arbitrary imprisonment and execution for "political crime," and led many marginal adherents of revolution into full-time support of the National Liberation Front (Elliott, 2003; pp.101-105).

Morgenthau raised another argument against the Vietnam War, which is that it could only be fought by morally unacceptable methods. He wrote:

> If the war in the South were to last long enough, we would have a good chance of winning it. We were not likely to win it in the traditional way by breaking the enemy's will to resist, but rather by killing so many of the enemy that there is nobody left to resist.... Hence, the "body count,", however fictitious, becomes the sole measure of our success. No civilized nation can wage such a war without suffering incalculable moral damage (Morgenthau, 1969b, pp.137-138).

Morgenthau's scenario was not literally realized as high natality led South Vietnam's population to grow rapidly throughout the war, despite casualties. He meant that a war of the kind the US was fighting in Vietnam necessarily

imposed heavy costs on the local population. Accounts in fact suggest that Saigon's often improved military position in the years after the Tet Offensive of 1968 owed much to a policy of "draining the pond to catch the fish" -- a phrase used by both General Westmoreland and CIA Director Colby -- hence to deliberately encouraging rural populations to move to cities. It was a policy of using air power, artillery, and other military measures with the understanding that doing so would create internal flight (Elliott, 2003; pp. 337-340).

Kissinger was consistent in his view that such moral and human rights considerations in Vietnam were eclipsed by geopolitical requirements. He told *Look* magazine in August 1966 that the war in Vietnam was "a crucial test of American maturity… We do not have the privilege of deciding to meet only those challenges which most flatter our moral preconceptions" (p.672). He responded in his memoirs to a "proclamation of America's immorality" from Morgenthau similar to the one above by observing: "In the post-World War II period, America had been fortunate to have never had to choose between its moral convictions and its strategic analysis" (Kissinger, 2003; p.44). Kissinger thus falls back to his comfort zone, a Kantian choosing-among-conflicting-imperatives. It is weak response, as it implies that Morgenthau was unskilled at weighing moral against strategic imperatives.

Notwithstanding sympathy for his subject, Ferguson acknowledges that Kissinger was wrong about the Vietnam War and Morgenthau was right. Far from accepting Kissinger's geopolitical concern about the expansion of the communist bloc, Morgenthau argued that a unified, nationalist Vietnam would be a constraint on Chinese power. To explain Kissinger's failure, Ferguson goes back to his opening argument – that Kissinger was the "idealist" in his book's title, who believed that South Vietnam's geopolitical importance and its "right to self-determination" were worth American lives. (Once again, drawing Kant into the argument does not work. As Kissinger understood, the Kantian imperative was formal, procedural. It did not yield up a substantive command.) Losing the argument with

Morgenthau was, as Ferguson sees it, part of Kissinger's education, a step toward becoming the more open realist he would become (pp.822-823).

Morgenthau argued by June 1965 that it was too late simply to withdraw from Vietnam, because it would "do great damage to US prestige" (which he defined as its "reputation for power"), hence that the US must negotiate its withdrawal. His view appeared close to where Kissinger's had by then evolved, as the latter realized even before his first trip to Vietnam in October 1965 that chances for a military solution were vanishingly small. Indeed, by December 1965, McNamara reached a similar view, and staggered Johnson by telling him privately that chances for a military victory were only between a third and 50 percent "no matter what we do" (p.675). This juxtaposition of views suggests consensus on the need to negotiate an exit. Nevertheless, the US troop buildup, which had reached about 180,000 by end-1965, would treble to an early 1969 peak level at over 500,000 – still with no negotiated settlement in sight.

The apparent agreement was misleading, as it masked different views of what should be negotiated. Kissinger's meeting in September 1965 with John McNaughton, an assistant secretary of defense, was revealing. McNaughton indicated that in no scenario, and at no force level, were US chances of "winning" higher than 40 percent. In every case, he went on, the greatest probability went to a "compromise outcome which would have the essential characteristic of recognized VC [Viet Cong] areas." Kissinger, almost dumbfounded, replied that "the VC in these conditions might well take over the country." McNaughton, undeterred, replied that the US were going to have to abandon those it was supporting, and that if Kissinger wanted to be "really constructive," he could prepare a paper on the best way to do it (p.635). Kissinger heard similar analyses elsewhere, and was then bemused and appalled when General Westmoreland and others in Vietnam spun their briefings to tell him of battlefield and "pacification" successes (p.649).

McNaughton briefed McNamara on the same discouraging data. But Defense civilians were constrained by senior

military opinion, which loudly opposed scaling back war aims. Walt Rostow, soon to replace Bundy as national security advisor, supported military views against the civilians. Internal study findings were closely held, and considerations of alternatives inside the Johnson Administration was stilted (pp.636-637); disarray regarding Vietnam policy had worsened from the already impaired level it had reached during the Kennedy years. The US war continued and intensified – ending in McNamara's departure from the Department of Defense, Johnson's decision not to run again, and election of a Republican president in 1968.

When Morgenthau recommended negotiations in 1965, he recognized the same facts on the ground that McNaughton had laid out to Kissinger. He advocated retreating to a few coastal bases, to maintain some negotiating leverage – and then essentially agreeing to Vietnamese reunification as a neutralist, but communist-dominated, state (Morgenthau, 1965: pp.9, 79-80). He privately reiterated his view in October 1968, indicating that it would be impossible to liquidate the war "while maintaining one's original justifications for the war." The real issue, he added, "is who shall govern, the Communists or the opponents?" (p.821-822).

DeGaulle's conclusions had been similar to Morgenthau's: forces of national self-determination could not be suppressed, so the US should withdraw and embrace neutralization -- implicitly to include a communist-dominated government in the South (Logevall, 1992; pp.76-77). Ferguson notes that David Nes, briefly Lodge's deputy at the US Embassy in Saigon during 1964, "came to realize that DeGaulle was offering a choice preferable to military escalation" (pp.705-706). DeGaulle's agenda regarding Vietnam was unwelcome to many because, as someone at Quai D'Orsay explained to Kissinger in May 1965, it also served the geopolitical objective of reducing the American role in the world (p.722). A reduced US role may have been a necessary pill to swallow. As Bismarck had understood a century earlier, Kissinger was later to observe that a balance of power requires "a common recognition of limits" (Kissinger, 2014b; p.371). To take on an ideological war on the world's periphery perhaps exceeded

those limits. Ferguson sheds light on Washington‘s effort to begin negotiations with Hanoi during 1967. The Johnson Administration selected Kissinger to open negotiations with Hanoi using French intermediaries, but the effort went nowhere. There has been controversy over the years about why that was, with McNamara, among others, arguing later that the US administration was not committed to the effort. We now know from Vietnamese sources, Ferguson tells us, that Hanoi had no intention of making peace in 1967 (pp.732-733). That is true, but also misleading. As DeGaulle, McNaughton and Morgenthau had by then argued for years, and as McNamara had already briefed Johnson, the US had little prospect of defeating North Vietnam militarily. The US had no reason to expect to obtain at the negotiating table what it had scant prospect of winning on the battlefield.

Kissinger‘s (1979) memoir leave the impression that he and Nixon left no stone unturned to reach an agreement after their administration arrived in January 1969. He even described his own position, in November 1968, as "not very different" from Morgenthau‘s – which the latter disputed (p. 822). In fact, as Kissinger summarizes in *World Order*, the Administration had "one irreducible condition": it would not agree to begin negotiations by replacing the government of South Vietnam (Kissinger, 2014b; pp.300-301). This reasonable-sounding condition actually ruled out serious negotiations, just as it had made contacts with Hanoi unlikely in 1967. Kissinger‘s, and Nixon's, after-action accounts have distorted the historical record. Unmentioned in either's memoirs, or in his 2014 book, Kissinger prepared a memorandum to Nixon on October 22, 1972, (declassified in 2010) calling for two-party talks between the US and Hanoi, perhaps using the Soviet Union as an intermediary. The proposal implicitly acknowledges weakness of the Republic of Vietnam (RVN), survival of which would have been an early casualty of such negotiations. Nixon shortly afterward wrote to RVN President Nguyen Van Thieu to tell him that Washington was going to reach an agreement with Hanoi, whether or not Thieu was on board with it (Woodward, 2015;

Ch.20).[14] In these communications, Kissinger and Nixon acknowledged what had been clear to others for at least a half-dozen years: a non-Communist government would not endure in South Vietnam.

Looking ahead, Kissinger as national security advisor negotiated the Paris Accords with North Vietnam by January 1973, which in fact left the RVN government in place in Saigon. One view is that this agreement was a success for US diplomacy, and that pessimists were wrong (Sorley, 1999; Kissinger, 2014b; p.301).[15] (In this view, the North Vietnamese takeover in 1975 could have been avoided, and followed on a collapse of US will to provide material or air support to its ally.) As we have learned more about Kissinger's and Nixon's own doubts in 1972 regarding the viability of the RVN, that argument has become less plausible. An alternative view, advanced by Mearsheimer is that Hanoi agreed to leave the RVN in place in 1973 because Northern officials thought that the fastest way to get the US to leave the country (Mearsheimer, 2014; p.105). At that point, North Vietnamese troops would be in a position to overthrow the RVN unobstructed, as they would do less than two-and-a-half years later. Vietnam historian William Duiker argues that "on balance… Hanoi had the better of the Paris deal, for the US withdrawal was not matched by a similar pullback [from South Vietnam] by the PAVN [Peoples' Army of Vietnam]." He also indicates that the Communists held a stronger political position in the South than did the weakened RVN (Duiker, 1981; p.297).

Vietnam and credibility

Over and again, Kissinger has stressed the importance of maintaining credibility of US commitments. Indeed, maintaining credibility seemed sometimes to stand independently as a reason for persisting in policy, apart from geopolitical competition or fear of domestic upheavals in the

[14] Kissinger's and Nixon's 1972 memoranda are quoted in (Woodward, 2015; Ch. 20).

[15] For a counter-argument, see (Isaacs, 2015).

unaligned world. After breaking his formal relationship with it in 1963, Kissinger argued that the Kennedy administration was undermining the US reputation for reliability – "the most important asset any nation has." He wrote in *Foreign Affairs*, January 1969, "However we got into Vietnam, whatever the judgment of our actions, ending the war honorably is essential for the peace of the world. Any other solution may unloose forces that would complicate prospects of international order" (p.843). Almost 40 years after leaving office, he summarized the view of the Nixon administration:

> [President Nixon] thought it his responsibility [to end the war] in the context of America's global commitments for sustaining the postwar international order… America could not jettison its security commitments in one part of the world without provoking challenges to its resolve in others. The preservation of American credibility in defense of its allies and the global system of order – a role the United States had performed for two decades - remained an integral part of Nixon's calculations (Kissinger 2014b; p.300)[16]

This and similar arguments have come under sharp criticism in political science literature. Jonathan Mercer (1996) studied several military crises to conclude that when a country backs down enemies do not make judgements about its "character", but instead assume that such decisions are made in response to "situations". Daryl Press (2005) examined pre-World War II "appeasement", the Berlin crises of 1961 and the Cuban missile crisis of 1962 to determine how high-stakes security decisions are reached. He concluded that leaders make decisions based on their judgement about their opponents' interests and relative power positions. Opponents' "past actions" – the crux of the credibility argument – are much less important. Looking at the US experience in Vietnam, Press commented:

> By fighting wars to preserve their country's credibility, leaders are expending *power* – which really *does* affect

[16] Kissinger temporizes somewhat on whether his view in 1969 remained his view 40-some years later; see final section, below.

> credibility – to build reputation, which does not seem to affect credibility.... The American decision to fight the Vietnam War provides a clear example of leaders making this mistake. They believed that losing South Vietnam might reduce US credibility to defend NATO. Therefore they decided to defend South Vietnam in order to hedge against possible losses to America's reputation. But in doing so, they seriously reduced American power. As a result of Vietnam, the US military was less prepared to defend core US interests from 1970 to 1980 than at virtually any other point in the Cold War (Press, 1996: p.159).

Morgenthau (whom Press cites) earlier offered similar illustrations, noting for example that France's reputation for power *rose* after if liquidated losing enterprises in Indochina in 1954 and Algeria in 1962. Similarly, he noted, America's Bay of Pigs debacle of 1961 weighed little in the scales of US prestige (Morgenthau, 1965: p.11). Where Kissinger speaks of forces that might have been "unloosened" by withdrawal from Vietnam, we should also acknowledge countervailing damages, both inside the US and in the coin of international reputation, that resulted from *not* withdrawing. This might further be the case given widespread popular opposition to the war in countries aligned with the US, especially in Europe.

In both the Berlin crisis and the Cuban missile crisis, Kissinger was frustrated that, in his view, Kennedy had backed down too easily. In the case of Cuba, Kissinger's disappointment rested on US acquiescence in a continued Soviet military presence on the island; he did not then know of the Cuban-for-Turkish missiles swap, which would have dismayed him further. Kissinger's main focus at that time was Europe, and his concern - shared by the influential Dean Acheson, among others -- was that the US nuclear guarantee for European security might collapse if the US were seen as unreliable (pp.494-495). As he expressed it in the 1958 Wallace interview cited earlier:

> If the Soviet Union attacks and in fact we are very much more afraid of total war than they are -- they will gradually blackmail the free world into surrender. Everything that I say is based on the assumption that

> we are as willing to run risks as the Soviet Union. If this is not the case, we are lost, and I think we ought to face that fact (p.413).

To somewhat reduce the downside odds in making strategic choices, Kissinger contributed to the ongoing dialog about building capacity for "flexible response": but flexible alternatives were unsatisfactory in Berlin, in part because Soviet conventional strength in central Europe exceeded NATO's. The nuclear guarantee – based on US readiness to go to either a limited or general nuclear war – raised nearly unanswerable questions about the willingness of the US to take action that might lead to millions of casualties. Uncertainty about the US commitment, in turn, fed French and German fears, which undermined the credibility of NATO, led to demands for a European nuclear force separate from NATO, and might offer diplomatic openings to the Soviets. It also raised the specter of a US-Soviet deal with the potential to subordinate the national security interests of western European nations.

Kennedy was ready to suffer a loss in US prestige, or to open some doubt about US reliability, if that was the cost of avoiding a nuclear exchange. Ferguson summarizes that Kennedy "simply had not been convinced that a limited war, or a conventional war, could be fought that would not rapidly escalate to an all-out nuclear war." So he looked for an escape (p.513). Ferguson concludes that Kennedy acted as more the realist than Kissinger – and that Kennedy was right (p.558).

This was a context for US decisions leading to the buildup in Vietnam. While instigating a conventional war over Berlin or Cuba would have been perilous in the extreme, the stakes in Vietnam during the 1960s were not going to be high enough to trigger a nuclear showdown. Paradoxically, the US then chose to fight a conventional war in what Ferguson describes as "a strategically inconsequential former French colony" (p.577). Some US officials, including Kissinger, anticipated that evidence of commitment in Vietnam would ricochet to improve US credibility in Europe.

Kissinger, visiting Germany in a semi-official capacity in January 1967, suggested to a formally retired (but still

engaged) Chancellor Konrad Adenauer that a US defeat in Vietnam would make it easier for East German leader Walter Ulbricht to put pressure on Berlin. As Kissinger reported back to Washington, the argument did not impress:

> Adenauer looked at me and said, and do you think that I believe that you will protect us? I said, yes. He said, I no longer believe that you will protect us. Your actions over recent years have made clear that to you détente [with the Soviet Union] is more important than anything else (p.716).

This exchange illustrates the logic of the political science criticisms cited earlier. Adenauer (and other Germans, across the political spectrum,) did not believe it was in the US interest to fight a nuclear war over Berlin, or even over Western Europe, and they would look for other means to advance their security. The US war in Vietnam amounted to an effort to roll back the clock, an effort to get NATO partners to take their places under a superpower-led order. What happened in Vietnam scarcely affected calculations of American power and interest – except to the extent the Germans considered the war a moral and political disaster, and a distraction from matters closer to their concern (pp.712-713).

When Kissinger, as Nixon‘s national security advisor, was called over by DeGaulle after a dinner at the Elysee Palace in February 1969, he was greeted with the question "Why don‘t you get out of Vietnam?"

> "Because," I replied, "a sudden withdrawal might give us a credibility problem."
>
> "Where?" the General wanted to know. I mentioned the Middle East. "How very odd," said the General from a foot above me. "It is precisely in the Middle East that I thought your enemies had the credibility problem" (Kissinger, 1979; p.110).

Kissinger's memoir does not indicate how he responded. Indeed, he seems to have treated the General‘s query in the manner of an eccentric aside from a creative genius. But Kissinger‘s subsequent account buttressed DeGaulle‘s premise. Soviet reputation was damaged by military losses of its clients Egypt and Syria to the Israelis in 1967, and Moscow

sought an opportunity to recoup. Kissinger advised Nixon less than a month after the conversation with DeGaulle:

> In my opinion … we were more likely to obtain Soviet cooperation in Vietnam by moving deliberately [that is, very slowly] in the Middle East, where the Soviet clients were the weaker party, than be relieving its embarrassment through talks that would give the Soviets a dazzling opportunity to demonstrate their utility to their Arab friends (Kissinger, 1979; p.352).

Kissinger's analysis put a paradoxical light on the credibility question. As DeGaulle had said, the Soviets lacked credibility in the Middle East. But because the US needed Soviet pressure against Hanoi, the US would have to take some measured action to *restore* Soviet credibility in the Mideast as a *quid pro quo*. Imagine a counterfactual in which the US had allowed its Saigon allies to be replaced, and then departed Vietnam. In that case, the US would not have been obliged to look for a favor from the Soviets in Southeast Asia, and hence would not have had to make concessions to them in the Middle East. Quite plausibly, therefore, US persistence in Vietnam could have weakened US leverage in the Middle East, just as it could have increased Soviet credibility there.

In the event, US Middle East diplomacy in subsequent years advanced American interests. Soviet credibility did not recover, and Kissinger commented to Soviet Ambassador Anatoly Dobrynin in March of the same year that the Soviet government's Mideast policy guaranteed its clients "only stalemate or military defeat" (Kissinger, 1979: p.1252). Egyptian President Anwar Sadat would expel 15,000 Soviet advisors in July 1972. The Soviets had a number of reasons for holding back from endorsing its clients' positions in 1972 - including concern about Israeli military strength, and their need for US support in ratification of new German treaties as well as for US grain. Kissinger, returning to the credibility issue, added:

> Our demonstration of firmness on India-Pakistan and on Vietnam (not to mention the conflicts [in Jordan] in the autumn of 1970) must have convinced the Soviets that one more crisis would overload the circuit (Kissinger, 1979; p.1297).

All three of these conflicts imposed material and diplomatic burdens on the US. Kissinger‘s argument seems to be that burdening US diplomatic and material resources can have a second-order effect in strengthening US credibility. Did he mean that US credibility in the Middle East would have been less if the US had left Vietnam years earlier because there would then have been no need to demonstrate "firmness" in a different part of the world? (This is the logic of what he told DeGaulle!) Surely, Sadat as well as the Soviets by 1972 were calculating US power and interests at stake in the Middle East, as the political science literature suggests – rather than reliving whatever decisions the US had taken years earlier in Southeast Asia.

Ferguson describes Antonin Snejdarek, director of a Czech research institute, as providing Kissinger with a "masterclass" in geopolitics during the latter‘s visit in September 1966. Snejdarek detailed tensions within Communist bloc countries, and then argued that tensions surrounding the US war in Vietnam ‘might be a convenient pretext [for Moscow] to tighten control over Eastern Europe." This was not a one-off insight, as Ferguson mentions that other Czech scholars were saying nearly the same thing (pp.738, 740, 745-746). Ferguson narrates this discussion as part of Kissinger‘s education, part of the process by which he became more "realist", and more inclined to make diplomatic approaches to Moscow, or to Maoist China.

But it also depicts an odd bias in Kissinger‘s thought process: keeping commitments was crucial for him, even if doing so strengthened the *Soviets'* geopolitical position. Kissinger‘s willingness to consider alternative frameworks seems to have bumped against his preference for order. It becomes clearer why DeGaulle and Adenauer concluded that US policies implicitly advanced a US-Soviet "condominium" at the expense of European interests. Not for Kissinger was a Kennedy-like move to end the Cold War – or a Reagan-esque move to win it.

Some perspectives

Ferguson intends his book as an account of Kissinger‘s life and education through 1968 in the spirit of a *Bildungsroman* (p.875). Historical verdicts on Kissinger will depend much more on what happened afterward. Part of Ferguson‘s case is that Kissinger overcame early rigidities to come more to admire realists Bismarck, DeGaulle, and Morgenthau.[17] But what stands out in gathering Kissinger‘s views on the American role in Vietnam is not personal growth, but rather how consistent his views have been, from a *Foreign Affairs* article in 1955 to memoranda in the early 1960s, through his time in the White House, his memoirs, and even to more recent writings.

Kissinger was more willing than the President he served to risk nuclear war over Berlin or Cuba. He was prepared to absorb tens of thousands of deaths to advance the greater good, and he felt justified by an ethics-linked imperative to advocate such exchanges. He was ready to slog on with the Saigon-based Republic of Vietnam (RVN), despite credible intelligence estimates that South Vietnam was unlikely to prevail under any circumstances – again, for the greater strategic good of maintaining US credibility. He subordinated concern about justice and human rights violations in the war in Vietnam to considerations of the broader US power position. While his views on some of these might have changed after 1968, all appear to have been part of his mental toolkit at the time he became Nixon‘s national security advisor in January 1969. Taken together they seem to overstate the strategic interest of the US in Vietnam, and are based on a view that by the 1960s subsumes most international politics into a bipolar US-Soviet competition. From the evidence Ferguson assembles, these reservations are not made only *ex post*, but would have been reasonable in 1968. Ferguson is accurate to doubt the depth of the early Kissinger's realism; it would have been better had Kissinger

[17] Lacouture (1986; p.252) described DeGaulle as an “implacable interprete de l‘histoire” – a good one sentence description of a realist mindset.

become a classic realist sooner. But it does not enlighten to describe positions noted here as "idealist".

The Nixon Administration's cardinal conceptual error in its Vietnam policy was to push aside what Kissinger should have understood by 1965 - that, given any plausible military scenario, Hanoi was not going to negotiate a settlement that would leave the RVN in power. Kissinger [3], decades later and somewhat backhandedly, acknowledged as much, noting that "contrary to conventional wisdom, the Nixon Administration *overestimated the scope for negotiation* (italics added). For the battle-hardened leadership in Hanoi… compromise was the same as defeat."

We know that the Soviet Union lost the Cold War, and that the US and the Soviets never traded nuclear attacks. Kissinger emphasized moral factors, and "ideals", as decisive in the superpower competition (p.25), and there is evidence that Soviet leadership and society were demoralized by the 1980s. Material factors also played a large role. Kissinger over-estimated Soviet economic power, as did many. The US won the competition because it and similarly situated countries had by far the more robust economic system, while the economic ascendance of East Asia left the Soviet Union looking passed-by. Soviet disintegration was accelerated by the collapse of oil prices in the middle-1980s, another material factor. Closer to security and diplomatic considerations, the US became quite effective at containment -- in gathering and leading a coalition of dozens of countries – with the important, but limited, objective of blocking Soviet expansion in either Europe or Asia. Containment turned out to be robust enough to survive any loss of credibility resulting from concessions over Berlin and Cuba. Indeed, the threat to go nuclear over either was never really tenable, so backing away from it was an act of diplomatic realism that over time perhaps strengthened containment, not weakened it.

Another argument holds that a US withdrawal from Vietnam would have led the Soviets to encourage more wars of national liberation (Turner, 2010; pp.105-106). This argument is unconvincing, for two reasons. First, given the extraordinary strain the Vietnam War brought to the US, the

Soviets might have seen it in their interest to encourage more such wars -- *especially* if they believed the US was committed to fighting them. Second, the Soviets *did* subsequently encourage wars of national liberation -- or, more accurately, wars of communist opposition -- in Afghanistan, Central America, and southern Africa. On the ledger of Cold War gains and losses, the outcomes of most of these went against the Soviets. Containment-after-Vietnam succeeded without large combat deployments.

What about Southeast Asia? Much of Asia has prospered since the last US helicopters left South Vietnam in 1975, and the region has avoided major war. Notwithstanding defeat of South Vietnam, did the prolonged US effort there contribute to laying a basis for political stability and long-term growth in the region? The *Economist* (1978) ran a lead editorial, "The Bottle Stayed Corked," arguing just that. Mark Moyar (2006; pp. 375ff) writes openly of the "domino effect", and quotes a variety of senior politicians or military leaders in Indonesia, Thailand, Malaysia, Taiwan, the Philippines and India who said the US role in Vietnam was critical to stabilizing their own nations. According to Moyar, the Indonesian Army, encouraged by the US commitment in Vietnam, resisted President Sukarno, who by 1965 was making peace with Indonesia's Communist Party (PKI) and collaborating with Chinese and Vietnamese communists. Moyar notes (with no hint of regret) that factions of the Indonesian Army led an effort that killed several hundred thousand communist party members in 1965 and resulted in their country becoming a "reliable friend" of the US. Kissinger himself records that Lee Kwan Yew –

> the founder of the Singapore state and perhaps the wisest Asian leader of his period, was vocal in his firm belief, maintained to this writing [in 2014] that American intervention was indispensable to preserve the possibility of an independent Southeast Asia (Kissinger, 2014b; p.297).

The essence of these claims is that the US presence in South Vietnam "bought time." The premise is that international communism had momentum in the early- and

middle-1960s that would be lost by the early 1970s, a consequence of Sino-Soviet split, the weakening of China as a result of the Cultural Revolution, Nixon‘s détente with Soviet Union and diplomatic opening to China, and an improving economic outlook elsewhere in Asia. To be clear, this argument -- Moyar‘s, Kissinger‘s, Yew‘s -- can be made even though the US eventually lost in Vietnam, and it could be made even if it was understood all along that the US was likely to lose. The argument is precarious, but not necessarily wrong. It has been a persistent claim in favor of the Johnson and the Nixon-Kissinger policies in Vietnam.

But there is contrary evidence. Ambassador Galbraith wrote later of attending a meeting in Washington on November 6, 1961, with Kennedy and Indian Prime Minister Jawaharlal Nehru in which the latter displayed indifference about UN or ICC[18] involvement in Vietnam. Notwithstanding Moyar‘s (2006; p.382) inclusion of India in his list of countries where stability was enhanced by US intervention in Vietnam, Nehru repeated emphatically to Kennedy that the US should commit no military forces to that country (Galbraith, 1969; p.219). This meeting took place in Washington at the height of internal contention following the 1961 Taylor mission about whether to commit US forces. Louis Joxe, the French minister who attended Nehru‘s funeral in 1964, commented to DeGaulle afterward that Indians felt threatened, even "terrorized" by US initiatives that might worsen relations with China. He also noted American and British hostility to France, and added that Indian leadership would welcome a more assertive French diplomatic role in Asia (Peyrefitte, 1997; p.496). As noted earlier, India supported the French-led secret peace talks in 1963, which, had they succeeded, would have led to US departure.

Indonesia's Sukarno, who hosted the 1955 Bandung Conference of nonaligned nations, visited Kennedy in Washington in 1961; in an upbeat atmosphere, Kennedy indicated eagerness to improve relations and the US

[18] The International Control Commission (ICC) was established in 1954 to oversee implementation of the Geneva Accords.

government increased foreign assistance (Douglass, 2010; pp.259-260). But after Johnson succeeded Kennedy, two policy decisions worsened US-Indonesian relations. First, Johnson (under pressure from Congressional hardliners) refused in January 1964 to sign a determination that economic aid to Indonesia was in the US national interest; Kennedy would have made such a determination almost routinely. Economic was then cancelled, although assistance to the Indonesian Army continued. Second, in June 1964 Johnson announced that the US would side with Malaysia in an on-going struggle between that country and Indonesia – all without consulting his own embassy in Jakarta (Jones, 1971; pp.299, 342-343).[19] In part as a consequence of the change in US policies, Sukarno turned for domestic support to the Indonesian Communist Party (PKI), and for external support to communist China (Jones, 1971; p.405). Both of these moves brought counter activity, by a faction of the Army against the PKI, and by US-led covert action which assisted in replacing Sukarno (Douglass, 2008; pp.375-377). In his subsequent account, Howard P. Jones, US Ambassador to Indonesia during 1958-1965, discusses Sukarno's rule, the Army's resistance, and the purge of the communists - while not even once identifying any US role in Vietnam as a factor influencing these events (Jones, 1971; *passim*). Indeed, for Jones an important consequence of the Vietnam intervention ran in the opposite direction -- it brought communists in Hanoi and Beijing closer together (Jones, 1971: p.338). Opposition to neutralism in Indonesia and elsewhere reflected an essential, although often unstated, argument among those advocating continued US presence in Vietnam.

Nixon, in 1967, as a then unannounced candidate for president, split the difference on the role of the US intervention in Vietnam as a stabilizing force. He sided to some extent with the war hawks, as he wrote in *Foreign Affairs* that the "[US] commitment in Vietnam" was "a vital factor in the turnaround in Indonesia." But Nixon's

[19] Ambassador Howard Palfrey Jones, author of Jones (1971), is not to be confused with Howard Jones, author of Jones (2003), cited earlier.

endorsement was restrained: he went on to emphasize growing economic success in a very large swath of Asian countries and, without saying it explicitly, but as Ferguson interprets it, concluded that "ultimate American failure in Vietnam really did not matter that much" – capitalism was winning in Asia (pp.802-803).

Ferguson promises to consider in his second volume whether Kissinger's concern over credibility was merited (p.842n). Here is an interim judgment. As Mercer and Press argue, major powers faced with security decisions will examine where an opponent's national interests lie, and what its potential power resources will be. When the US drew back from war over Berlin or Cuba, it did not seriously weaken its power position, but, as Kissinger would argue, it *did* create uncertainty about the structure of defense in Europe and elsewhere (p.510). That was not on balance a change for the worse, as defense structures have since moved in a direction they were going to have to move in any event. A consequence was that regional powers challenged US leadership on security issues after the Cuban crisis, somewhat attenuating the bipolar framework. For example, DeGaulle and Adenauer negotiated a treaty of mutual friendship in January 1963. Kissinger remarks in *Diplomacy* that:

> Vietnam [as it appeared to Nixon and Kissinger in 1969] *finally signaled that it was high time to reassess America's role in the developing world*, and to find some sustainable ground between abdication and overextension (Kissinger 1994; p.704.) (italics added)

This choice of phrase must mean that Kissinger came subsequently to believe the US commitment in Vietnam reflected strategic misjudgment -- not simply that an advantageous intervention was operationally or tactically mis-managed. Perhaps, as in the case of Berlin and Cuba, US diplomacy should have dealt with challenges to US leadership that would result from disengagement in Vietnam -- rather than doubling down on the earlier mistake. (But Kissinger elsewhere defends the earlier mistake.)

It is hard to accept undiluted Morgenthau's premise that there was no spillover from one country to the next, or that

there was no momentum in the attraction of communism during the 1950s and 1960s, even if communist movements were not centrally directed. (Decades later, authoritarian gains in one region of the word, including in the US during the Trump era, appear to boost authoritarian prospects elsewhere.) Changing strategic direction has costs; the question is whether a new direction is likely to be wise on its own merits. The parallel between concessions during potential nuclear crises and concessions regarding the Vietnam commitment is closer than we might expect. It was abundantly clear long before Nixon and Kissinger acceded to power in 1969 that the US was not again going to intervene with hundreds of thousands of troops in another divided-country war.[20] That was going to be true no matter what the Nixon administration would undertake in Vietnam. The US would nevertheless find a way to continue its diplomatic and military leadership – without the implicit promise of large or extended American troop deployments (Duiker, 1994; pp.379-383).

Ferguson's biography is often depicted as sympathetic to Kissinger. Maybe so, but on the not-so-narrow topic of stewardship of Vietnam diplomacy, the detail Ferguson provides suggests that, as of January 1969, Kissinger misunderstood what terms of a settlement would have to look like, and exaggerated the reputational consequences of altering the US commitment. If anything, these failures followed from too much embrace of abstractions – the obligation to defend free DeGaulle, who presumably understood it, stayed on the sidelines. dom, the obligations to honor commitments, a constrained mental framework of geopolitical competition. These mistakes were not based on "realism"; abstractions are a species of ideals. Writing forty years after the fact, Kissinger left the door slightly open to the

[20] During 1973-1975, the US Congress would not approve war materiel for the RVN. While US allies surely understood that the US would be unlikely to commit troops elsewhere on anything approaching the scale it had in Vietnam, the decision not to provide materiel was a different matter – and is harder to defend.

possibility that he had assigned too much priority to maintaining the US commitment in Vietnam:

> …whether another definition could have been given to American credibility [in the context of US Vietnam policy] will remain the subject of heated debate (Kissinger, 2014b; p.301).

What matters from a realist perspective are the consequences of adjusting or abandoning commitments. Treating the question as one of the "definition of credibility" recalls Kissinger's earlier Kant-inspired language about the process of selecting from among "maxims." But Kissinger's approach to Vietnam is harder to reconcile with his earlier writings on nineteenth century European diplomacy, including on offshore balancing and on the limits of national power.

Ferguson suggests that his sequel will show a seasoned Kissinger in a more realist light, in part a result of having learned from the Vietnam ordeal. But regarding Vietnam diplomacy -- it is hard to imagine a Castlereagh or a Bismarck as so slow to recognize power dynamics that had been clear to others for years, and dragging his country through such a morass. Nor is it likely that either would have embraced such policy in the first place.

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6 Inflation policy, 2022: Background *

My intent here is not to predict an inflation level, but to identify some monetary and market dynamics now driving inflation, investment, and international capital flows. We have some red flags that were not waving at this time last year. We should also consider that the worst of this inflation cycle may be behind us, and that it is time to begin to take counter-measures against a more-serious-than-necessary downturn.

Monetary targets

Just as after the financial crisis and subsequent Great Recession of 2007-2009, many commentators, including some professional economists, predicted a damaging level of inflation to result from Central Bank policy, combined with deficit spending, in the wake of the 2020-2021 pandemic. Forecasts in 2009 of inflation to come turned out to be wrong.

* This paper is also being published in the *Journal of Economics and Political Economy*, June 2022.

While Fed critics in the earlier case cited sharp increases in the monetary base (currency and bank reserves), current monetarists, including Steve Hanke and Tim Congdon, draw attention to increases in much broader money supply indicators (eg, M3 or M4 – which includes most short-term, liquid assets). M3 and M4 were indeed up sharply during most of 2020 and 2021, and price increases gathered steam in late 2021 and in the first half of 2022; critics are thus far more correct this time.

Federal Reserve Chair Jerome Powell and Treasury Secretary Janet Yellen commented publicly in the Spring 2021 that they believed inflationary pressures were manageable, and might even aid in recovery from the slowdown. Paul Krugman (2021a, 2021b) argued that price jumps could be attributed to pandemic-linked supply bottlenecks and other temporary factors. And *Bloomberg* reported on May 20, 2021:

> For a sign that accelerating inflation may be fleeting, look to the housing industry, Conor Sen writes for Bloomberg Opinion. Rising prices are starting to cool demand, anecdotal evidence suggests builders are starting to take a pause, and lumber prices have responded. A start-and-stop growth environment is unlikely to sustain a higher level of inflation (*Bloomberg*, 2021).

That view, despite its association with prominent economists, seems not to recognize quantitative monetary factors that have usually been understood to determine price trends. Krugman (2021b) notes that demand for cash increases as interest rates decline toward zero, and cites evidence that narrow money indicators (M1, M2) have not correlated well with changes in prices or income. Krugman does not acknowledge that monetarism has evolved, and now uses broader money quantity indicators – for which price and income correlations are much better.

In the 1920s, John Maynard Keynes argued that inflation was a monetary phenomenon. Keynesian economists – often over-simplifying Keynes' message -- have focused on interest rate management as the essential policy tool for managing inflation and growth. The "Taylor rule," proposed in 1992, has

similarly deployed interest rate management to stabilize price and growth performance. Highlighting a different policy lever, Milton Friedman argued in the 1950s and 1960s that changes in money supply would lead "with long and variable lags" to changes in price levels. By the 1980s and 1990s, however, many or most international monetary authorities were targeting an inflation level directly – an end-variable -- rather than locking into interest rates or tracking money supply indicators. Late in his life,[2] Friedman adapted his view to agree that central banks could target inflation directly rather than seek to stabilize an intermediate variable (Svensson, 2008; p.3).

It has long been clear that central banks could target an outside standard as an end-variable, for example that a currency's value could be fixed to another currency or to a gold or silver price – whereby we get a sterling standard, a gold standard, a bi-metallic standard, etc. We know now that monetary policy can also target an inflation indicator; and we can ask, still more recently, if we can target a price indicator, why not a growth indicator? An advantage to targeting end-variables is a shorter time lapse between policy action and end-variable results. For example, rather than wait for a change in the quantity of money, or in short term interest rates, to impact upon inflation or growth, monetary authorities can act as soon as they see a change in an inflation or growth indicator. Closely related, economist and central banker Lars Svensson summarizes that monetary authorities should base policy on a forecast of where inflation and growth trends are leading:

> Inflation targeting is in practice always flexible inflation targeting. That is, it aims to stabilize not only inflation around an inflation target but also the real economy. Furthermore, because inflation and resource utilization respond with considerable lags to monetary-policy actions, it is necessary to rely on forecasts. Flexible inflation targeting then boils down to what I have called "forecast targeting" (Svensson, 2008; p.3).

[2] Friedman died in 2006.

What drives macroeconomic performance is the relationship between the cost of capital (including interest rates) and expected returns on investment, what Keynes called the schedule of marginal efficiencies of capital (MEC), which we can never do more than estimate.[3] And MEC is highly variable, contingent on the whims of finance market fashion, usually much more so than is the rate of interest (Keynes, 1936; Ch.11[4]). Consequently, an interest-rate guided monetary policy is likely to lead either into a slump (where MEC collapses to a level below prevailing interest rates), or to over-heating (where investors become excessively bullish on prospects).

A frequent confusion merits a few words. One often hears that, to be effective, interest rates must be higher than the rate of inflation, or higher than the rate of nominal growth. In fact, the relevant relationship for heating or cooling economic prospects is between interest rates (or other measures of the cost of capital) and the marginal efficiency of capital. Relationships between interest rates and other variables matter less. In a rising economy, the volatile MEC will move above the cost of capital; in a falling economy, MEC will fall below the cost of capital. In the US in June 2022, MEC appears to be falling sharply relatively to rising interest rates. Given more money growth, interest rates must be higher in order to have a cooling effect – and to close any gap with the marginal efficiency of capital. If money growth is less, then a lower interest rate can be sufficient to have a slowing impact. To put it differently, interest rates are endogenous to other factors (especially money growth) – changes in interest rates are half-blind in their impact on other factors. It is more

[3] Equity prices reflect MEC, the cost of capital, and the expected growth rate of profits into the future.

[4] In fact, much of Keynes (1936) and his earlier *Treatise on Money* (1930) were constructed cognizant upon the relationship between the cost of money (called the market rate in the *Treatise*) and the marginal efficiency of capital (called the natural rate in the earlier book.) Indeed, it is the same relationship that MBA students are taught to recognize in corporate finance classes.

useful to target changes in end-variables – price indexes or nominal income.

The correlation between "broad" money supply and prices and nominal income occurs, in Friedman's phrase, with "long and variable lags."[5] Consider the underlying money equation MV = PT[6]: In the shorter period changes in velocity of money (which measures approximately what Keynesians call "liquidity preference") will often upset an immediate correlation between the quantity of money and nominal income. The best target is usually the one with *the shortest time lapse between policy adjustment and effect upon end-variable.* The last could be nominal GDP (NGDP), some inflation indicator, or even the exchange rate against the dollar or euro. Central banks, politicians and almost everyone else care mostly about end-variables.

In August 2020, the Federal Reserve announced that it would revise its "fixed" inflation target (set for at least the previous decade at 2 percent annually, a target usually undershot in practice,) to an "average" inflation target (AIT), still set at 2 percent annually. By some early months of 2021 – using the Fed's preferred indicator of "core inflation" – growth in the US price index exceeded 2 percent, and perhaps also the 3 percent rate. *The Economist* challenged Fed officials in April 2021 on the implementation of AIT:

> A new monetary-policy framework it adopted in August dictates that it should push inflation temporarily higher than its target after recessions, to make up lost ground. The problem is that nobody knows by how much or for how long it wants inflation to overshoot after the pandemic. With the risks of an inflationary episode greater than they have been in years, the ambiguity is an unfortunate additional source of uncertainty (*Economist*, 2021).

Announcing an NGDP target would in fact overcome the ambiguity implicit in an AIT. As the real growth component

[5] Tim Congdon explains in a recent email to me, "the relationship is between [broad] money and nominal GDP over the medium term." I understand the medium term to be measured in years.

[6] MV = PT: (money quantity) (velocity) = (price level) (real transactions).

of NGDP's growth increased, the Fed would be committed to tightening, hence to reducing the inflation component of nominal growth.[7] NGDP targeting thus has two advantages:

1. a relatively short time lapse between policy adjustment and impacting end-variable; and
2. it is counter-cyclical, unlike targeting money and more so than targeting interest rates.

But the Fed resists announcing that NGDP is an important policy target – perhaps because it was not so many years ago that it formally announced an inflation objective, and it hopes not to appear inconstant? Plausibly, the Fed is now working with an implicit NGDP target.

The Fed pumped the money pedal quite hard early in the pandemic, often through quantitative easing (QE), or aggressive purchases of treasury and agency securities. Broad money in the US – measured as M3 -- increased by 26 percent in the year up to June 2020, and by 19 percent in the year to March 2021 (Congdon, 2022). Given nearly unprecedented public spending in 2020 and 2021 to maintain activity during the pandemic, the Fed should perhaps have slowed money expansion to brake private sector demand. On monetarist logic, the US economy was in for a burst of inflation as 2021 unfolded. But an important context should be highlighted. The economic dimension of uncertainty in early 2020 was comparable to what happens in a major war. Cautionary liquidity preference rose, velocity of circulation fell; a determined rise in the quantity of money was likely necessary to prevent a collapse in economic activity – in which goal the Fed certainly succeeded. Indeed, the Fed succeeded too well, as aggregate demand rose by enough to bring measured unemployment to the lowest level since the 1960s; this was the flip side of growing demand pressure.

The Fed should have reacted in 2021, perhaps later in the year, by withdrawing liquidity, hence by ending asset purchases and aggressively raising the overnight rate target. This would have been true whether the central bankers were tracking a broad money indicator, an inflation indicator or

[7] On NGDP targeting, *inter alia*, see Selgin (2018b), and Sumner (2012).

NGDP. Whatever the Fed was targeting, it missed. More alluring tasks beckoned:

> [T]he Fed's failure also reflects an insidious change among central bankers globally… around the world many are dissatisfied with the staid work of managing the business cycle and wish to take on more glamorous tasks, from fighting climate change to minting digital currencies. At the Fed the shift was apparent in promises that it would pursue a "broad-based and inclusive" recovery. The rhetorical shift ignored the fact, taught to every undergraduate economist, that the rate of unemployment at which inflation takes off is not something central banks can control.
>
> In September 2020 the Fed codified its new views by promising not to raise interest rates at all until employment had already reached its maximum sustainable level. Its pledge guaranteed that it would fall far behind the curve….
>
> The result was a mess which the Fed is only now trying to clear up. In December [2021] it projected a measly 0.75 percentage points of interest-rate rises this year. Today an increase of 2.5 points is expected (*Economist*, 2022).

Bluntly, as *Economist* (2022) then summarized, the Fed made "a historic mistake." Not only does the US now have to contend with a serious round of morale-sapping price increases; from a monetary economist's perspective, damage has been done to the mostly valid concept of AIT, due to its inept application. And the US central bank's anti-inflation credibility, reinforced over decades since Paul Volcker's reign as Chair (1979-1987), has been damaged. The honorable step for Fed Chair Powell might be to resign, as a step toward restoring institutional reputation.

Yesterday's mistakes do not reliably set up today's do-overs. Broad money growth in the US during the first half of 2022 has slowed to low single digits, and may even go into reverse for months at a time before the year is out (Congdon, 2022). Just as the Fed has been late in combating inflation, there is reason to fear that it will continue to counter excessive liquidity just when it should again loosen the reins.

How do we decide when to shift from expansion to contraction, and back to expansion? Sumner has proposed that we establish an NGDP futures market, so that monetary policy might be linked to and adjusted in line with market expectations. We can get some of the same information from implied forward prices on government bonds. But there is a dilemma involved in basing policy on forward market prices: only in part does the forward price anticipate where current policy is leading. Forward prices are also a bet on whether, or how much, monetary authorities themselves will adapt current policy. Sumner intends that the link between the NGDP futures market and adjustments to monetary policy should be automatic, hence eliminating the central bank's discretion, something like the way monetary action is taken under a genuine currency board. I suggest a smaller step -- get monetary authorities to take expectations into account, via use of AIT or NGDP targeting.

Surely relevant in estimating near-term inflation prospects is another end-variable: the dollar exchange rate. Prior to the Great Recession, the dollar: euro value dropped by nearly 30 percent from November 2005 to July 2008. It was followed by a rapid dollar recovery of more than 20 percent from that date into November 2008. The strengthening from 1.60/euro to 1.25/euro in less than four months was evidence of sharp contraction in dollar liquidity, which turned what had been a financial crisis into a deep monetary recession. The Fed, acting in conjunction with other central banks and treasuries – or, if necessary, acting alone – should have bought up treasuries, or even used FX to buy up dollars, to brake the dollar appreciation, presumably around 1.40 or 1.45 to the euro.[8]

Nothing very unusual happened in foreign exchange markets during the first year or more of the Covid pandemic.

[8] Mundell, at his Santa Colomba, Italy, conference in July 2009 (which I attended), was explicit about the connection between the dollar-euro appreciation and the 2008-2009 slump. He argued that the dollar should have been stabilized at around 1.40 or slightly lower. I have not seen the link between the strengthening dollar and the subsequent Great Recession asserted so clearly anywhere else.

But since May 2021, the dollar has risen by more than 10 percent against each of the euro, pound and yen, including a rise against the euro from 1.21/euro to 1.05/euro at the end of June 2022, against sterling from 1.42/USD to 1.21/USD and against the yen from 111/USD to 136/USD. The movements are surely driven in part by Fed tightening, and the prospect of continuing US interest rate increases. It is also plausible that exchange markets are reacting to the sharp brake on US money expansion in 2022, as indicated by an actual decline in US bank deposits – a major component of M3 -- in April and May (Congdon, 2022B). Exchange markets are also affected by the prospect of continuing US interest rate increases, and hence to the prospect of a squeeze on dollar liquidity and perhaps a US recession. There are grounds here for moderating the program by now in place to end the US inflation, and for taking steps to slow or to stop US dollar appreciation against other leading currencies.

Capital flows and fiscal deficits

In an important book, *Trade Wars are Class Wars* (2020), authors Matthew Klein and Michael Pettis argue that current account surplus countries, led by China and Germany, under-consume relatively to national income because of the way income is distributed domestically. This argument is a reversal of the conventional view that the US current account deficit reflects over-consumption and under-saving in the United States. But Klein & Pettis are on solid ground inasmuch as trade deficits -- including for the US over several decades -- and surpluses are "nearly always" induced by financial transfers (Mundell, 1992; p.49); this was also Keynes' premise at Bretton Woods in 1944 (Klein & Pettis, 2020; pp.189-190). The authors bring together consideration of growth and inflation on one side with discussion of damage from income inequality ("class wars") on the other. Based in part on their study, I offer two conclusions and an inference.

The volume of cross-border capital flows has much to do with an open economy's capacity to finance fiscal deficits. When China or Germany, or other surplus countries, consume less than they produce, large amounts of savings look abroad

for placement and safe harbor, just as large amounts of surplus product look for markets. (The accounts' imbalance was aggravated following the emerging markets financial crisis of 1995-1999, as the world's currency reserves grew during 1999-2013 from $1.9T to 11.6T (*Stastica, 2022*). To grow reserves at such a rate required constraint on domestic expenditure in surplus countries – that is, in much of the world.) As the US dollar is the *de facto* world currency, the equivalent of hundreds of billions of dollars of foreign savings seek refuge every year in US dollar instruments – preferably in low-risk treasury or government agency issues. The inflow of finance to the US (and, to a lesser extent, to other deficit countries Britain, France, Canada and Australia) makes it inevitable that these countries will consume more than they produce. This has been called America's "exorbitant privilege," among others by Charles DeGaulle. But Volcker, in a 2018 interview, captured the flip-side of consequences for the provider of the world's currency: "The top dog pays the price." (Klein & Pettis, 2020; p.224.) Problematic fallout for deficit countries have included: 1) a flood of manufacturing imports;[9]

[9] Take a stylized example. Imagine a world with two countries, US and CH, each with 100 units of production (50 each of goods and services) and 100 units of consumption. CH then draws on savings to export 100 units of capital to US – which absorbs the capital and increases its purchasing power to 200. Now imagine that CH doubles production to 200 units, but its domestic consumption stays at 100 units. It is easier for CH to export goods than to exports services, so most of the increased capital in the US will go to consuming imported goods. The US as a whole is better off; it consumes more goods, and, because it has expanded purchasing power, also demands more services. Consequently, a portion of the 50 units of production capacity in the US that previously went to producing goods will shift to providing services. Some US workers who previously produced goods will have lost their manufacturing jobs. The magnitude and composition of these shifts will vary from one situation to the next. Also, see MacKinnon (2013). To understand the political consequences of such capital movements, consider evidence that 89 of the 100 counties in the US most affected by Chinese competition went for Donald Trump in the 2016 Republican primaries, Klein-Pettis (2020, p.2). (One reader pointed out to me that many US counties went for Trump in the 2016 primaries, and other common trends in those counties might have been more important than losing production orders to Chinese competitors.

2) a decline in manufacturing as a share of US GDP, from 16 percent in 1997 to below 11 percent in 2021 (World Bank, 2022a) – while Germany's manufacturing ratio is around 18 percent of GDP (World Bank, 2022b), and China's around 26 percent (World Bank, 2022c); 3) skewing of income toward financial sectors that manage the capital transfers; and 4) lots of private capital sloshing around – looking for borrowers -- that will increase debt-to-income ratios in deficit countries, and be drawn into speculative vehicles, eg subprime mortgages in the US prior to 2008.

To fix this global imbalance would require structural change in China, Germany and elsewhere to redistribute more income down to households. For China, Klein & Pettis suggest increased dividends from state-owned enterprises to be paid to employees, a wealth fund, recognition of property rights, an income tax for higher-earners, lower consumption taxes, and an end to the *hukou* system (which restricts movement and re-location.) For Germany, they recommend higher inheritance taxes to de-concentrate wealth, lower taxes on most labor, and regulatory integration with the European Union – including with what have been deficit countries within the bloc. For both, the authors recommend fiscal deficits that should be used to direct heretofore exported savings to domestic purposes. (The authors propose having an international conference, call it Bretton Woods II, and dusting off a variation of Keynes' bancor proposal, from the original Bretton Woods I, to force surplus countries to reduce capital exports.[10]) If we do not see the kind of reform that would fix systemic imbalances, the US might sooner or later look for other ways to discourage or block massive capital inflows; absent such reform, it might be difficult to maintain the

True enough about data analysis – but I suspect that job losses to trade were an important electoral motivator that year.)

[10] (Klein & Pettis 2020, pp.189-190, 228). Keynes intended that IMF member countries in deficit would be able to draw on bancor balances to support their currencies – and, symmetrically, that surplus countries would either reduce surpluses or forfeit bancor balances. US negotiators rejected the bancor proposal, seemingly acting on the confused premise that the US would always be a surplus country.

dollar's role as the world's main reserve currency. Current trade imbalances are a consequence of these capital movements – so any effort to address the problem through the usual trade negotiations, or imposition of tariffs, will fail.

In the meantime -- absent such reform -- the US could explicitly provide more of the debt instruments that are in such international demand (including for the purpose of augmenting national reserves across much of the developing world); that is, the US might run larger budget deficits. Very low, even sub-zero interest rates, for a post-2009 decade or so, on US and several European treasury securities suggest that supply of such securities scarcely met global demand. Klein-Pettis note that there are now redundant funds for corporate or other private sector outlays, and indeed that corporations, net, are spending less than they generate in cash flow, and are often using excess cash to repurchase stock. They cite evidence that US private equity firms are unable to deploy trillions of dollars (Klein & Pettis, 2020; p.79-80). Hence, they argue, this is not the time to funnel massive international savings into private sector projects in deficit countries. It would be more stabilizing, and better for longer term growth, were the US to run larger fiscal deficits and use proceeds – as suggested above for China and Germany -- to upgrade infrastructure, boost education, and counter growing income inequality.

Some imagine massive fiscal deficits as a harbinger of inflation to come (*Washington Post*, 2021); the claim is also a staple of partisan discourse, usually hurled at Democrats by the GOP. Indeed, as noted, the longer-term impact of growing deficits is problematic. In the interim, the choice is in how much of that incoming capital will be cycled to the US private sector, and how much will be used to finance US public sector deficits. Either boosts US aggregate demand, with similar monetary consequences. And both imply a current account outflow. If the Federal Reserve wants to expand its balance sheet – to "monetize the debt" -- there are $trillions of existing treasuries or agencies to purchase, apart from any new issue of either. Similarly, the Fed can sell off assets if the purpose is to drain market liquidity. US fiscal deficits should not force

expansion upon US monetary policy over plausible time horizons.

A word on Modern Monetary Theory, which essentially recapitulates a closed-economy Keynesian argument that public sector deficit spending is not inflationary – not for as long as the economy is in a high-unemployment (partial) equilibrium (Coats, 2019). That is, MMT tries to replace monetary stimulus as a policy instrument with fiscal expansion. Its premise was that financial markets could absorb a great deal more government debt – without over-heating, and without generating price inflation. It was an old argument, one essentially rejected for closed economy contexts (short of severe recession) by most macroeconomists decades ago. Yet it gained recent plausibility because debt issue was expanding during the previous decade, without causing obvious distress. In fact, the logic of borrowing during the previous decade had little to do with closed-economy Keynesianism, or with MMT. The US is an open-economy, and – at the same time as it was losing manufacturing jobs -- it was absorbing savings from abroad. Much of the foreign savings was going directly into purchase of US government debt, in what may have seemed an infinite virtuous cycle.

Klein & Pettis (2020; p.81) argue that growing income inequality is often accompanied by growing debt ratios – and they begin with evidence from the US in the 1920s. The premise is that those with higher incomes did more saving, and – as a portion of income – less consumption. Evidence from the past decade similarly suggests that a savings glut at the top of the income and wealth pyramid in the US has financed growing indebtedness among the "lower 90 percent" (Stropoli, 2021). The problem, given growing inequality, is that the only way growth in consumption can keep pace with growth in national income is by having higher-propensity consumers take on new debt – indeed by increasing debt-to-national income ratios, and hence increasing susceptibility to financial crisis. (By the same reasoning, were economic growth instead to be led by the lower 90 percent – by those with higher propensities to consume – consumption could

increase while the ratio of consumer debt to national income would decline.) Monetary stimulus (hence, national income expansion) under conditions of high, or growing, inequality will give impetus to financial breakdown – as the authors believe it did in 2007-2008. Redistribution of income and wealth in the US and elsewhere would reduce consumer debt, and hence contribute to financial stability.

Back to inflation, my first *conclusion* is that US government deficit spending is likely not to be, a separate factor boosting price increases now, or in the foreseeable future. Indeed, given massive inflows of foreign capital to the US, for the US to run fiscal deficits and issue such debt is essentially wise. The world wants to hold US government debt! A liquidity squeeze in the near future, as suggested in the previous section, would contract economic activity, reduce tax revenue, and increase public sector borrowing; but the new borrowing would certainly *not* cause a general increase in prices.

My *second conclusion* is that a systemic mechanism should be negotiated to reduce international capital flows; that is, to get surplus countries to increase domestic consumption and investment, and thereby to reduce debt buildup in deficit countries. My *inference* is that weak economic growth for the past decade or more is, in part, a consequence of contractionary monetary policy on the part of the Federal Reserve, the European Central Bank (ECB) and other central banks. A bit of price inflation, perhaps consistent with the Fed's AIT guidelines, might have been a necessary (or, at least, collateral) complement to boosting demand during 2020 and part of 2021. But as noted earlier, the Fed allowed AIT guidelines to be far exceeded during much of 2021 and into 2022, which has damaged the central bank's credibility.

IOER and deflation

Understanding current monetary policy demands a moment of attention to the consequences of paying interest on excess reserves (IOER) – that is, commercial bank deposits, held at the central bank.

The Federal Reserve, ECB and Bank of England now operate with "floor" systems, rather than a corridor system, for guiding overnight interest rates.[11] In a corridor system, the unsecured overnight market rate (called the fed funds rate in the US) is higher than whatever interest rate banks can earn by placing funds on reserve at the central bank. The difference between the market rate and the reserves rate is the "corridor." In a floor system, the IOER is as high or higher than the fed funds rate. The Federal Reserve had used a orridor system since its founding in 1913; it began to pay IOER at a level as high as or higher than the fed funds rate only in October 2008, thereby collapsing the corridor into a floor system – and it has kept the IOER rate a few basis points above the fed funds rate ever since. The unsecured interbank market, which used to be the venue for banks to meet their reserve requirements on a day-to-day basis, is now much shrunken. Banks can earn as much or more by placing reserves with the Fed – all with zero credit risk and no need to monitor activities of interbank counterparts.

The Federal Reserve balance sheet grew from less than $1 T in 2008 to nearly $9 T by June 2022, the last doubling from March 2020. The gross increase reflects QE – the Fed's aggressive open-market purchase of treasury and agency securities. But much of the increase in central bank assets has been matched on the liability side by increases in excess reserves. Placing deposits at the central bank stops the reserve multiplier (and hence monetary expansion) in its tracks; the impact on market liquidity of placing commercial bank deposits with the Fed is the equivalent of performing a central bank open-market sale – it is deflationary. What is the purpose of an open market purchase if it anticipated ahead of time that it will be offset by a commercial bank deposit at the Fed? Answer: it would allow the Fed to change the maturity structure of the federal debt, for example by replacing 20-year bonds with 6-month bills. Or it could replace treasuries in its portfolio with mortgage-backed or other agency securities –

[11] Selgin (2018a) is the outstanding reference on IOER.

thereby giving a boost to the mortgage-backed market (Bernanke, 2013).

Consequences of the floor system have thus included giving the central bank a larger role in the allocation of credit than was ever intended. Quantitative easing involved Fed purchase of treasury and agency (usually mortgage-backed) securities – hence removing them from the market – while IOER then took much injected money out of circulation. In consequence, far more treasuries and mortgage-backed securities were purchased by the Fed than were needed to boost liquidity. As this is written, the Fed holds approximately two-and-a-half $trillion of mortgage-backed agencies, approaching 30 percent of the central bank's balance sheet.

In immediate context, the link between Fed balance sheet management and monetary policy is more tenuous than it was before October 2008; that is, much of the purported expansion evaporates. By most accounts, implementation of IOER slowed the recovery from the 2008 -2009 nadir (Selgin, 2018; pp.90-91). Indeed, IOER was presented in 2008 as a contractionary policy – a way to keep the fed funds rate from sinking. (That was misguided; in October 2008, the US should have had an expansionary monetary policy to move beyond the financial crisis.) These consequences of the floor system have been disappointing. The main reason central banks have maintained it appears to be that reducing balance sheets to pre-October 2008 size would require recording losses on their ever-growing inventory of government security assets.

What did *not* happen in 2008-2009 was a "helicopter drop" of new money.[12] Much of the money injected through QE has been placed on deposit at the Fed and effectively withdrawn. But ongoing QE operations during 2020 and 2021 have led to increases in narrow and broad money indicators despite the floor system. Expansionary fiscal and monetary policy during the first year or more of the pandemic (2020-2021) generated

[12] A "helicopter drop" has more technical definitions, but is generally an aggressive, deliberate increase in the quantity of money. The reference is to a metaphor introduced by M. Friedman.

enough stimulus to overwhelm built-in brakes from policy of paying IOER.

But IOER remains clumsy policy. Future monetary expansion will be easier to manage if the IOER is reduced to a level well below the market fed funds rate, thereby restoring a corridor system. Restoring an active fed funds market would boost banking sector allocative efficiency and end the deflationary mechanism implicit in current IOER policy.

Conclusion

1. Central banks are able to target inflation rates, or nominal GDP growth, without long lead times; the Federal Reserve is capable of responding if, and when, unexpected price trends appear. This time, however, it did not respond adequately, or on-time, to evidence of surging money quantities or of price trends. The consequence has been a burst of price inflation in 2021-2022, and to damage to the Fed's anti-inflation reputation and to the credibility of its AIT operating premise. The Fed Chair should consider resigning. There are reasons now to caution against anti-inflation zeal; this is not the time to move from over-heating to slump.

2. US current account deficits reflect excessive savings abroad, especially in China and Germany, and consequent massive capital flows to the US. US government debt issuance can provide securities demanded nationally and internationally; inflationary consequence, or not, will depend on monetary policy, not on the mix of private and public US spending.

3. The Fed's current operating method – use of a floor system for interest rate management – carries a deflationary bias that has slowed economic growth since its adoption in 2008. It also undermines functionality of the interbank funds market, and has given the central bank a larger role in the distribution of credit than it ever should have obtained. and should be discontinued.

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7 Monetary policy and the Great Recession: Seven Myths *

Once, years before the onset of the Great Depression, John Maynard Keynes offered a laundry list of things to which people attribute economic hard times – everything from structural factors to technological change to moral decline. But he then observed that the root of the problem was usually monetary. Keynes' off-hand remarks often conveyed insight.

And looking ahead, while conventional wisdom saw it otherwise, the origins of the Great Recession of 2008-09 largely lie in monetary policy, as does the way back to prosperity. Back in 1998, after publication of my book on the Depression, I was asked what caused that catastrophic collapse of output and employment in the early 1930s. I answered (as others have) that the decline had its origins in deflationary monetary policy – but reassured the questioner that the world had learned its lesson and we weren't likely to

* A slightly abbreviated version of this paper was published in the *Milken Institute Review* in 2011. The text here include a contemporaneous outline of strains in the Eurozone that was not included in the earlier publication.

see the same mistakes again. Looking at developments since 2008, though, I am dismayed by the similarities between the current policy debate and that of the late 1920s and early 1930s.

Today, hands-on monetary policy is almost an orphan; no influential group understands and embraces it. Those leaning left have generally treated monetary tools for fighting slow growth as inapplicable or otherwise suspect, and have called instead for public spending and jobs programs to "reboot" the economy. Those to the right are inclined to follow the siren call of hard money and assume that expansion of the money policy is the road to inflation – which, for them, ends the discussion. Also, many on the right have injected some Old Testament fervor into the mix, arguing that the United States must pay for past financial excesses with massive deleveraging of all kinds of private and public debt, which must exact great pain. Neither side is persuasive; both parties to this argument show more conviction than insight.

For accessibility, I have gathered a number of frequently-cited beliefs about monetary policy (dubbed "myths"), and what we should instead understand about them ("realities"). I will discuss recent events, events from the 1930s, and conceptual confusions. The confusions, alas, have contributed to inept policy choices, continued slow growth and high unemployment, and countless misleading op-ed pieces. Monetary policy is the key to whether the bull market resumes, to whether the fiscal deficit comes down in the next 2-3 years, and to who wins the 2012 US elections. It will perhaps impact whether American cities will see English-style riots in high unemployment areas, and whether there will be a Eurozone sovereign debt crash.

Myth 1: The Federal Reserve has followed a highly expansionary monetary policy since August 2008

Reality: nearly the opposite is the case

The widely held view that the Federal Reserve has pursued an expansionary policy is based on the rapid growth of some

measures of the quantity of money in circulation, and on the Fed's publicly stated goal of keeping short-term borrowing rates very low. But look more closely at each. The Fed's assets expanded from about $900 billion in August 2008 to $1.8 trillion in October 2008 (along with liabilities, since it pays for the assets with cash that ends up as bank deposits): they reached $2.8 trillion by late July 2011. And it's widely reported that this trebling of the central bank's balances has led to a trebling of liquidity.

The great bulk of the increase in Fed liabilities has been in the form of bank reserves (commercial bank deposits in Fed accounts) in excess of the minimums required by Fed regulation. These excess reserves have increased *800-fold,* from a mere $2 billion in August 2008 to about $1.6 trillion in July 2011. There is no credit expansion effect from excess reserves as long as they remain on deposit with the Fed rather than loaned to businesses or households.

The reserve accumulation is in large part a response to the Fed's decision in October 2008 to pay interest on reserves for the first time since the Fed was established in 1913. Rates on reserves have since been set at levels slightly higher than Treasury bill yields, which gives commercial banks every reason to empty their books of T-bills and place the proceeds in their risk-free reserve accounts at the Fed. The impact is almost identical to "open market" sales by the central bank – which are deliberately deflationary.

There has also been an increase in currency in circulation, from $800 billion to just over $1 trillion in the same period. Much of the increase occurred during the distress of 2008 and 2009 and reflected demand for immediate liquidity – not an increase in loanable funds. Thus, on balance, any increase in monetary aggregates has been inadequate to offset the crisis-induced boost in appetites for liquidity. This is a liquidity matter that central banks are supposed to address.

On Sept. 18, 2008, at a tense juncture three days after Lehman Brothers collapsed, the Fed met and chose not to lower the overnight funds rate from its 2 percent target – an indication that the central bankers had yet to see the need for easier money. When they did see the need, the rate was

gradually lowered until mid-December 2008, when the target was set in the very low 0 to 1/4 percent range. But a near-zero market interest rate – as reflected in the rate that banks charge in overnight loans to other banks – is not always expansionary; it may simply reflect aversion to risk in uncertain times. It occurs because commercial banks' supply of unused cash exceeds demand on the part of interbank borrowers. Near-zero interest rates then reinforce this dynamic from the side of lenders. As a consequence, the interbank market is now only one-third the size it was before the 2008 collapse, which makes it more difficult for banks to facilitate commercial lending. It is hard to anticipate any financial sector contribution to an economic recovery until interest rates recover to more normal levels.

Because of the dollar's role as the international currency of choice for storing liquid assets and for financing trade, its exchange value is a useful measure of global liquidity conditions. Until July 2008, with the dollar as weak as $1.60 to the euro, monetary conditions were quite easy. Then, from early July to mid-October 2008 the dollar rose rapidly to $1.25/euro, an indication of systemic liquidity squeeze. The Nobel laureate Robert Mundell has argued that if central banks had chosen to stabilize exchange rates somewhere between the dollar's July low and the October high – perhaps in the $1.40/euro to $1.45/euro range – much of the downturn might have been avoided. This result could almost certainly have been achieved through aggressive, coordinated interventions in the government debt and foreign-exchange markets. That it was not accomplished was, Mundell concludes, "one of the worst mistakes in the history of the Federal Reserve" (Rushton, 2010).

Beyond these specific missteps, the evidence suggests a broader systemic problem: the Fed has a cramped and unimaginative view of its capacities. Monetary policy works best by guiding expectations of growth and prices, rather than by just reacting to events through adjusting short-term interest rates. The comments of Ben Bernanke during the past three years suggest either lack of conviction about the economy's prospects or acquiescence to expectations of low

rates of growth. Instead of assuring the market that growth will be restored, the Fed has set interest-rate targets or promised to undertake specific volumes of open-market operations over defined periods. Much more could be done to create the expectation that necessary liquidity would be provided.

Myth 2: Recovery from recessions triggered by financial crises is necessarily slow

Reality: Effective monetary policy can bring rapid recovery from financial crisis

We might draw some inferences from two incidents – the aftermaths of the 1929-1932 Depression and the 2008-2009 Great Recession. The first saw a stock market crash, followed later by massive upheaval in the banking sector. In the latter case, the impetus for downturn was doubts about the quality of bank assets, which led to a freeze-up in the interbank lending market. In the first case, we know that rapid recovery occurred as soon as the Roosevelt Administration demonstrated that it would take aggressive action to expand liquidity and allow prices to recover. In the second, aggressive monetary ease had not occurred by 2011.

During the first four months of Roosevelt's first term, from March to July of 1933, Industrial Production rose by 57 percent, the fastest rate of growth ever recorded for such a period of time in the US. The trigger for this growth was the decision to allow the dollar to float – and, hence, to depreciate -- against gold, which was then the world's essential monetary reserve. Doing so led to the expectation that money would be more abundant and prices would rise, following years of deflation, which would then facilitate higher profits and recovery of investment and hiring. The decision to depreciate the dollar was reinforced at the World Monetary Conference (WMC) that June, where Roosevelt rejected pressures to stabilize a new dollar-gold price. Financial markets interpreted Roosevelt's action as again encouraging easier money and price recovery, and stock prices rose.

Those represented the best of Roosevelt's economic initiatives. Unfortunately for economic recovery, Roosevelt had another set of economic advisors who discounted monetary factors and believed the cause of economic hardship was rapacious businessmen, sometimes called "economic royalists." The National Recovery Administration (NRA), established immediately after the WMC, negotiated cartel-like arrangements with most major industries; the most important were anti-deflationary floors below which no company would lower prices or wages, and agreements on maintaining employment and production.

In a phrase, the NRA wanted to increase prices by restricting output rather than by increasing demand. Keynes himself pointed to the fallacy of the RA approach: "rising prices caused by deliberately increasing prime costs or by restricting output have a vastly inferior value to rising prices which are the natural result of an increase in the nation's purchasing power." He added that it was "hard to detect any material aid to recovery in the National Industrial Act [which anticipated the NRA]" (Keynes, 1934). Within six months after the NRA went into effect, industrial production had dropped 25 percent from a higher level, erasing more than half of the gains recorded during Roosevelt's more successful initial months in office (Wikipedia).

The 2008 financial crisis started with doubts about the quality of bank assets. Interest rate spreads between short-term bank and US Treasury obligations started to rise as early as the Fall of 2007, and spiked upward in late September and early October of 2008. Then, on October 13, the US Treasury acted through the Troubled Asset Relief Program to recapitalize the large banks. Risk premiums then fell, following which the interbank market thawed. By mid-November, rate spreads fell back to where they had been in late September, and they continued downward over the next several months.

This 2008 history offers a useful parallel to the issuance of long-term debt to US banks in 1933 via the newly created Reconstruction Finance Corporation. The condition of banks in 1933 remained parlous, and uninsured depositors lost more

that year than in any of the previous three years (Hetzel, 2009; Appendix). But that did not prevent recovery. If the downturn of 2008-2009 had been driven primarily by credit concerns and a frozen financial se have eased with the recapitalizations. But in 2008 – driven by monetary constraint – US and world stock markets and commodity prices continued to fall for several months following the recapitalizations. In early March 2009, the dollar strengthened again to $1.25, about where it was the previous October, evidence of liquidity strain. Only a couple of weeks later did the Fed begin modest "quantitative easing (QE)," which involved purchases of set volumes of government securities over specified periods of time, and which had much to do with starting the subsequent two-year recovery in financial markets. But reaction to QE from the political right has been heavily critical, which may have lessened the Fed's enthusiasm for more aggressive measures.

In an historic parallel, several bank recapitalizations were undertaken in Japan during 1997-1999, and they largely succeeded in restoring capital ratios and in writing down bad debts. Recovery of lending was nevertheless blocked by continued economic weakness. Even more than in the US since 2008, Japan was stuck in a near-zero interest-rate trap, which limited profitability of lending. The potential remedy was not in bank management or regulation, but in more effective monetary policy (Goyal & MacKinnon, 2002).

Myth 3: Monetary policy becomes ineffective when short-term interest rates fall to close to zero

Reality: Central banks have ways of stimulating demand even when interest rates hit bottom

Keynes pointed to the circumstance – dubbed the "liquidity trap" – in which "the central bank would [lose] effective control of the rate of interest." Under such conditions, it was (and still is) argued, a central bank's purchase of short-term Treasury securities on the open market will not be expansionary because the replacement of

ultrasafe, highly liquid securities with cash in private portfolios will have little systemic impact.

But there are alternatives to "monetizing" existing debt. Central banks can use a more aggressive technique to monetize new debt. This technique combines Treasury issue of a new security with the Fed's cash purchase of an already existing Treasury security. The effect is a net increase in cash in the system that, unlike conventional monetary tools, increases net liquid assets. The net effect is an increase in cash in the system – used to purchase the outstanding security -- while the impacts of the two securities transactions cancel each other. This expansion can take place whenever the government runs a fiscal deficit, and hence has need to issue additional securities. The use of this mechanism is limited only by the extent of the current fiscal deficit – which, as I write, is scarcely at all a constraint in the US and many other countries.

There is another expansionary measure available to the Fed: it could reverse the unfortunate 2008 decision to pay interest on excess bank reserves held in Fed accounts. Doing so would give banks a profit incentive to increase commercial lending, as large chunks of balance sheets now earning interest would otherwise lie idle. This discussion, though, still misses the most important influence that central banks should have over monetary policy, even in conditions of near-zero short-term rates. As Lars Svensson, deputy governor of Swedish Riksbank, observed a few months before the 2008 crisis:

It is now generally acknowledged that monetary policy works mainly through the private-sector expectations of future interest rates and future inflation that central-bank actions and statements give rise to. Those expectations matter much more than the current interest rate. That is, monetary policy is "the management of expectations" (Svensson, 2008).

We have gotten frequent pledges from the Federal Reserve during the past three years of its intention to continue to focus on interest rates and to keep short-term rates close to zero. Yet, far from an augur of an improved liquidity environment, this Fed assurance seems more like a forecast

that slow growth and high unemployment will continue well into the future. The critics of quantitative easing are right in one respect. It would be better used as part of an overall effort to shape expectations, and hence to convince markets that interest rates would return to normal levels. Instead, the program has involved Fed purchase of long-term Treasury securities, with the intention of lowering their yields. So, while quantitative easing has provided some additional liquidity, it has not addressed the imbalances introduced by the near-zero rate trap.

Where interest rates are stuck in a liquidity trap, it is usually because markets believe that central bankers are not serious about prying back the trap's hinge – that is, committing to policies that give greater weight to employment and growth. One observes repeatedly that central bankers assert either that they are not capable of undertaking, or not legally permitted to undertake, what, for doctrinal or political reasons, they do not want to do. Keynes' own view of the way monetary policy works (and his discussion of liquidity traps) was more nuanced than many of his disciples suggest. He acknowledged later in *The General Theory of Employment, Interest and Money* (1936) that an increase in the quantity of money could affect business expectations and investment independently of any effect on interest rates. This contradicts the frequent claim that Keynes thought monetary policy might became completely ineffective in a low-interest rate environment.[2]

[2] See also "Did Keynes Make His Case," a version of which was published in 2016, included in this volume.

Myth 4: The greater the indebtedness incurred during growth years, the larger the subsequent need for debt reduction and the greater the downturn

Reality: The pace of recovery largely depends on current policy, not on past excesses

This inference is related to Myth #2, but merits added attention since it is so widely believed. Non-economists sometimes think it is self-evident that piling up debt requires a painful reckoning. Indeed, the "Austrian" school of economics is often cited to support the view that systemwide deleveraging must delay recovery. Part of what is at issue here is the misleading resemblance between managing the finances of a household or business and the dynamics of national finance. De-leveraging a national economy *can* slow down aggregate spending, but need not. A recent blog post by David Beckworth, an economist at Texas State University, makes the distinction:

> Yes, deleveraging is a drag on the economy, but for every debtor deleveraging there is a creditor getting more payments. …In principle the creditor should increase spending to offset the debtor's drop in spending. The reason they don't – creditors sit on their newly acquired funds from the debtor instead of spending them – is because they too are uncertain about the economy. There is a massive coordination failure, all the creditors are sitting on the sideline not wanting to be the first to put money back to use. If something could simultaneously change the outlook of the creditors and get them to all start using their money at the same time then a recovery would take hold. Enter monetary policy and its ability to shape nominal spending expectations (Beckworth, 2011b).

Deleveraging becomes a systemic problem if it leads to uncertainty that increases demand for liquidity, and thereby slows spending. But uncertainty can be overcome by new injections of liquidity – that is, through monetary policy.

A closely related argument in the past was that central banks should discount -- that is, issue money in exchange for -- only "commercial" bills (short-term business debt), and not "financial" bills (debts of financial institutions). When the need to deleverage arises, goes this "real bills" doctrine, fewer commercial bills will be issued, hence there will be less discounting at the central bank, and less need for systemic liquidity. But this practice aggravated the credit cycle, causing more uncertainty rather than less, and made downturns worse. Lingering adherence to real-bills doctrine among United States and French officials in the late 1920s and early 1930s became an impediment to undertaking monetary measures necessary to overcome the Great Depression.

Keynes' *Treatise on Money* was a sustained criticism of this real bills doctrine. What mattered for Keynes was not the purpose of the discount at the central bank, but the volume of money creation or destruction relative to the system-wide demand for money. Milton Friedman reached a similar conclusion decades later, using data to cover expansions and downturns over more than 80 years. He wrote that "there appears to be no systematic connection between the size of an expansion and of the succeeding contraction," and concluded that this phenomenon cast "grave doubts on those theories that see as the source of a deep depression the excesses of the prior expansion" (Friedman, 1969).

Neither logic nor evidence supports the arguments of the castor oil advocates.

Myth 5: When monetary policy breaks down, there is a plausible case for a fiscal response

Reality: Not usually; fiscal activism works only where expectations and the monetary environment support it

Uncertainty brings added demands for liquidity, which means lower demand for investment and consumption. If the trend continues, borrowing demands decline, and lenders earn less interest. Nominal interest rates can then decline, sometimes to close to zero percent. This is the environment

we have seen in the US for most of the past three years, and in Japan for much of two decades. A number of Eurozone countries are not far away.

The cycle of uncertainty and rising liquidity preference can be broken by purposeful central bank action, which undermines the case for fiscal activism (Myth #3 discussion). But another question looms: even if the *necessity* for fiscal stimulus is called into question, can fiscal stimulus in fact work, or under what circumstances can it work?

Fiscal policy has been caught in the battle between big-government liberals and small government conservatives. The former, one might infer, will leap on any argument to justify government spending. The latter, by contrast, see economic downturn as an opportunity to "starve" government – and will reject any government spending, even one-off temporary stimulus spending, as a means to escape near-depression conditions. If small government conservatives were, as an alternative to fiscal largess, to advocate more monetary stimulus under these conditions – as Mundell generally has (Rushton, 2011)- they would have an argument worth winning.

In 2011, unfortunately, many small-government conservatives seem instead convinced that monetary activism would be wildly inflationary. In other words, despite anemic growth and continued high unemployment, they oppose either fiscal or monetary stimulus. (Consider Ron Paul, Paul Ryan, etc.) Friedman's death in 2006 has set back awareness of the importance of monetary policy among small government conservatives.

Evidence regarding whether fiscal stimulus works is at first glance contradictory. Paul Krugman of Princeton and the *New York Times* often cites studies to support it. But John Taylor of Stanford (and formerly of the Bush administration) argues that fiscal stimulus has done little to boost spending or investment. What to make of this? Krugman would quickly agree that most fiscal stimulus has failed because, he would urge, it has been inadequate. In other words, because people do not expect the stimulus to last, they do not spend what they believe are temporary boosts to income. This has, in fact, overlap with Taylor's argument – which is that "temporary

discretionary countercyclical fiscal policy" has little impact. The historical example of which Keynesians are most fond is the US military build-up beginning in 1941, which at last brought an end to Depression-era stagnation and unemployment. That the WW2 fiscal stimulus worked is generally consistent with both Krugman's and Taylor's arguments *because it was expected to last*.

But this brings us full circle to earlier discussion of Myth #3: expansionary monetary policy can spring a zero-interest trap only when the monetary authority succeeds in driving expectations. Similarly, fiscal stimulus will succeed if it reduces uncertainty (and hence reduces liquidity demands) to the point that market participants are ready to resume spending. Fiscal stimulus thus works when it succeeds in altering *monetary* dynamics – by increasing the public's willingness to spend on investment or consumption. Under the unusual condition that the market can be convinced fiscal stimulus is likely to endure, it can succeed. Otherwise, probably not.

Taylor refers in his study to a "basic Keynesian textbook model" of temporary stimulus, but this may be misleading about Keynes' own view. By the time of the *General Theory* (1936), Keynes wrote less of public works projects and more of "the State… taking an ever greater responsibility for directly organizing investment" (Keynes, 1936: p.164). The government's role was to be on-going, not only episodic or countercyclical. This put Keynes' mature formulation very close to Krugman's or Taylor's – fiscal stimulus works through its impact on expectations.

Long-term fiscal activism has hardly been discussed in the post-2008 context. Given the increase that longer-term fiscal stimulus might bring to the US national debt, or what it would require in terms of an increased role for government intervention in the economy, it would be a very hard sell in today's environment. Temporary fiscal stimulus makes sense where spending provides something the public needs. As a way to drive expectations, it is usually a sideshow.

Myth 6: The rising prices of food and other commodities are evidence of expansionary monetary policy and inflationary pressure

Reality. The only way the Federal Reserve -or the ECB- could prevent rising commodity prices would be to force the world economy into a sharp contraction

Commodity prices, which are generally volatile, have risen much faster than other prices since 2007, generally at a rate of 20 percent annually or higher, except for a sharp spike downward from about the middle of 2008 to the middle of 2009. By contrast, The US Consumer Price Index (CPI) has risen by about 7 percent since its low point in November 2008, but less than 3 percent since its high in July of that year (US Inflation Calculator). Another price index, the US GDP Deflator, has risen by less than 4 percent since October 2008, or just over 1 percent per year (US BEA). Leaving aside raw commodity costs, US prices have risen by even less that the CPI or Deflator indexes suggest.

A very popular view in some investment and political circles is that the rise in commodity prices is a consequence of expansionary policy by the Federal Reserve, the ECB, or both. Evidence, however, is clear that commodity price changes correlate closely with growth or lack of it in Emerging Markets, as measured by an Industrial Production Index. Here it is visually (Beckworth, 2011a):

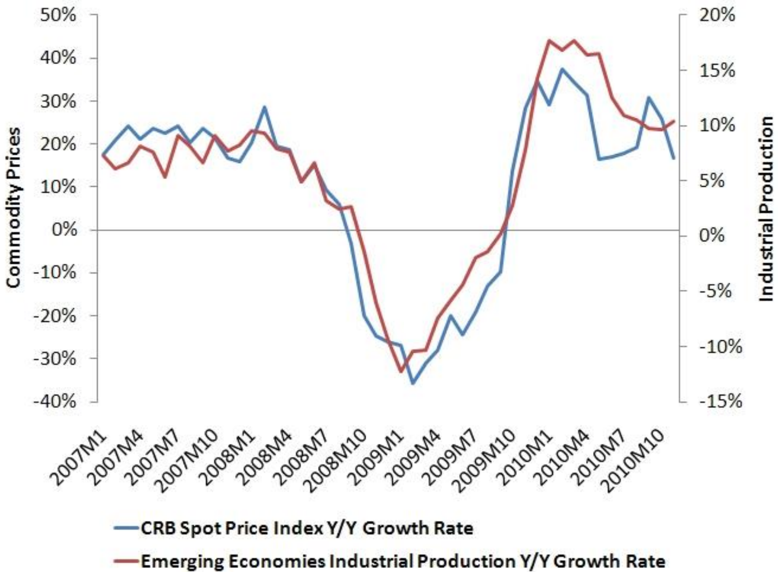

Figure 1.

A couple of implications from this data:

1 Western central banks have limited causal role in driving the pace of emerging market growth, hence, the control of commodity price trends should not be thought part of their mandates.

2 Given rising demand for commodities in other parts of the world, it is likely that the cost of commodities will continue to rise in the US and elsewhere. This trend could only be offset by significant improvements in production or technique.

We need one qualification. It *would* be possible for the US or European Central Banks to stop the growth of Industrial Production in emerging markets by imposing a sharp monetary contraction – something that might repeat the 2008-2009 downturn. As the dollar and euro are international currencies, a monetary shock involving either could slow world growth. This would be seriously damaging, to say the least – yet it is the only plausible means by which Fed or ECB action could slow or stop commodity price increases.

Financial markets seem to understand quite well that commodity price increases do not now presage an increase in general prices: annual yields on medium term 5-year US treasuries have fallen in early August 2011 toward 1 percent annually, which is the lowest in a Federal Reserve's data series going back to 1953 (Federal Reserve, 2011). Price inflation appears to be the least of concerns in the US Treasury market these days.

Myth 7: The underlying problem in the Euro-zone is the common currency among economies with differing income levels and growth rates

Reality. The Euro-zone's problems stem from a combination of careless, politically-driven assurances and contractionary monetary policy

It is essentially true that if Greece, Ireland, Italy etc, were able to depreciate their currencies, they would be able to ease monetary policy and boost demand, thereby boosting income and employment. But before initiating a breakup of the euro zone – which I do not advocate -- we should understand how we got here.

There are advantages to having a common currency for twenty contingent or nearly contingent countries. These include reducing transactions costs, reducing medium- and long-term price uncertainties, and encouraging efficiency through cross-border investment and capital market integration. A goal of a currency union is to instill discipline in economic choices. Currency "borders" would no longer be a block to enhanced service or production efficiencies.

There are two essential preconditions for a common currency to work, and both have been undermined in the Eurozone for apparently political reasons. First, a common currency must not require that all sovereign debt within the currency arena be treated equally. The US government, for example, does not guarantee debt issued by the separate US states. It would have been possible for European countries to

use the same currency, and thus to have the same monetary policy, without having the ECB agree to treat every member country's sovereign debt as equivalent, with the practical consequence that it stood behind commercial bank purchases of Greek or Italian debt. This practice encouraged profligacy and undermines the intent of "discipline" mentioned a moment ago.

Second, monetary policy for the common currency should be directed toward what is best for the whole group of economies. But, perhaps in deference to Germany and other "core" countries that would otherwise not have agreed to embrace the euro, the ECB charter adopts a single objective – to prevent price inflation. But low inflation in core countries might have led to unfortunate results in periphery countries (the latter including the southern tier and some of the new East European members.) A single chart demonstrates how far out of balance things have gotten. (Nechio, 2011; Figure 2)

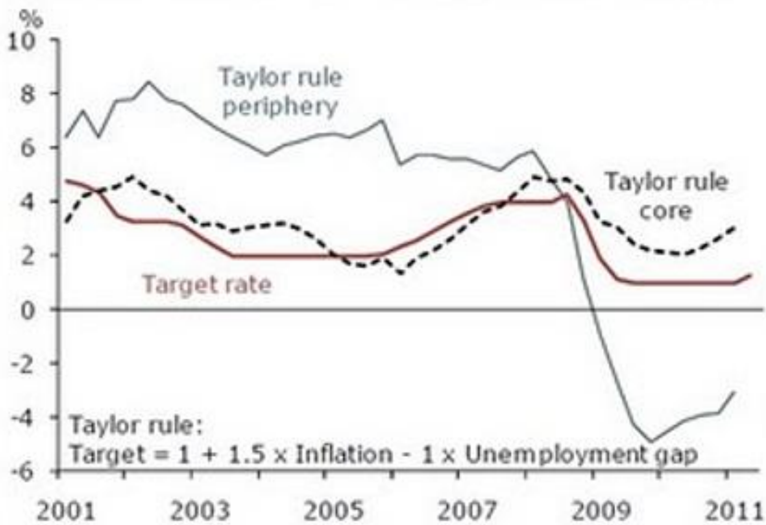

Figure 2. *Policy rules: Periphery vs. core (quarterly average)*
Source: OECD, Eurostat.

To unpack this chart: the Taylor Rule is an often-used gage – taking into account inflation and unemployment levels -- for where monetary authorities should target interest rates. We

see that lack of discipline in the periphery countries for the first seven or eight years of the euro's existence set them up for a crash. For the early years, banks and investors were encouraged to accept periphery country debt, which kept interest rates artificially low, and led to excessive borrowing and spending.

But once periphery debt was called into question, in part by the 2008 crisis, a squeeze on periphery country assets resulted, which led to a slowdown in economic activity, rising unemployment, and price deflation. The appropriate Taylor Rule ECB target rate for periphery countries is now far below zero percent.

The combination of implicitly guaranteeing sovereign debts of weaker countries and running an interest rate policy on behalf of stronger countries created imbalances that *cannot be undone without changing operating premises that have characterized the Eurozone since its beginning*. Pricing factors that should be self-correcting were not allowed to work. In the short-period, a more expansionary euro zone monetary policy would ease the crisis over sovereign debt in the periphery. It would increase demand across the zone, including in periphery countries. It would tend to raise prices in Germany and other core countries relative to periphery countries (because of slack demand in the latter), hence would mean a real depreciation on the periphery. Thus expansionary ECB monetary policy would accomplish some of the re-balancing that could otherwise be achieved by the drastic step of allowing periphery countries to escape from the euro and devalue.

At the same time, a more expansive policy by the Federal Reserve – which would also be a good idea for domestic US reasons – would ease world monetary conditions, hence would also make euro crises easier to resolve. An example from the 1933, reflecting the increase in the dollar price of gold under the new Roosevelt administration, may be relevant. An interwar near-equivalent to the present-day concern over sovereign euro debt was anxiety about WW1 war debts. The *NY Times* observed:

> Wall Street notes a remarkable contrast between the attitude toward the war debt question last December [1932] and that of the present time [June 1933]. Last year, financial circles began to become apprehensive about the war debt question long before Dec. 15… At the present time, although the war debt payments are due by next Thursday, there has been almost no discussion of the subject in financial circles, and the possibility of wholesale default have left the markets unperturbed (*NYT*, 11 June 1933).

Bad debts are easier to absorb in an expanding economy. While the ECB should increase liquidity, Fed easing would also ease conditions in the world outside of the US.

Suggestions forward

As much as the US needs to address medium and long-term budget issues, these are not the only drags on economic growth. We have an immediate stagnation and unemployment situation that will be largely unaffected by even the most dramatic longer-period tax and budget changes. No doubt there is also room for structural improvement in the labor market and regulatory boosts to enterprise.

On the other hand, there has been no negative supply-side shock of the sort introduced by the NRA or various efforts to boost wages that occurred during Roosevelt's terms. Nor does it seem plausible that there has been a structural change in technology, organization, or demographics that would inhibit post-2008 recovery. Given the very low rates of nominal income growth in the US since 2008, certainly the slowest in several decades, the potential for faster growth in production and employment simply by increasing liquidity and boosting growth expectations is considerable.

Arguments for fiscal activism fade once we acknowledge the difficulty of planning and sustaining large scale counter-cyclical spending, and hence in using it to alter expectations. The "fiscalist" argument that monetary policy is necessarily ineffective in a low interest rate environment is even weaker.

The Japanese experience of near-zero interest rates over the past two decades should serve as a warning of the consequences of setting the goals of monetary policy in terms of interest rates rather than in terms of expectations. The zero-interest trap has meant stagnation, soaring national debt, and weak financial markets. Yet the Federal Reserve has indicated that its near-zero rate policy, in place since late 2008, will now continue at least into 2013.

To be effective, U.S. monetary policy must include a program for boosting demand enough to raise interest rates to levels at which the interbank credit market can function. The higher rates must be part of a plan to reflate in the wake of a financial crisis and subsequent collapse of demand. Once somewhat higher interest rates were again in place, further additions to monetary stocks will be more likely to find their way into commercial lending – and less likely to turn up as "hot money" in emerging markets.

There is little recognition today that tight monetary policy is even an issue, or of the role it had in converting a banking crisis into the 2008-09 Great Recession. It took three decades after the 1929-32 crash – until the publication of Friedman and Schwartz's *Monetary History of the United States* (1963) – for understanding of its monetary causes to reach anything like critical mass. One wonders how long it will take this time.

The "hard money" case against monetary activism rests on 1) a theoretical argument that massive de-leveraging, particularly in the financial sector, and will constrain growth as long as it continues; and 2) on a factual argument that Fed policy has already boosted commodity prices. As considered in discussion above, neither of these arguments has much substance.

European decisions will determine whether the euro shall succeed. A common currency requires credit market discipline and a monetary policy that recognizes common requirements, not just those of a governing group within the currency area. If these measures are in place, some convergence of monetary policy requirements will occur. Absent these measures, it will be ever harder to maintain a common currency.

Downward moves in the US and world economy since 2008 have tended to match upward spikes in the dollar-euro exchange. The US would do well to seek exchange rate stabilization and coordinated monetary recovery with the Eurozone – on the condition that European leaders intend to put measures discussed above in place to make the euro succeed. If not, the euro is likely to impart systemic deflation to the world economy for some time to come. In that case, the US is left with a "second best" alternative – allowing the dollar to float against the euro, probably downward. Either way, the US should deploy monetary policy to change expectations of future interest rates, prices, and growth.

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8 Monetary targeting, financial crisis and the Great Recession, 2007-2009 *

Inclusion of Scott Sumner's "The Fed and the Great Recession: How Monetary Policy Can Avert the Next Crisis" in the May-June issue of *Foreign Affairs* marks a milestone in public education in monetary economics (Sumner, 2016). Targeting of nominal GDP as a technique for monetary management has moved from a few blogs[2] -- to a leading US policy journal. Sumner's blog, *The Money Illusion*, was identified in *The Economist* (2011) as the lead voice for "market monetarism" (which calls upon monetary authorities to stabilize growth of nominal income – or NGDP -- rather than target inflation, unemployment, or other economic indicators) and the clearest example of the power of blogging to get "fringe ideas" noticed. *The Economist* (2016) has since embraced NGDP targeting as a superior approach to

* An earlier version of this paper appeared in *Applied Economics and Finance*, March 2017.

[2] Sumner's blog The Money Illusion probably received the most attention. Other bloggers with comparable agenda include Lars Christensen, David Glasner, and David Beckworth.

monetary management, while cautioning that a decision to revamp central bank objectives should not be taken lightly. Sumner and *The Economist* are accurate that NGDP targeting can bring an advance over much prior central banking practice, and it can help to realize the old vision of "leaning against the wind."

Some of early literature on the Great Recession emphasized roots in the financial crisis that started in 2007, or even more narrowly in the bursting of a real estate bubble.[3] An alternative perspective, advanced by, among others, Mundell (2012), Congdon (2011), Hanke (2015), and a number of bloggers, including Sumner, identifies monetary roots of the contraction. NGDP targeting adds value upon other monetary approaches. But we need both. The NGDP framework alone does not explain the financial crisis that initiated the Great Recession; nor does it provide a policy framework sufficient to contend with an international monetary storm.

NGDP targeting as a monetary framework follows an unraveling of received economic wisdom. The unraveling was reflected in the less than cogent response of the economics profession (and of the Bernanke Fed) to the financial crisis of 2007-2008 and the subsequent Great Recession. During the years of the post-1944 Bretton-Woods-mandated gold exchange standard, monetary (and sometimes fiscal) policy were conducted within the constraints of fixed exchange rates and the signals of reserve movements. With the devaluation of the dollar in 1971 and the decision to allow major currencies to float against each other in 1973, monetary economics opened a new chapter.

Conceptual breach and Great Recession

Chicago School monetarists, led by Milton Friedman, had long advocated floating exchange rates; it was natural for them to take the lead in shaping a new set of operating rules. Friedman rose to the moment with his AEA presidential

[3] See Lo (2012) for an early review of literature.

address on "The Role of Monetary Policy" in 1967. Fresh from his and Anna Schwartz' *Monetary History* (Friedman & Schwartz, 1963), he said monetary policy should avoid being disruptive, which might best be accomplished by stabilizing the price level. He continued that central banks should target only variables they could control, and feared that attempts to influence prices directly would make monetary policy a source of volatility. He proposed instead that monetary authorities should seek to stabilize the rate of growth of monetary aggregates – which would impact prices and other variables with "long and variable lags." His language was provisional: he said it was beyond the capacity of central banks directly to control the price level "at the present stage of our understanding" (Friedman, 1968; p.13). Until such a breakthrough in understanding might occur, Friedman proposed that a steady rate of growth in a money quantity be an exogenous variable that would drive prices, growth, and nominal income. For decades, the monetarist framework dominated discussion, even if the results of its occasional application by central banks during the 1970s and 1980s were disappointing.

Then it broke down. The core money quantity identity, MV = PT, has turned out not to imply a straightforward money quantity rule.[4] An increasingly complicated financial system has added new channels for holding liquidity, which has made predictions based on past patterns less reliable. Also, V – velocity – is frequently unstable, especially during periods of financial market stress, which alone makes targeting a money quantity variable insufficient.[5] Friedman himself told the *Financial Times* in 2003, "The use of quantity of money as a target has not been a success… I'm not sure I would as of today push it as hard as I once did." And Friedman told the *American Prospect* in 2005 that it was easier for central banks

[4] M is the supply of money, V is velocity of M (or the frequency with which money changes hands), P is the price level, and T is the volume of transactions – or real income.

[5] Congdon (2011) attempts to reboot monetarism using a broad definition of money.

to target inflation than he had anticipated, and that they could do so without using money growth rules (Svensson, 2008; p.3). The Federal Reserve has stopped even reporting data for some of the money quantity series that informed policy in the past.

Monetarists are surely correct in their understanding that the quantity of money plays an important role in nominal income determination. But the essential monetarist policy argument is flawed, as it simplifies a general equilibrium relationship to a one-variable nominal income determinism. Keynes (1936; pp.84-85), in contrast proposed that the quantity of money, such financial factors as the proclivity to save and invest, the level of interest rates, the demand for liquidity by individuals, corporations, and financial institutions, and nominal national income (NGDP) are *jointly determined*. Holding one variable constant – the rate of increase in the quantity of money – has not reliably stabilized either the rate of inflation or the rate of growth in national income (Svensson, 2008; p.4). If we use a broader measure of money as an indicator, say M3 or M4, we get a better empirical fit with nominal income, but its trend remains buffeted by the same financial factors. Friedman (1968; p.10) acknowledged this point with the comment: "The market rate will vary from the natural rate [which variation affects the rate of savings and of investment, interest rates, asset prices, and nominal income] for all sorts of reasons other than monetary policy." Friedman's comment somewhat undermined his case for money quantity determinism.

The Great Recession, followed by only a slow recovery in much of the world, has coincided with often-conflicting efforts to find an updated conceptual framework. Most have not succeeded. Among economic conservatives, momentum shifted back to the "hard money" analysis that Friedman sought for decades to undermine. Faced in the autumn of 2008 with the sharpest fall in economic activity in the US since the 1930s, a groundswell of opinion, often from credentialed economists, criticized the Federal Reserve for pursuing an excessively expansionist policy, one that would surely lead to accelerating inflation. Emblematic conservative

viewpoints in the US appeared in the Congressional movement to "audit the Fed" – that is, to reduce its independence; and in a November 2010 letter to the *Wall Street Journal* signed by twenty-three mostly Republican economists calling for an end to quantitative easing (QE). Signatories included past Republican officials Michael Boskin, John Taylor, and Douglas Holtz-Eakin, as well as Stanford economist Ronald McKinnon and economic historian Niall Ferguson (WSJ, 2010). Hostility toward the Federal Reserve was not limited to conservatives. Self-described "socialist" Bernie Sanders co-sponsored audit-the-Fed legislation. "Market failures" exponent Joseph Stiglitz (2016; p.172) fears that expansionary policy could lead to asset bubbles.

The hard money argument has by no means gone silent; but it has been undermined by the absence of significant price inflation in any of the world's leading economies since monetary interventions began in 2008, indeed by the difficulty central banks in any of them have had in meeting even modest inflation targets. US treasury note and bond interest rates over the last several years have been historically low, suggesting that market expectations for future inflation are similarly low.

A more frequent policy response has been to confine monetary initiatives to influencing interest rates. Because the Federal Reserve emphasized interest rate decisions in its policy pronouncements, financial market participants have focused on them as a key indicator of the central bank's intentions. The emphasis on interest rates cuts across conservative and liberal boundaries. Taylor Rules, which link short term interest rate targets to stabilizing unemployment and inflation levels, were sometimes taken as a replacement for targeting money quantities (Taylor, 2009; p.69), in effect reinforcing the impression that short-term rates are an essential, and "conventional", policy indicator.

Former Fed Chairman Ben Bernanke did not embrace a Taylor Rule, but his account of policy during the financial crisis of 2007-2008 and afterward repeatedly emphasizes interest rates as the chief policy variable for the Federal Reserve (Bernanke, 2015). Short-term treasury rates were zero-

bound – between zero and 20 basis points -- from about November 2008 until the fall of 2015. These are levels associated with risk aversion and high preference for liquidity, indeed they approximated "liquidity trap" levels.[6]In December 2008 and March 2009, the Fed undertook quantitative easing, which was dubbed "unconventional" policy, and was sometimes interpreted as an effort directly to inject new money. But Bernanke has indicated that the Fed, on the contrary, sought to work through the channel of lowering longer-maturity interest rates. He has explained that the Fed's October 2008 decision to pay interest on commercial bank reserve holdings at the Fed served to constrain increases in money aggregates that might otherwise have resulted from aggressive open market operations (Bernanke, 2013: pp.102, 104). (In fact, lower long-term rates would encourage issue of longer dated credits for mortgages and otherwise – which would gradually boost money quantity. Also, there was some leakage – not *all* of the commercial banks' new liquidity was placed at the Fed as excess reserves.)

Like the monetarist approach to money quantities, interest rate targeting treats an intermediate variable as exogenous to determining national income – when interest rates are in fact endogenous to a variety of monetary and financial factors. The conceptual problem with using market interest rates as a policy target is that anticipated returns on investment (which are reflected in the "natural rate"[7]) are implicitly more volatile than the market rates that central banks seek to manage.[8] Economic recovery requires that the market be no higher than

[6] Keynes (1936; p.207) reasoned that in conditions where interest rates could not be lowered further, "absolute liquidity preference" might hold. He observed, "In this event, the monetary authority would have lost effective control over the rate of interest." This condition has been described as a "liquidity trap."

[7] The natural rate is sometimes called the "equilibrium real rate" – the rate at which the economy's output is equal to potential output, without underperforming or overheating. Sumner (2016; p.121) defines the natural interest rate as "the rate at which inflation and NGDP remain on target."

[8] E.g., Keynes (1930) frequently noted the volatility of the natural rate, just as Keynes (1936) often remarked on the volatility of the (conceptually similar) schedule of marginal efficiencies of capital.

the natural rate, and preferably lower. Natural rates, however, reflect *expectation* of future spending and liquidity demands, and hence of future profitability.[9] Interest rate targeting alone does not easily allow for incorporating expectations – as we cannot easily anticipate the relationship between market rates and future levels of volatile natural rates. Hence interest rate level targeting has had disappointing results when the investment climate turns sharply for better or worse. Taylor Rules, for example, are usually based on current unemployment and inflation data. (On occasion, Taylor Rules have applied anticipated future levels.) Further complicating the task of interest rate targeting, in recent years the (unobservable) natural rate has sometimes been negative – which has led some central banks to experiment with negative interest rates.[10]

Under such all-too-frequent recent circumstances, pledges by central bankers to keep interest rates at close to zero for years into the future are at best confusing to financial markets as a signal about direction or trajectory of recovery in investment or employment. Pledges into future years of zero-bound interest rates may telegraph that central bankers lack either the means or the will to boost very low equilibrium real rates – that is, the market cannot expect them to spring a liquidity trap. Such pledges suggest to potential investors that any economic recovery will be drawn out and bumpy. Pledges aside, near-historically low treasury rates across the spectrum during the last several years offer further evidence of expected weak demand well into the future.

Friedman (1998) sharply criticized the Bank of Japan (BoJ) for confusing very low interest rates with an "easy stance of monetary policy" during the 1990s. He argued instead that very low interest rates sometimes – as in the case of Japan -- reflect prior collapse of aggregate demand. In a similar vein,

[9] Johnson (1997; pp.13-14) notes obstacles to anticipating "rationally" what natural rates will be in the future.

[10] Bernanke's (2016) memoir does not mention negative interest rates. His successor Janet Yellen has indicated that the Fed might consider using negative rates were economic signals to worsen (CNN, 2016).

an earlier Friedman (1968; pp.6-7) suggested that the way to increase nominal market rates was aggressively to increase the money supply, and hence aggregate demand and prices, through debt market operations. Professor Bernanke (2000), before he joined the Federal Reserve, similarly criticized BoJ for expecting very low interest rates to lead to recovery. He indicated BoJ would have done better to engage in aggressive debt market operations. His subsequent tendency as Federal Reserve Chairman to concentrate more narrowly on short and long-term interest rates has drawn criticism from critics, including Sumner (2010), who view some Fed decisions as a backtrack from Bernanke's earlier understanding, and even as timid.

Another consequence of the loss of confidence in monetary action has been the revival of "Keynesian" fiscal arguments – that the best way to revive a sagging economy is through public sector borrowing either to finance infrastructure spending or to boost consumption through transfer payments. Where many hard money advocates see monetary activism as portending out-of-control inflation, some to the left doubt that private sector participants will increase their spending no matter how liquid they become. This fiscalist argument has taken added life in the face of persisting zero-bound interest rates since 2008 in the US, the eurozone, and elsewhere. Prominent advocates have included Stiglitz, Paul Krugman, and Larry Summers. Bernanke's (2015) memoir, in the same spirit, frequently indicates frustration that the US Congress would not boost demand through aggressive fiscal expansion.

In further evidence of breakdown in consensus,[11] Stiglitz (2016; p.151) argues not only that monetary expansion beginning in 2008 did not induce recovery from the Great Recession but also that Friedman's monetary approach does not explain the coming of the 1929-1933 Depression. Stiglitz thus casts his net wide to suggest that the largest economic

[11] Following publication of Friedman & Schwartz (1963), "consensus develop[ed] among economists that the Great Depression was in large part due to monetary phenomena and in particular to the Federal Reserve letting money growth decline" (Taylor, 2009; p.71).

fluctuations of the past century did not have monetary causes, Friedmanite or otherwise. But Stiglitz' fiscalist argument confines monetary mechanisms to realized quantity monetary impact. To illustrate, the Fed's often-cited open market purchases in mid-1932 had limited impact because financial markets anticipated that gold standard constraints – including fear of reserve outflow – made it unlikely that the Fed purchases would continue (Sumner, 2015, Ch.7).

Almost on his assumption of power in March 1933, Franklin Roosevelt acted to allow the dollar to depreciate against gold. Following three-and-a-half years of depression, the US then saw a sharp increase in economic performance -- to register a one-off 57 percent jump in industrial production in the next four months. Sumner points to gold standard constraints on monetary activism prior to 1933, followed by the explosive nature of recovery *almost immediately* after those constraints were lifted. The before-and-after impact on expectations better explains those events than does the Friedman and Schwartz (1963) story of changes in money quantities acting with a lag (Sumner, 2016; Ch.7). Following devaluation of the dollar in 1933, investors expected the constraint on the supply of US currency to lift relative to demand –and did not await confirmation in a rising US money supply.

Sumner observes that, were the fiscalist argument correct, a combination of higher US taxes and reduced government spending in 2013 would have caused a slowdown or reversal of growth that year. In the event, however, monetary conditions (presumably led by aggressive QE) resulted in a speed-up in real GDP growth from 1.3 percent in the 12 months ending in December 2011 to 2,7 percent during the following year (BEA), and NGDP growth rose from 3.2 to 4.3 percent (BEA). The S&P 500 stock index also rose markedly in 2013 – combined evidence that monetary factors may in fact dominate tax and government spending decisions in their effects on recovery (Sumner, 2016: pp.122-123). I have argued elsewhere that Keynes' own case against monetary policy effectiveness was

surprisingly weak -- whether we look at his empirical evidence or his theoretical argument (Johnson, 2016[12]).

Similarly, a conventional view that low interest rates demonstrated that monetary conditions in the US were easy during August, September, and October of 2008 is contradicted by the sharp rise in the dollar-euro exchange from 1.60 to 1.25 over nearly the same period. The strengthening in the dollar was a strong systemic deflationary signal, indicating market expectations that dollars were, and would remain, scarce relative to their demand (Mundell, 2012[13]). The rising dollar was matched by steep falls in the dollar price of oil, gold, and other commodities – and, given the dollar's role in world liquidity -- also in commodity price declines measured in other currencies. Economic indicators in the US, including NGDP growth, flattened in the third quarter and turned negative in the fourth. Sumner (2016; p.122) is among the rare US economists who have drawn attention to this evidence from the foreign exchange market. Bernanke (2015) and Tim Geithner (2014), who in 2008 was president of the New York Fed, do not mention the dollar exchange, either on the way down during the eleven months prior to July 2008, or as it recovered sharply after that. One infers that it was not a topic at FOMC meetings – indeed, even as the dollar ascended, some regional Fed presidents continued to see over-heating as the primary threat.

We can generalize that both monetary and fiscal policy work in the first instance by influencing expectations, rather than by the direct impact of increased money, lower interest rates, or more spending. Absent a near-term matching increase in money, expectations of future growth can be accommodated by increased velocity of circulation. Krugman,

[12] A slightly revised version of that article is included in this volume – "Did Keynes Make His Case?" Keynes cites four cases from the 1890s to the 1930s (two of them in Keynes, 1930) to tout the importance of fiscal intervention. In none of the four does Keynes include adequate discussion, or sometimes even acknowledgement, of systemically important monetary contexts.

[13] Mundell has also mentioned the July-November 2008 dollar-euro run-up in oral discussion, e.g. at his Santa Colomba conference in July 2009.

as a fiscalist Keynesian, has doubted the impact of money injections by the Bank of Japan at intervals during the late 1990s and early 2000s. Sumner responded that the injections failed because markets did not expect them to continue. Indeed, at one point the Bank of Japan sought to reassure the public that Japan would not experience price inflation as a result of the new money – which gainsaid the purpose of the injections in the first place! (Sumner, 2012) In parallel fashion, Cogan & Taylor (2010) argued that Obama Administration attempts at fiscal stimulus during 2009 did not succeed because the public would save, rather than spend, any new cash. A Keynesian's response (e.g., Krugman, 2009) would have been that stimulus spending works only if it reaches critical mass and the public expects it to continue.

Second-order targeting: Expectations

Central banks can directly set overnight rates and discount rates. And open market operations can work directly on the money supply. These are first-order targets.

Friedman's (1968) argument that monetary policy acted with a lag precluded directly targeting the price level – a second-order target; he could only advise that stable money growth would likely result in stable prices, or perhaps in a stable, and low, rate of price increases. But if, drawing on reasoning above, monetary policy works through the channel of expectations, then the time "lag" for impact on the second-order objective is compressed, or vanishes altogether. When the impact lag disappears, central banks are able to adapt open market operations or other interventions to build or manage expectations for second-order variable targets – eg, for price level or nominal income.

When central banks in the past sometimes targeted M directly (or targeted non-borrowed reserves in the case of the Fed during part of Paul Volcker's first term,) it was not using its capacity to influence expectations for future levels of second-order variables. Similarly, when the Bernanke Fed indicated that interest rates would stay low over a period of several years, it undermined its own channel for potentially

influencing expectations. A more effective policy would have set a target for a higher rate of inflation, or for an aggressive rate of nominal income growth. Targeting second-order variables enables a central bank to leverage its impact via expectations, even over the short period.

A premise in Sumner's embrace of monetary action is that even in conditions of near-zero rates, central banks are not "out of ammunition;" expanding the supply of liquidity can directly boost economic activity. Sumner embraces the Bernanke Fed's quantitative easing, noting that while the Fed should have moved sooner, rounds of QE "did help end the recession in the United States" (Sumner, 2016; p.122). QE worked in part through boosting expectations of future monetary conditions. Over a period of several years post-2008, the US stock market went into a tailspin whenever someone at the Fed suggested reducing ("tapering") the volume of QE. Monetarist Tim Congdon offers perspective:

> One way of denigrating debt-market operations is to classify them as "unconventional" techniques of monetary policy. On the contrary, the epithet "unconventional" should be attached to the unfortunate modern habit of regarding the setting of short-term interest rates as the alpha and omega of monetary policy. The tendency to see the setting of short-term interest rates as, by itself, a complete description of monetary policy results in a grotesque underestimation of the monetary authorities' ability to influence macroeconomic outcomes (Congdon, 2011; p.81).

Congdon's essential argument here (matching Friedman's) is that the quantity of money – not such financial factors as interest rates – primarily determine national income. Although Congdon does not embrace NGDP targeting as a policy framework, he does share Sumner's conclusion that more extensive use of "unconventional" techniques might have changed economic history over the past quarter century:

> Monetary policy [in a failed, conventional view] is 100 percent about money-market operations and the

> setting of the very short term interest rate.[14] In the author's judgment this mistaken set of ideas goes a long way to explain the policy inertia in Japan in the last fifteen years and the more general failure of macroeconomic policy to avert the Great Recession (Congdon, 2011; p. 419n).

But Sumner's argument goes a step further, to say that open market operations can quickly influence expectations, and hence boost the natural interest rate, thereby facilitating recovery (Sumner, 2016; p.122). Keynes in the *General Theory* similarly pointed to expectations as a channel through money injections might work:

> …the schedule of marginal efficiencies of capital [an iteration on the discussion of the "natural" rate in Keynes (1930)] will partly depend on the effect to which the circumstances attendant on the increase of money have on expectations of future monetary prospects (Keynes, 1936; p. 298).

This Keynes-Sumner concept moves us beyond Friedman's (1968) view that monetary policy moves with "long and variable lags."

Lapses post-2008 and in Japan aside, central banks have learned that inflation objectives are easier to realize than they once imagined. Many central banks now target inflation indexes; indeed, Canada, New Zealand, the UK, Sweden, Finland, and Australia adopted inflation targets during the 1990s. The German central bank during the 1990s publicly used a money quantity target, but, "whenever there was a conflict between achieving the money-growth target and the inflation target… [the Bundesbank] consistently gave priority to the inflation target" (Svensson, 2008; pp.2-3)[15]. The European Central Bank is committed by its charter to price stability, which amounts to a rigid form of inflation targeting.

[14] Money market operations refer here to short-term loans by the monetary authority to banks with the intention of influencing the short-term policy rate. Debt market operations with non-bank counterparties seek to influence money stocks directly.

[15] Warren Coats, an advisor to at least 20 central banks in recent decades, agrees in discussion that most central banks now target inflation, and have in most cases been able to come close to meeting intended targets.

Bernanke's Fed announced in November 2007 that it was adopting "flexible" inflation target (Bernanke, 2015; pp.172-175). Friedman's (1968) condition has been met – the "state of our understanding" has changed as the role of expectations is recognized.

But inflation targeting has shortcomings. In the context of the Federal Reserve's "dual mandate," which requires attention to both inflation and unemployment targets, inflation targeting can work only if it is repeatedly adjusted, depending on the level of unemployment and, hence, of real growth.[16] Central banks have traditionally wanted to "lean against the wind," that is, to implement counter-cyclical monetary policy Bernanke (2015; p.74) acknowledges the dilemma with his clarification that price targets would be flexible, and only "needed to be met over a period of several years." But what we have seen the last few years is that major central banks have been reluctant to allow their inflation targets to be exceeded – even during or in the aftermath of recessions. Keynes argued in his *Treatise on Money*, to the contrary, for aggressive monetary expansion in the face of a prior collapse of activity, particularly where wages and other cost factors were somewhat rigid. The hypothetical conditions he described were comparable to what would appear with the 2008 crisis and its aftermath:

> …the conclusion holds good that an expansion of the volume of investment, resulting in rising prices, may be extremely advisable as a general rule, when it is corrective to a pre-existing Commodity Deflation… When, for example, a condition of widespread unemployment exists as the result of the downward phase of a Credit Cycle, but without the Commodity Deflation having passed over into an Income Deflation [because of wage and cost rigidities], it will be impracticable to bring about a recovery to a normal level of production and employment *without allowing some measure of expansion and of rising prices as a corrective to the existing Deflation*… In short, to

[16] The dual mandate was outlined in the Full Employment and Balanced Growth Act of 1978, commonly known as the Humphrey-Hawkins Act.

> stabilize prices at the bottom of a Commodity Deflation would be a stupid thing to do. (Italics added) (Keynes, 1930; Vol I, pp. 297-298).[17]

McKinnon (2015) and Hanke (2015) noted the tendency of zero-bound US interest rates to trigger destabilizing hot money flows to emerging markets in pursuit of higher returns. Calomiris (2016) calls attention to various obstacles to lending, having to do with the microeconomics of banking, that arise from persistence of zero-bound interest rates. The economics of using bank branches is undermined when wholesale deposit rates come down almost as low as branch-based no-interest deposit rates. The low interest environment over the last few years has seen reduced deposit-to-lending spreads and flattened yield curves. (The narrow spreads and flat yield curve likely reflect soft aggregate demand -- rather than some inevitable consequence of very low interest rates.) Another consequence of narrowing spreads is that banks then look for higher returns through riskier projects.[18] Both McKinnon and Calomiris propose boosting market interest rates as a corrective. The problem, of course, is that even low market rates may be high relative to natural rates in the post-2008 low-demand environment; absent a parallel effort to raise overall liquidity, higher market rates are likely to bring more contraction, not less. As Friedman (1968; p.7) observed, the best way to raise interest rates is by "engaging in an inflationary policy." Such a policy cannot be implemented as long as inflation targets are maintained at long-term low levels.

We need a second-order target that facilitates counter-cyclical monetary policy. It should also make it easier to meet *both* inflation *and* unemployment mandates. Summarizing other research, Sumner (2016; p.124) notes that changes in unemployment correlate more with moves in NGDP than with changes in the rate of price inflation. And, following Keynes' reasoning, policy should seek to make changes in the

[17] For a more recent statement, see Calvo, Coricelli, Ottonello (2013).

[18] A New Jersey banker in 2020 called my attention to his bank's placements in cow futures and Venezuelan bonds.

rate of inflation counter-cyclical. A steady NGDP target will make for more inflation, and hence less unemployment, during and coming out of a downturn. And, when the economy starts to heat up, by which time the level of employment and real growth have recovered, an NGDP target will explicitly brake price level increases.

Where monetary policy is pro-cyclical, unemployment typically declines slowly in the wake of a downturn, and inflation gathers steam during the subsequent upturn. Recent history is indicative. During and coming out of the mild 2000-2002 recession, the US saw NGDP growth rates of 2.2 percent during the 12 months to December 2001 and 3.8 percent to December 2002. During 2003-2007, NGDP growth picked up to annual rates of about 6.4, 6.3, 6.5, 5.1 and 4.4 percent by December of each year (BEA). Inflation rose as the expansion gathered steam; measured by the GDP deflator index, prices increased from an annual average of 1.2 percent in 2002 to 3.4 and 2.7 percent during 2005 and 2006 (BEA). Concurrent data for the consumer price index moved roughly in step at 1.6, 3.4 and 3.2 percent (BLS-A). NGDP growth during these years was thus pro-cyclical; it was relatively slow during the recession and immediate recovery, but heated up during years that included the housing boom and much increase in off-balance sheet lending among financial and other firms. The annual average NGDP growth rate (compounded) over the seven years (2001-2007) was about 4.95 percent. A more even NGDP growth rate over the cycle might have shortened the recession and lessened some of the imbalances in the subsequent boom.

The pattern during subsequent years is revealing. NGDP *fell* by 0.9 percent from the end of 2007 to the end of 2008, and fell at an annualized rate of 1.3 percent in the third quarter of 2008 and 7.2 percent in the fourth quarter. During the following year, through December 2009, NGDP was nearly flat at +0.1 percent (following a large decline during the first few months of the year.) The following six years saw NGDP increases of 4.6, 3.6, 3.2, 4.3, 4.1, and 3.0 for an annual compounded average of 3.8 percent (BEA). Not one of these years had NGDP growth as high as the compounded *average* for 2000-2007. If we add to the calculation the two years in

2007-2009, we get an eight-year annual compounded average NGDP growth for 2007-2015 of just over 2.8 percent. If we draw a trend line from 2000 to 2007, it will be followed by a sharp fall below the earlier trend during 2008 and 2009, and a *further* fall-off each subsequent year through 2015. The pattern of slow NGDP growth beginning in 2008 was matched by slow growth in broad money indicators during the same period (Hanke, 2015). US monetary authorities have sought low rates of inflation since 2007, and have indicated for most of that period that they intended to keep short-term interest rates close to zero – levels that, in fact, usually reflect ongoing weakness of aggregate demand.[19]

A more aggressive policy would have generated a burst of inflation that might have lifted both market and natural interest rates to more normal, pre-2008 levels. This could have been achieved with aggressive debt operations directed toward increasing liquidity (not just toward lowering interest rates), ending interest payments on reserves held at the Fed, -- and using an NGDP growth target at least a percentage point higher than the annual 3.8 percent average of 2009-2015. Also, the central bank should make its intention more credible by "targeting the level," meaning that falling short of (exceeding) the NGDP target over one time period will be compensated by an effort to exceed (undershoot) by an equivalent amount in the following period (Sumner, 2016; p.124). An effort should have been made in 2009, 2010, and 2011 to reach NGDP growth targets high enough to return, or at least approach, to the 2001-2007 trend.

Unhelpfully, professional economists have encouraged doubt about whether monetary policy can be effective under conditions of zero-bound rates. But we have seen that monetary policy can work through quantitative easing (direct injections of liquidity) as well as through managing interest rates. And targeting of future NGDP levels, can restore monetary policy to the centrality that it should have in generating growth and maintaining stability. The monetary contraction that began during the third quarter of 2008 and

[19] As discussed in previous section.

the slow recovery over subsequent years is evidence of the most serious monetary policy mistake in decades by the Federal Reserve.

Financial crisis

After a period of more than two decades known as the Great Moderation, business cycles returned with a vengeance during 2007-2009 – a consequence aggravated by very tight money conditions from the third quarter of 2008.[20] Slightly preceding such monetary distress, what has been called a "Quiet Period" in US banking came to an end – that is, a period going back to the 1930s without system-wide runs on banks or bank-like entities (Gorton, 2009; pp.38f). Economists considering the Great Recession frequently focus attention either on monetary matters or on financial sector and regulatory issues. But to make sense of this downturn, we need to consider both.

Sumner emphasizes the monetary dynamics. He argues that financial crisis occurs "when NGDP growth falls sharply relative to expectations" (Sumner, 2016; p.119). This cannot be the whole story. Sumner (2015) is surely correct that the US and central European banking crises that began in 1931 were triggered by the systemic monetary contraction and fall in NGDP in the months and years before (Sumner, 2015). But during the Quiet Period, from passage of the Banking Act of 1933, the US endured a large number of downturns – including the depression of 1937-1938 and the sharp recessions of 1973-1975 and 1981-1983 – but none of them put the banking system under pressure.[21]

Severity of credit crunches and of counter-party concerns – and hence of susceptibility to financial crisis -- can usually be quantified by interest rate spreads between secured or risk-free (usually sovereign-guaranteed) rates and rates on unsecured private sector assets. Serious financial pressure

[20] Taylor (2009) uses the term "Great Moderation".
[21] The Savings and Loan crisis of the late 1980s was a partial exception; but Gorton (2009) treats it as non-systemic, confined to a portion of the financial system.

began in August 2007, as the spread between the LIBOR (unsecured) to repo (secured) cost of borrowing rose from about 20 to about 160 basis points (bp). A few days later the LIBOR-OIS spread increased from its usual level, below 10 bp, to about 90 bp (Taylor, 2009; figure.8).[22] These spreads fluctuated over the next year, sometimes moving to even higher levels, but never fell enough to approach pre-August 2007 levels. The financial system was susceptible to crisis through the entire period. The LIBOR-OIS spread exploded to 364 bp in October 2008, but came back to 128 bp by the end of 2008 (Gorton & Merrick, 2010; p.18), and to the 10-15 bp range by September 2009 (Wikipedia, OIS), as the storm passed.

There was no significant fall-off in NGDP growth prior to the increase in spreads in August 2007. Using quarterly data, NGDP increased by 4.5 percent in the twelve-month period from June 2006 to June 2007, and at an annual rate of 4.1 percent during the quarter through September 2007 (US BEA[23]). Hence the immediate pre-crisis period saw faster NGDP growth than did 2001, 2002, or any of the years since 2008 – years that saw no bank crises or money market pressures.

We will do better to look for roots of financial crisis in financial fragility – that is, where *stocks* of longer-term assets are mismatched on a balance sheet against *stocks* of short-term liabilities, or where assets are themselves of questionable value. The 1933 Act and introduction of deposit insurance the following year ended retail bank panics in the US. But changes in banking practices, in part induced by deregulation since the 1980s, led to a large increase in banking-like activity among scarcely regulated financial firms – dubbed "shadow banks." Shadow banks have borrowed extensively, often for short maturities, usually backed by repurchase (repo)

[22] LIBOR is the London Interbank Offered Rate, a private sector rate. OIS is the three-month overnight index swap. A swap involves credit exposure on net interest payments, rather than on underlying principal. A swap therefore involves much less counterparty exposure than exists for an unsecured bank credit.

[23] Quarterly data for NGDP are compiled from Real GDP and GDP Deflator indexes.

agreements using securitized collateral. The collateral, especially in the middle years of the last decade, was often based on a growing stock of housing loans, including for subprime mortgages, which were then packaged into often non-transparent Mortgage Backed Securities (MBS). The event of a drop in housing prices beginning in 2006 called the value of MBS collateral into question. The 2007-2008 financial crisis was driven by a wholesale bank run in the shadow-banking sector. Most subprime loans were not originated by regulated commercial banks, and most were packaged into securities and held by shadow banks (Blinder, 2013: pp.58-59) (Gorton & Merrick, 2010; pp.11-13). Once the value of securitized assets was called into question, counterparty risk in repo markets became palpable. Fears then spread for the value of other classes of securitized assets.

After money market spreads opened, Fed officials apparently concluded that they faced a problem of insufficient liquidity. The Fed's Term Auction Facility (TAF) was introduced in December 2007 to facilitate easier bank borrowing. During August 2007-April 2008, the dollar weakened from 1.36 to 1.56 against the euro, and it fell further to over 1.60 in July 2008 – a pattern of dollar weakness roughly matched against currencies other than the euro. The LIBOR-OIS spread came down from 100 bp to 30 bp or so during January and February 2008, but then rose again to the 60-80 bp range for the next several months. Taylor (2009, pp.20-21) sees this pattern as evidence that the source of unease in the market arose from counterparty risk rather than illiquidity.

Offering some counter-evidence, annualized NGDP growth during the first half of 2008 was only about 2.0 percent. Taken alone, this rate of NGDP growth suggests too little monetary expansion, not too much.[24] Selgin (2018, pp.89-90)

[24] A counter-argument regarding the falling dollar in 2008 might be that international capital flowed out of the US with the weakening of the domestic real estate market; consequently, the dollar would have weakened, and domestic investment would have shifted to export-oriented industries. This argument is not convincing because at the time the dollar fell almost everywhere, including against currencies of other economies that had seen real estate meltdowns.

& Sumner (2016) cite this or similar evidence to agree that Fed monetary policy was too contractionary during the last months of 2007 and the first half of 2008. But various other price data suggest that the monetary stance was easier. The GDP deflator and consumer price indexes (CPI) moved roughly in step during 2001-2007, showing increases of 17.9 and 20.6 percent. But this relationship changed noticeably from December 2007 to June 2008 as the deflator index (reflecting the cost of goods and services produced in the US) grew at just over 1.0 percent, for an annualized increase of 2.1 percent. The seasonally adjusted CPI in contrast rose by 3.6 percent over a seven-month period – or by 6.2 percent annualized (BLS-B).[25] The producer finished goods index (unadjusted) rose by 5.9 percent over six months, or 12.2 percent annualized (BLS-A). The Mundi commodity price index meanwhile saw an historic spike of 65 percent in 11 months (72 percent annualized) from August 2007 to July 2008 (Mundi). It seems a reasonable inference that the world economy was not constrained by a shortage of dollars during the first half of 2008.

It is thus unlikely that interbank confidence could have been restored by more determined monetary expansion in the US during the first half of 2008. The best corrective would have involved increases in capital and introducing some regulatory oversight of the quality of assets in shadow banks, perhaps combined with aggressive "stress testing" beginning in late 2007. Instead, because the problem was treated as one of insufficient liquidity, the capital issue was addressed only months later with Treasury injections of long-term debt in October 2008 (Taylor, 2009; Figure 13), and with more-than-typically credible bank stress tests the Spring 2009.

Balance sheets of financial institutions should absorb losses that may arise from even severe economic downturns. A slowdown of income or revenue *flows* should trigger counterparty risks only under unusual circumstances. Some

[25] Raw CPI data – not seasonally adjusted – showed an even higher inflation rate; 4.7 percent over the seven month period, or 8.2 percent annualized (BLS-A).

countries have gone for very long periods without financial crises; Britain, for example, had no systemic crisis from 1866 until 2007 (Gorton, 2012; p.8) The frequency of crises in the US prior to 1934 made it something of an international outlier (Gorton, 2010; p.62). Financial firms that maintain capital balance should be able to turn to central banks for liquidity assistance – as the latter were established in part to formalize pooling of reserves. Alas, none of the institutions that faced crises in 2008 – Bear Stearns, Lehman Brothers, Merrill Lynch, Washington Mutual, AIG – were regulated as commercial banks, so they did not have automatic access to the Fed discount window.

Sumner (2016; p.123) argues that the Dodd-Frank Act was "well-intentioned" but misdirected, as the roots of the problem were monetary, not regulatory. Dodd-Frank is a lengthy bill, much of which has been criticized. But an important motive in drafting it was to bring at least a portion of the sector where the financial crisis occurred -- securities and insurance firms (shadow banks) -- under Federal Reserve supervision.[26] The view that financial crises are caused by shifts in interest rates or other monetary factors, or by changes in the fiscal environment – neglecting the role of capital structure -- is widely held and has done damage.

Financial crises in developing countries illustrate similar patterns, and allow some generalization regarding their origins. Prime examples include Latin American crises in Argentina and Chile around 1980, in Mexico in 1995, and the 1997 "Asian crisis" – followed by crisis in Brazil and Russia. All of these were preceded by voluminous capital inflows, rising domestic prices and growing interest parity violations (where two countries have different interest rates, but intend to maintain fixed exchange rates.) In some cases, just as capital inflows slow, and income expansion hiccups, governments

[26] Some Chicago School economists, e.g. Eugene Fama, argue that a financial crisis in the US would do limited damage were it allowed simply to burn out, absent government intervention (*Chicago Booth News*, 2011). Gorton offers evidence, to the contrary, that financial crises have large costs; he also cites evidence that firms reliant on external finance tend to grow more slowly in years after a crisis (Gorton, 2012, pp.8-9).

were forced to raise interest rates on their short-term debt – which could lead to credit squeezes elsewhere in the economy, a run on foreign exchange reserves, and pressure to devalue. Absent the capital imbalance caused by the initial inflows, banking and currency crises would not have occurred (Eatwell & Taylor, 2001; Pettis, 2001).

The IMF, facing these crises, usually neglected balance sheet mismatches (Johnson, 2005[27]). In most cases, it instead demanded that small countries reduce their government budgets, and perhaps increase taxes, raise interest rates, and devalue. In contrast, Rudiger Dornbusch (1999) argued that the national balance sheet deserves "near exclusive focus" in understanding the causes of recent crises, not only in East Asia, but in Mexico, Russia, and Brazil.

Financial crises in large rich countries have some structural commonality with banking panics and currency runs in smaller, poorer countries. NGDP targeting (or other monetary policy rules) alone would not address financial sector balance sheet issues, or the kind of asset-liability mismatches that generate counterparty concerns and can cause financial panics. As a first approximation, banks – especially US shadow banks -- during 2007-2008 were undercapitalized. Similarly, emerging market countries subject to currency crises in the 1980s and 1990s required restructuring (lengthened maturity) of sovereign debt and increased foreign exchange reserves. These requirements were eventually addressed: in the case of US shadow banks, as noted, through TARP injections of long-term debt; in the case of FX reserves, through massive accumulation of US dollars – a flip side of growing US balance of payments deficits.

Internal balance and external stability

Another area for caution in Sumner's embrace of NGDP targeting lies in its Friedmanite, closed-economy, logic. Keynes' *Tract on Monetary Reform* (1923) – which is often viewed favorably by monetarists and their successors – drew

[27] A version of that paper is included in this volume: "Did Keynes Make His Case?"

an opposition between conflicting "aims of monetary policy": that is, between internal balance (domestic prices, employment and growth) and external stability (exchange rates, perhaps a fixed currency-to-gold link.) Keynes (1923, p.126) acknowledged that a relatively small country with a large dependence on foreign trade might choose external stability, even at a cost of some domestic price inflation or deflation. But the thrust of Keynes' argument was that larger economies, those of Britain, France, or Germany, should be prepared to let their exchanges float against each other's, and certainly to end the gold link. Monetarist Friedman (1968, p.15) took the case further, arguing that foreign trade and investment, because they comprised only about 5 percent of the US economy in the 1960s, should not be allowed to drive monetary policy. Any impact from trade or investment, he said, should be absorbed through adjustments in the price of foreign exchange – leaving domestic authorities independently to pursue domestic inflation and employment goals.

Keynes argued in his *Tract* – anticipating monetarists -- that trade imbalances are rectified through price adjustment – that is, the surplus country would see higher prices, while prices would decline in the deficit country (Keynes, 1923; p.130). Within this partial equilibrium framework, currency appreciation or depreciation would facilitate necessary price and wage adjustments. In fact, Keynes' *Tract* argument mis-represented the adjustment mechanism – a mistake repeated in his debate on the transfer mechanism with Bertil Ohlin in the *Economic Journal* a few years later, and leaving "a legacy of error" (Mundell, 1992; pp.13-16). In an applicable general equilibrium framework, transfers of income, expenditure, securities and real estate holdings, and government reserve stocks can take place without a change in prices of traded goods, or in prices of their inputs. Recognizing such a framework, the use of floating exchange rates may introduce self-reinforcing price volatility.

Another flaw in the monetarist case for floating exchanges appears in their premise that having a floating exchange rate would be an alternative to holding foreign exchange reserves –

as there would be no fixed exchange to defend (Friedman, 1953; p.172). This argument failed on economic grounds, as few governments have been willing to allow "clean" floats – exchange rate volatility is damaging to investment and employment in the traded goods sector. Governments, hence, want to hold enough reserves to be able to intervene in FX markets. In fact, world reserve holdings have grown from about 2 percent of world GDP in 1970, when the fixed rate system was intact, to over 15 percent of world GDP in 2007, when most currencies floated (Coats, Di, & Yuxuan, 2015; Figure 10).

At about the same time as the Bretton Woods fixed-rate framework was breaking down, Mundell, in two papers presented in 1970, launched a counter-attack emphasizing the importance of external stability and in support of fixing exchange rates. Mundell's argument drew attention to the role of a common currency in removing exchange risks, and hence in encouraging cross-border diversification of assets and related improvements in capital efficiency. Citizens of a country sharing a common currency that suffers an economic shock (e.g., where a major exporting industry suffers a competitive setback and loss of foreign markets) would maintain much of their stock of hard currency liquidity. They would be more likely than without a common currency to hold cross-border assets (McKinnon, 2004).

Sumner's argument for NGDP targeting is domestically-focused, and does not broach discussion of external stability or currency integration. Given relatively weak economic performance in the Eurozone since 2008, and rising nationalisms – the Brexit and Trump votes offer recent illustration – we are unlikely to see further movement toward currency integration among major economies in the near future.[28] Indeed, floating rates may be better aligned with

[28] Coats (2014) models a prospective IMF-directed currency board that would stabilize currencies against the price for a basket of internationally traded goods, thereby avoiding both price inflation and the sort of deflationary pressure that weakened the interwar gold standard -- or the Eurozone post-2008.

political realism than is a fixed rate model, whatever our judgment of the underlying economic reasoning. But understanding can expand even where policy is passive. It is instructive to view the events of 2007-2009 in an open-economy, international context.

Changes in NGDP are reflect the GDP deflator price index – which measures prices only for domestically produced goods and services in the economy. A subdued rate of increase in the US GDP deflator (while real GDP dropped by about 0.5 percent) indicated sluggish US performance from the third quarter 2007 into July 2008. Strictly following NGDP targets, we might conclude that US monetary policy should have been more expansionary, notwithstanding ongoing depreciation of the dollar against the euro – even to 1.70, 1.80, or 1.90. But use of a price indicator that measures only domestically-produced items separates US economic conditions from those elsewhere, treating an open American economy as though it is closed. The falling dollar signaled that US monetary policy was exporting inflation. This was especially the case as the weak dollar trend was co-incident with upwardly spiking international commodity prices. This evidence should have been a signal to look at headwinds from non-monetary sources, hence to respond to evidence of persistent risk in financial markets and fragility in capital structures.

The subsequent sharp recovery of the dollar after July 2008 was evidence that what had been very easy monetary conditions rapidly turned contractionary. (Perhaps higher commodity and traded-goods prices led to fear that liquidity was insufficient to sustain them, bringing an initial shift upward in cautionary demand for liquidity.) Once again, the GDP deflator data understated what was happening. During the third and fourth quarters of 2008, when the rising dollar indicated systemic deflationary pressure, US prices measured by the US deflator index actually *rose* by about 0.4 percent, or 0.8 percent annualized. But the CPI (seasonally adjusted), which includes the impact of price changes with origins outside the domestic US, *fell* significantly by over 3.2 percent over the two quarters, or over 6.2 percent annualized (BLS-B). Once again, there is a large variation in the pictures we get

from different inflation indices – and, hence, in the appropriate monetary policy response.

Consequently, market expectations were reflected more quickly in foreign exchange rates – which anticipated systemic feedback -- than in the measured changes in US NGDP. The dollar began to rise in July and August 2008, but the drop in NGDP gathered steam only in the fourth quarter. From a policy perspective, even if the first objective of monetary policy is internal balance, external stability conditions merit attention. It should be possible to calculate changes in nominal income in a way that would take into account broader measures of price data.

Concluding note

Monetary policy-makers are usually in a position where they have more objectives than policy levers to meet them. Regarding internal (domestic) balance, they want to suppress inflation while maximizing employment. As an external objective, they would like to stabilize exchange rates with their countries' trading and investing partners. An ideal, if improbable, monetary policy would facilitate maintaining both internal balance and external stability.

The use of inflation or NGDP targeting to achieve internal balance would be an improvement over policy rules focused on the quantity of money or interest rates, both of which are intermediate objectives. Second-order targeting (of inflation or NGDP growth) can be used to shape expectations of future market conditions – allowing ongoing adjustments in management of money quantity and short-term interest rates. But more than inflation targeting, an NGDP framework allows monetary policy to address *both* inflation and unemployment objectives. When the economy is slow, NGDP targeting seeks to raise aggregate demand and employment. When the economy heats up and employment prospects become more abundant, an NGDP target seeks to slow demand growth, and thereby to moderate price increases. Use of NGDP guidelines would allow central banks to "lean against the wind." As NGDP fell sharply below trend during the third and fourth

quarters of 2008, aggressive open market operations to prevent or reverse deflationary pressure would have been in order.

But we saw in 2007 and 2008 what an NGDP framework would not inform. The Federal Reserve treated the slowdown following August 2007 as a consequence of illiquidity rather than of growing counterparty risk. As a metric, NGDP tracks domestic production and prices. The pressure building toward crisis in the financial sector did not appear in NGDP data.

A summary of the sequence of events in 2007-2008 calls attention to three fact patterns. First, movements in the dollar-euro exchange, and corroborated by CPI, wholesale and commodity prices indexes, indicated that money was too easy during most of the 12 months leading into July 2008 (hence that we should have looked to non-monetary causes to understand the distress), and too tight afterward. Second, the financial crisis did not have its *origins* in monetary policy, either too easy or too tight – but in unstable balance sheets and questionable assets. Third, restrictive monetary policy after the summer of 2008 took the recession to a new depth, even as evidence of strain in money markets (financial risk spreads) eased after October. As a guide to monetary stance, exchange rate signals came sooner and with more definition than did the NGDP signals, and should have received more attention from decision-makers during those critical months. But the dollar exchange, NGDP data, and the collapse in growth in broad money indicators all pointed to dramatic tightening of monetary policy stance that turned the financial crisis into the Great Recession – avoidably.

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9 Financial crisis management in emerging markets, 1995-1999 *

A striking pattern in the 1997-1998 East Asian financial meltdown is that in the announcement of International Monetary Fund (IMF) packages was routinely greeted in financial markets with outright disappointment. The IMF Board approved the Thai program on August 20, 1997. Within hours of Managing Director Michel Camdessus' public announcement the following day, the Thai baht plummeted, and continued to fall into January 1998. First Deputy Managing Director Stanley Fischer held a press conference on December 5, 1997, to announce the Korean package. The following week the Korean won fell each day to its 10 percent stop-limit in FX trading. On January 15, 1998, Camdessus again went before the cameras, this time to announce details of the newly negotiated Indonesia package. As IMF staffers were on their way to lunch to celebrate, they

* A shorter version of this paper was published in the *Milken Institute Review* in 2005. My thanks to Scott Sumner, Michael Pettis and Daniel Hewitt for comments and discussion.

received news that the Indonesian rupiah was falling on FX markets, and it would continue to fall for some time.

Why the perverse reaction? The IMF could not cure a disease it had misdiagnosed – and the markets understood that. In South Korea, the IMF package failed to address the commercial banking system's tens of billions of dollar-denominated short-term debt that would soon come due. In Indonesia, the Fund's program did not deal with the foreign debt burden of domestic corporations; and so on. The stumbles did not end in Asia. In 1998, the Fund urged Russia to stand firm on its fixed exchange rate. Yet, in spite of a $6 billion rescue package delivered in July, the exchange peg collapsed in August. A few months later, when the IMF offered a bailout for the Brazilian real that was contingent on a sharp increase in interest rates, both the real and the Brazilian stock market plunged.

There is further evidence that IMF planners failed fully to appreciate important economic issues at stake. An interest rate and fiscal austerity package of the sort proposed in Thailand would most plausibly stabilize the currency only by imposing severe economic hardship. IMF economists nevertheless estimated among themselves that Thai GDP would be approximately flat during 1998, but GDP in fact fell by a full 10 percent. For Korea, the package omitted to address the matter of tens of billions in dollars of short-term commercial banking debt that would soon come due. In the case of Indonesia, an unhappy World Bank economist told Camdessus, accurately, that the Fund's soon to be announced program was inadequate because it did not deal with the foreign debt burden of domestic corporations (Blustein, 2001). As important, and as Fischer has since acknowledged, the Fund underestimated the role that unrestricted capital movements might play in generating financial crises (Bhagwati, 2000, p.8).

Fiscal-monetary crisis

The traditional view of financial crises was that fiscal or monetary mismanagement leads to excess domestic demand,

which in turn generates a trade deficit and, hence, a current account deficit. If the country's investment climate is attractive, the current account deficit may be offset by inflows of private foreign capital, and thus becomes sustainable. If not, a currency crisis is almost inevitable. Thus, the IMF has generally seen its role as provider of tough love, lending foreign currency to those willing to adopt austerity measures that cure the profligacy underlying the problem.

This perspective was developed in part from observing events in Latin America during the 1950s, 1960s and 1970s. When faced with severe social and distributional pressures, Latin American governments often adopted redistributionist policies that typically led to chronic fiscal deficits, accelerating inflation and low national savings rates. By many accounts, IMF recovery packages often worked in these circumstances.

However, recent interventions have often occurred under different circumstances. By wide agreement, neither the 1995 Mexican crisis nor the 1997-1998 East Asian crisis was triggered by fiscal distress or low domestic savings. In fact, by these criteria, most of the afflicted Asian countries were model citizens. The triggering events here, as well as in the contemporary crises in Russia and Brazil, were rapid changes in international capital flows.

Most of the criticism of the IMF's management of international crises during the past half-decade can be divided into two categories. The first stresses moral hazard -- the expectation that investors will be less prudent because they believe they will be bailed out in the event of major losses. In this view, the 1995 Mexican rescue encouraged international investors to ignore warning signs as they plied emerging markets with low-cost capital. But moral hazard created by the presence of a reliable lender of last resort (eg, the IMF, the U.S. Treasury) seems to have played only a minor role in driving the capital flows preceding the East Asian crises. Most investment in East Asia before 1997 was in the private sector rather than in lending to the government. And while some lenders might have assumed that national governments would back their own banks, it is a stretch to believe that foreign

banks thought loans to corporations were covered by the umbrella. Note, too, that much of the foreign investment in East Asia was in the form of stock purchases, for which losses would certainly not be covered by an IMF bailout.

A sometimes more plausible critique emphasizes the role of "hot money." The gist of the argument is that domestic employment and income stability should not be hostage to the uncertain benefits of easy access to foreign capital. Criticism of unrestricted capital movements has now gained considerable acceptance, and even the US Treasury and the IMF have softened, if not abandoned, their opposition to some controls on cross-border capital flows.

Balance sheet crisis

There is an approaching consensus among economists that crises since 1995 in Mexico, East Asia, Russia, and Brazil, as well as in Argentina and Chile in 1980, were triggered, or at least aggravated, by volatile international capital flows. The existence of large amounts of private sector debt brings new instability to the current account. Most of the afflicted countries had weak regulatory frameworks and unbalanced FX positions -- that is, banks and corporations were large net borrowers of foreign exchange.

If we introduce premises that match many recent situations, the impact on the capital account balance of imposing fiscal austerity becomes harder to anticipate. Consider equity: high interest rates and fiscal constraint dampen profits as well as prospects for future profits. Under a scenario with large capital flows to the non-government sector, a policy mix that upsets profit prospects may independently contribute to outflows by equity investors.

The story with privately issued debt – usually bank loans and commercial paper -- tends to be similar. Privately issued debt is lower quality than government debt. Also, private debt is often collateralized with equity, including that in golf courses, real estate, or shares of stock. Such debt, therefore, often demonstrates the market valuation characteristics of portfolio equity. Higher interest rates are more likely to cause

default of private sector debt instruments, hence to discourage both voluntary rollovers and inflows for new purchases. Similarly, fiscal constraint – when imposed deliberately to dampen economic activity – makes private sector defaults more likely. There has, for example, been a measurable "flight to quality" in emerging market debt holdings since the Asian crisis (IMF, 2001, p.387).

Absent case-by-case consideration, we cannot know which of the flow factors will dominate in the event that an austerity package is imposed. A comment from Charles Kindleberger underlines the uncertainty: "...with elastic expectations of change – of falling prices, bankruptcies, or exchange depreciation – raising the discount rate may suggest to foreigners the need to take more funds out rather than bring new funds in" (Kindleberger, 1978, pp.112-113). The consequences are striking. Former Treasury Secretary Larry Summers (2002, p.34) commented recently, "Confidence is widely recognized as essential in treating financial crises. In fact, I know of no textbook that would treat the confidence of investors as irrelevant to financial stability." Yet application of the standard IMF crisis remedy might in some cases actually *worsen* capital outflows in the kinds of crisis that have recently become most common.

Most crises since 1995 were preceded by exchange-rate shifts that left real currency rates too high in crisis countries. All were preceded by voluminous capital inflows and rising prices. Capital inflows to the five Asian countries (Thailand, Korea, Indonesia, Malaysia and the Philippines) totaled $93 billion during 1996, but swung to a $12 billion outflow during 1997, including a $34 billion outflow during the second half of 1997. Of the swing, 77 percent was in commercial bank lending, predominately to the private sector (Radelet & Sachs, 1998; p.5[2]). So movements in "other private sector debt" dominated portfolio movements into or out of presumably interest rate sensitive bank accounts, thereby frustrating expectations of the tight money strategists.

[2] Radelet and Sachs cite the Institute of International Finance.

One of the best predictors of imminent balance sheet crisis is a large "uncovered interest parity" (UIP) violation, where the differences in two countries' interest rates do not reflect expected changes in their exchange rates. If Center Country (with a hard currency, say dollars or yen) has a 5 percent interest rate, and the rate in Periphery Country (with a soft currency that is not used as an international store of value, say the Thai baht or the Brazilian real) is 10 percent, Uncovered Interest Parity (UIP) conditions predict that Periphery's currency will depreciate about a 5 percent annual rate against Center's currency during the course of the lending commitment. But if Periphery's exchange rate is pegged to Center's currency, and the interest rate differential continues, UIP conditions are violated. And if Periphery's commercial banks expect the peg to hold, they will borrow as much of the Center currency as they can get at 5 percent in order to lend at the Periphery's 10 percent rate -- thereby earning arbitrage profits from the interest rate differential.[3]

Suppose Periphery has a boom in real estate or stock prices -- which, of course, happened in most of East Asia during the early- and mid-1990s. As the economy heats up, banks continue to lend to the overheating sectors. At this point, some outside event stirs the central bank to apply the monetary brakes. Higher interest rates under such conditions put pressure on commercial banks' profit margins. Lenders then begin borrowing heavily at low rates in dollars and lending at high rates in the local currency -- not because they believe the exchange rate will hold in the long run or that their borrowers are sure to pay them back, but perhaps because their more immediate concern is keeping their jobs and year-end bonuses. Financial booms and busts are often generated by self-interested behavior, accompanied by inadequate financial regulation and lack of financial transparency.

In the case of East Asia, the logic of transactions became yet more convoluted. Indonesian corporations (to take one

[3] Eatwell & Taylor (2000) discuss concept of Uncovered Interest Parity, and incidents of it.

example) regularly borrowed dollars from Korean banks, and probably at interest rates that understated the risks. This sort of behavior generated "externalities" -- that is, economy-wide consequences apart from the potential profit or loss to the contracting parties. The buildup of debt and foreign exchange exposure increased susceptibility to default, making crisis ever more-likely.

Sovereign capital structure

The finances of countries -- especially those with unsophisticated markets -- have much in common with finances of corporations. Both have balance sheets with asset and liability management issues. The asset side usually gets more attention. In a corporation, this has to do with how people, productive equipment, real estate and customer relations are managed. In a state, it has to do with what is consumed, imported, exported and invested. Well-run corporations also manage the liability side of the balance sheet with the goal of matching expected outflows and inflows, thereby avoiding liquidity crunches. Sovereign countries, too, should manage their liabilities this way, but many developing countries have not.

Both corporations and small countries can do little to affect their systemic environments. Corporations cannot change the business cycle, which affects demand for their products; developing countries cannot control monetary policy or investment trends in or capital flows of the United States, Europe and Japan. But better capital structure management would enable these countries to avoid getting snagged in most international financial crises.

The orthodox framework—and its lead practitioner, the International Monetary Fund – have paid little attention to balance-sheet issues. The IMF has always focused on monetary and fiscal policies -- details about these items fill its country reports. But the Fund has often missed the crucial point -- namely that the explosive dynamics of financial crises are not driven by current account trends and fiscal mismanagement, but by capital structure imbalances. The late

Rudi Dornbusch, a forthright MIT economist, called neglect of these issues "stark mad."

A capital-structure "trap" works by linking debt servicing costs to the economy in an inverted way, increasing the burden just when borrowers are least able to bear it. For example, during an international liquidity crunch, when periphery countries' export markets contract and commodity prices fall, their short-term borrowing costs rise and financing at longer maturities become nearly impossible.

Enron was a company, not a country, but its collapse is instructive. Enron's published financial statements indicated a capital structure in reasonable balance, comprising equity plus long- and short-term debt, and the firm's credit ratings were good. But Enron wanted to take on a number of long-term projects, for which profits might not appear for some time. Rather than show more debt on its balance sheet or issue new equity, Enron made heavy use of Special Purpose Entities (SPEs) in order to borrow off the balance sheet. Typically, Enron collateralized off-balance-sheet borrowings by promising to add cash to SPEs if the value of its corporate stock fell below specified levels – a practice akin to meeting margin calls on leveraged stock positions. This amounted, in part, to funding long-term investments with short-term loans from banks. It left Enron vulnerable because financing costs would rise just when the company's profit outlook was weakest – a classic debt trap. And once the market boom of the late 1990s ended, Enron's financial fragility was quickly exposed.

Similarly, balance sheet traps trigger crises in economies with fragile financial structures, and forward-looking government management can usually enable states to avoid them. Regulating bank exposures alone is insufficient to protect the financial system because domestic banks often hedge their foreign currency borrowings by lending to corporations on terms tied to the exchange rate. But that just transfers the exchange exposure to a new set of parties. Governments may therefore wish to regulate the buildup of corporate short-term borrowing in foreign currency, whether from banks or through other channels. Corporate off-balance

sheet items, including special purpose vehicles and financial derivatives, should also be included.

The most straightforward way to avoid foreign currency exposure is by developing efficient financial markets in local currency. An added advantage to minimizing dollar- (or other foreign-exchange) exposure is that it leaves open the option of devaluation if crisis does strike. Sovereign management should push local lenders and borrowers toward debts with longer maturities. First, local corporations need longer-term maturities to manage their own capital structures. Second, borrowings bunched together in the short-maturity range can lead to a bulge in interest servicing costs during a period of constrained liquidity -- thereby feeding a sovereign debt trap.

The best way to develop local-currency credit markets is for the government to issue its own local currency securities at longer maturities, so as to establish a continuum of interest rate benchmarks. China, Poland and South Africa have avoided currency crises in large part because they developed markets in their domestic currencies. But sovereign borrowers, encouraged at times by their bankers, have often avoided extending maturity on their debt because they believe their rates will be lower in the future.

Allowing exchange rates to float in countries with soft currencies makes large interest parity violations unlikely, and hence would block an important channel that can contribute to a crisis. Free floating, however, often brings its own frustrations. Periphery economies usually lack deep financial markets in their own currencies, and floating generally leads to interest premiums on borrowing in foreign currencies. Where crisis can be avoided, development occurs faster when national financial markets are integrated, slower when they are isolated. Allowing currencies to float thus changes the dynamics of capital structure issues without removing them.

Sovereign risk management

At the conceptual extreme, managing a sovereign capital structure is like managing a trading position spread across different currencies, debt instruments and maturities. If a

trader is “short“ dollars, but believes there is a significant possibility the dollar will rise, he might offset a short position by buying dollar call options. If he purchases enough upside options, his portfolio position is converted from one that is short dollars to one that is long dollars – and he manages this without actually canceling any of his contractual commitments to deliver dollars. A finance minister might replicate what is conceptually an identical strategy by buying dollar calls. Similarly, if the minister determines that domestic currency borrowing is too concentrated in short-term maturities, she might buy call options on longer-dated domestic currency debt.

Most periphery countries do not have derivative markets in their own currency. Some larger ones could easily develop them—Russia, China, Brazil, India and South Africa, for example. And smaller countries might hedge using currencies of nearby states whose economic cycles tend to be correlated (for example, central Asian states might use the ruble and southern African states might use the South African rand). They could also hedge along the maturity spectrum by using debt derivatives denominated in other currencies. Doing so would carry its own hazards, however, because correlations in bond prices across currencies tend to become less predictable during periods of crisis.

These considerations point to the importance of managing exposures through more pedestrian means, such as regulating capital inflows and outflows. They also suggest the priority of settling exchange and currency issues, either by creating regional currencies that could sustain large-scale exchange or derivative markets, or by pegging currencies to the dollar or another hard currency.

The 1995 Mexican crisis should have been a warning to East Asia. Mexico’s fundamentals appeared strong: the budget was balanced, inflation seemed under control and heavy capital inflows (both short-term and for direct investment) implied confidence in the currency’s stability. Economic liberalizers in Washington and elsewhere praised Mexico’s performance. But several imbalances were developing. Capital inflows boosted prices and the money stock, making Mexican exports

less competitive. Meanwhile the Mexican central bank, deferring to politicians facing an election, never seriously pressed the monetary brakes. Growing exchange risks led to interest-rate increases, generating interest parity violations. But rather than concede the need for devaluation, the government chose to signal its commitment to a fixed dollar peg by issuing *tesobonos* – treasury securities that guaranteed interest and principal payment in dollars. A policy sensitive to capital structure would instead have addressed growing financial fragility in both the private and public sectors by extending debt maturities and seeking to limit dollar exposures.

Unlike Mexico in the early 1990s, or in most of East Asia in 1997, Russia in 1998 had terrible financial fundamentals. Among other problems, Moscow could collect only a fraction of the taxes needed to balance its budget. The Russian Central Bank financed fiscal shortfalls, while seeking at the same time to maintain a fixed ruble-dollar exchange rate. Large UIP violations – a balance sheet mismatch -- developed. While many savvy Russians were sending capital abroad, some Russian banks were borrowing in dollars to profit from the difference between hard-currency and ruble interest rates. Short-term ruble debt was soon paying interest in the range of 50 percent per year.

In the early summer of 1998, the Russian government issued debt denominated in dollars, underwritten by Goldman Sachs. Coincidentally, the IMF announced a $6 billion rescue package, intended to save the ruble from devaluation. But when fresh doubts about Russia's finances arose a few weeks later, the market price of the new dollar-denominated securities fell. Banks that had borrowed to participate in the issue were then in trouble. Far from bringing a solution closer, the combination of the IMF's rescue package and the dollar debt issue worsened Russia's balance sheet problem. Issuing dollar debt was an effort to signal that the Russian government was committed to holding the peg. But, as in Mexico with the *tesobonos*, it worked instead to tighten the debt trap. The rescue package should have required Russia to implement a more stable sovereign capital structure. For

example, rather than issue dollar debt, the government (parallel to what happened in Mexico three years earlier) might have tried to extend the maturities of its ruble-denominated debt and to demand that commercial banks reduce their liabilities in dollars.

The conventional view is that the recent exchange crises in Brazil were driven by the government's inability to rein in the budget deficit. It is more useful, however, to think of them as balance-sheet driven. The underlying problem is the large federal debt financed with short-term notes, most of it in local currency. Brazil's central bank, perceiving the issue to be one of the credibility of the government's commitment to sustaining the exchange rate, raised interest rates sharply in October 1997, in the midst of the East Asia crisis. The approach backfired, however, as Brazil walked into a classic capital structure trap: the spike in interest rates caused interest payments on the short-term debt to soar, which led to further doubts about the stability of the Brazilian real.

In January 1999, Brazil devalued the real – and without much pain because doing so permitted interest rates to climb back down to levels bearable for Brazilian businesses. But the underlying structural problem of short-maturity debt was not addressed. The IMF rescue then compounded the damage by treating Brazil's currency problem as one of too-easy credit, to be treated again by high interest rates that rose to 40 percent in real (inflation-adjusted) terms. This, of course, aggravated the balance-sheet problem, which by 2001 and 2002 led to new crises. Triggered by the meltdown in neighboring Argentina, the interest premium paid by Brazilian debt over U.S. Treasuries rose from seven percentage points in April 2002 to over 20 percentage points during spikes in July and August. A general easing of monetary conditions worldwide in 2003 and 2004 allowed Brazil to avoid another crisis. But pressures for devaluation are likely to return unless Brazil lengthens the maturity of its debts.

It was argued above that free-floating exchange rates might come at the expense of closer financial integration. But the other extreme, tried by Argentina, is not much better. Adopting a currency board – a peg to a foreign currency that

is guaranteed by the government's commitment to hold exactly as much foreign currency as local money in circulation -- adds to the pro-cyclicality of national balance sheets. Large inflows of capital lead money stocks and domestic prices to soar, while outflows have the reverse effects. This easily generates the capital structure trap mentioned earlier, as debt servicing costs tend to rise just as international demand contracts. At the least, the domestic monetary volatility inherent in a currency board arrangement should be offset by reserve stabilization funds and the elimination of debts denominated in foreign currency -- and Argentina did not attempt either. Strengthening sovereign balance sheets is essential to long-term stability. Exchange rate decisions should be subordinated to balance sheet decisions, not offered as a substitute for them.

Looking ahead

Balance sheet crises are typically triggered by the excesses of economic booms, where domestic price increases lead to overvalued currencies. The recession-prone post-2000 world economy has thus generally avoided the shocks of the more prosperous 1990s. But international flows of capital will surely recover, and, with them, patterns of leverage in corporate and sovereign balance sheets that make both corporations and countries vulnerable. And there is evidence that much post-crisis reform activity is still based on misconceptions.

- The Congressionally-mandated Meltzer Commission report on international monetary reform recommends that borrowing countries should meet "fiscal standards" as a condition for borrowing from the IMF during future crises. That requirement—absent any mention of national balance sheet management—appears to reinforce the orthodox emphasis on current-account issues in currency crises at the neglect of capital-structure management.

- The Bush Administration wants other countries to accept unrestricted capital movement as a condition for bilateral trade agreements with the United States. But free movement of capital works best in a context of sophisticated financial

market regulation and balance sheet management, neither of which is in place in most developing countries.

- The IMF wants to institutionalize procedures for international bankruptcy and debt restructuring. Not a bad idea in itself. But the Fund's proposal largely ignores fundamental balance sheet issues.

- The Basle Accords setting capital-adequacy standards for private banks were designed for developed countries, but apply in emerging markets, too. However, the standards provide for inadequate regulation of the sort of foreign exchange mismatches that were so damaging in recent financial crises.

Western advice (and cash) to countries in financial crisis tends to come with a hefty portion of fire and brimstone, which follows from the concept that crises are triggered by monetary excess and fiscal profligacy. But as we have seen, the traditional advice has missed the point in the international financial convulsions of the past decade. Economic stability will increase if capital structure traps can be avoided. Similarly, the sort of crisis that gives impetus to rapid devaluation, resort to free floating, or confidence-sapping controls on capital outflows, would be less frequent.

Epilogue (2022)

A striking aftermath of the 1995-1998 financial crises was the subsequent build-up of foreign exchange reserves, most often held in dollars, in emerging market central banks and treasuries. During 1999-2013, world currency reserves grew from $1.9T to $11.6T (Stastica, 2022). Reserves, gathered by abstaining from consumption and domestic investment (that is, by running current account surpluses) provide protection against balance sheet mismatches. The flip side of the reserve build-up was massive US current account deficits, year after year. There have been far fewer emerging market financial crises in the two decades since 1999, in large part because nearly all of them now hold much larger reserves. Another factor was growing acceptance, among economists and then incorporated into IMF policy structures, of measures that

would restrict capital inflows into countries that lacked regulatory structure to cope with them.

An interesting exception is the financial crisis in Greece in the years after the 2008-2009 meltdown. Greece had replaced its drachma with the euro in 1999, and going forward no longer had either a sovereign monetary policy or currency reserves. During the early boom years of the new euro, money flowed into Greece, both for government spending and private sector investment, usually at interest rates not much higher than those in Germany or other countries in northern Europe. When European prospects turned south later in the decade, what had been capital account inflows turned sharply negative – much as what happened in afflicted Asian countries from 1996 to 1997. Greeks were not in a position to meet servicing requirements. The European Central Bank (ECB) and IMF, both in the pre-1998 mode of crisis understanding described above, insisted on fiscal austerity as a condition for any relief. Growth went into reverse, and unemployment went to Depression levels -- over 27 percent of the workforce in 2013 (Stastica, 2021).

Greece began to recover when: 1) debt was restructured, hence easing the debt trap and forcing lenders to take losses; 2) because of the debt restructure, the Greek sovereign budget moved away from primary surplus – hence generating fiscal stimulus; and 3) under Mario Draghi's leadership at ECB, Eurozone monetary policy became less contractionary, allowing what should be self-correcting factors to work (Sandbu, 2015). Money expansion would increase demand across the Eurozone, including in periphery countries. It would tend to raise prices in Germany and other core countries relative to periphery countries (because of slack demand in the latter), hence would mean a real depreciation of terms of trade on the periphery. Thus expansionary ECB monetary policy would accomplish some of the re-balancing that could otherwise be achieved by the drastic step of

allowing periphery countries to escape from the euro and devalue.[4]

A decade after the Asian Financial Crisis of 1997-1998, the US, and then the world, experienced the 2007-2009 Great Recession. The IMF initially treated the first as a fiscal-monetary crisis, one of aggregate demand outrunning supply. So the Fund wanted to close fiscal gaps and slow demand growth in afflicted countries. The IMF had it wrong; markets repeatedly disdained IMF packages that failed to recognize the asset-liability imbalances at the root of sovereign vulnerabilities; these could include borrowing short-term and lending long-term, or borrowing foreign currencies to finance domestic assets. Similarly, in 2007, a spread opened up in world markets between intrabank interest rates and US treasury interest rates. The Federal Reserve, followed soon by other central banks, treated the problem as one of liquidity, and aggressively lowered overnight interest rates. The US fed funds rate was lowered from 5.25 percent in August 2007 to 2.0 percent in April 2008. Inflation indicators got worse, but the money market spreads did not close. The Fed during that period was wrong. Markets were concerned about counterparty risk – that is, risk in counterparties' balance sheets due to potential bad assets, for example, portfolios of subprime mortgages. The counterparty risk problem was addressed only in October 2008 with capital injections from the US Treasury, mostly in the form of long-term debt; at that point, money market spread began to come down.

We should close with some nuance. Following an inflationary spell running into about July 2008, US monetary policy turned contractionary, even sharply so, indicated by a strong strengthening in the dollar-to-euro rate. Financial institutions were bailed out; but the economy, based on employment and growth indicators, nevertheless got worse going into 2009. What started as financial turbulence in about August 2007, accompanied by fairly easy money and a

[4] Also see "Monetary Policy and the Great Recession," included in this volume.

softening dollar, turned into a deepening monetary recession by October and November of the following year.

It is striking to consider the way economic interpretations of these events have shaken out. An early paper by Andrew Lo (2012) reviewed 21 books on the then-recent financial crisis, and none of them emphasized monetary factors. The study that more than others persuaded me that the 2007-2008 financial turbulence – which led to full-blown banking crisis by September 2008 – did not have monetary causes was John Tayor's *Getting Off Track* (2009). But Taylor never shifted his subsequent views to recognize that the financial turmoil had been addressed, and was followed by very-avoidable monetary contraction. To the contrary, Taylor joined mostly "conservative" economists in signing the "Audit the Fed" letter in the *Wall Street Journal* in November 2010, which argued (incorrectly) that monetary policy was then inflationary and called for an end to quantitative easing. Meanwhile, such monetary economists as Tim Congdon, Scott Sumner and George Selgin have emphasized the monetary contraction that became the Great Recession. They have doubted that we need a non-monetary explanation for money market turbulence going back to August 2007.[5]

There are two benefits to reconsidering the course of emerging market currency crises during 1995-1999. First is historical, to see what happened 20-some years ago, and how bad policy gave way to better understanding. Second, it is a reminder that policy can go wrong for quite different reasons. The IMF's monetary-fiscal understanding of exchange rate crises from the 1950s, 1960s and 1970s is structurally similar to the argument that advanced economies can over-heat or under-heat for reasons of fiscal and, especially, monetary policy – and apart from, or absent, any turmoil arising from the financial sector. But the message from the balance sheet crises of 1995-1999 is that they can arise even when some of the most-credentialed economists are looking elsewhere.

[5] For more discussion, see "Monetary Targeting, Financial Crisis and the Great Recession, 2007-2009," included in this volume.

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10 Missing economic strategy in Iraq

Much of the story of the U.S. and Coalition effort in Iraq from late 2006 has been about discarding one security strategy and then implementing new approaches that have succeeded beyond expectations. A diplomatic and human disaster was averted, to the point that a less violent and politically stable Iraq has become a realistic prospect. Nevertheless, the stability is fragile, and Iraq remains "in play." Military correspondent Thomas Ricks concluded recently, citing discussions with Ambassador Crocker, that Iraq is likely someday to be remembered for things that have not yet happened. [For example, the departure of the US in 2011 and the subsequent rise of ISIS. – added later.] Inter-sectarian strife, even civil wars, both of which have occurred recently in Iraq, have high rates of recidivism.

The military turnaround has not been matched in the economic sphere. Unemployment and underemployment remain widespread, private sector and agricultural credit are difficult to obtain, and the pace of non-oil foreign investment is anemic. The role of oil exports as an economic driver is

scarcely dented. Various Iraqis have told me, approximately, that we are "re-patching together Saddam's old government-dominated economy." Certainly there is little evidence of growth in the size of the non-oil economy.

To some extent this reflects inertia on the part of Iraqis, particularly those who have spent much of their lives in state bureaucracies. But it also reflects an inadequate economic policy on the part of the Coalition. What follows will illustrate some of the efforts made since 2003, and their limitations. Different US and international agencies lacked either authority or capacity to devise overall strategies, with the result that policy embraced the most conventional "default" views. Back in Washington, senior department and agency officials declined to challenge decisions made in the field – or to challenge their absence. Lack of cogency was reinforced by frequent turnover of personnel. The good news, nevertheless, is that a more cogent and unified economic strategy could still be introduced in Iraq, and the benefits from it might be considerable.

Grand vision fades

The grand vision in 2003 was to create a market-driven alternative to the oil-based and state-dominated economic model common in the Middle East and in other petroleum exporters such as Iran and Venezuela. This economic model was offered alongside "democracy" as an alternative to the region's typically centralized and autocratic political practice.

In that spirit, the focus from the first few months was to encourage Iraqis to privatize state-owned enterprises. Iraqis dragged their feet. One objection to privatization was that it would lead to shuttering enterprises and loss of employment; in this, the Coalition's privatization effort was seen as parallel to what was viewed as the large mistake of disbanding the Republican Army under Coalition Provisional Authority (CPA) chief Paul Bremer shortly after his arrival in May 2003. Following the collapse of the Soviet Union a decade earlier, the sale of state-owned enterprises moved forward in part because many of them had protected access to vast raw

material resources – hence well-positioned managers and others had an incentive to privatize resources and pocket their rents. In Iraq, oil resources (the country's crown jewels) were not to be up for sale, and most other state-owned companies showed limited prospects for profits or capital gains. For these and other reasons, there was thus little constituency for privatization in Iraq, and the effort flagged. It suffered further when a CPA lawyer pointed out that an occupying power had no authority under international law to sell state assets.

The effort to privatize in 2003 was conceptually out of sequence. The economic argument for selling state-owned companies to the private sector is that assets will be redistributed to private owners who are able to make the best use of them. But where financial markets, including markets for corporate assets, are thin, the judicial system scarcely works, and rules on corporate bankruptcy are weak und untested – it is implausible to expect that state assets can be efficiently distributed. The difficulties increase if we consider that by the summer Iraq had entered a spiral of civil breakdown.

At the same time, there was an effort to boost the state-owned banks, eventually to be privatized, but within a shorter time frame to enhance intermediation between savers and borrowers. The state-owned Rafidain and Rashid were an early focus of Coalition advice. In 2003, the CPA mandated cross-cancellation of state-owned enterprise loans and deposits on bank balance sheets. We sought ways to remove Saddam-era liabilities from state-bank balance sheets. The Trade Bank of Iraq (TBI), a joint effort by the Government of Iraq (GOI) and several large international banks, was set up, initially with a two-year charter, to provide letters of credit (L/C's) in connection with public sector reconstruction needs. But neither the state banks nor TBI, itself a quasi-state bank, were equipped to lend to private sector enterprises. A number of private banks sprung up, but they too have not been a large source of private sector lending. And the head of one of the private banks told me in early 2008, in a summary that probably applied to Iraqi private banks generally, that

most of their credit was extended to "insiders." (This practice would be illegal for a Western-regulated bank.) A Central Bank (CBI) source estimated to me in late 2008 that some 85 percent of private bank lending is for speculative purposes.

As the early vision for privatization and banking reform was frustrated –although never abandoned -- economic strategy floundered. Coalition military leaders – who have insisted from the beginning that finding jobs for Iraqis was critical to achieving and maintaining stability – looked elsewhere for direction. Their response was to increase Commander Emergency Response Funds (CERF) and other military-controlled outlays for project-by-project efforts, essentially an extension of the role of Civil Affairs units in immediate post-combat environments.

Urged on by Coalition military leaders, the US Defense Department (DOD) then introduced civilian-led job creation efforts. A DOD project (Brinkley Group) reversed the emphasis on privatizing state enterprises, for awhile pumping money into or buying equipment for often non-viable firms with the intent of maintaining or boosting employment over short-to-medium horizons. They also launched efforts to support private banks. DOD efforts were often led and conducted without coordination with those of State or Treasury, and even in physical isolation from them – although by most accounts communication later improved. Reflecting typical turf and time-management issues, but perhaps also lack of mission-wide coherence on economic issues, the US Agency for International Development (USAID) and State-directed Provincial Reconstruction Teams set up barriers to access and discussion with representatives and contractors from outside agencies.

The grand schemes of 2003 gradually faded. GEN Petraeus, in his April 2008 Congressional testimony, described his objectives as "minimalist", with a goal of "sustainable security" – without mentioning "democracy." This sort of mission scale-back led also to a damping down of economic objectives. That was unfortunate, as the reasons for introducing democracy are distinct from those for introducing market-based economics. The national elections of December 2005

contributed to the sectarian divide (in part attributable to use of closed party lists) that brought Iraq to the verge of civil war the following year. But it is hard to see a "down side" to advancing economic reform. Even authoritarian governments gain stability and legitimacy from improved economic performance – Deng's China, Pinochet's Chile, and Lee Kuan Yew 's Singapore come to mind. The centralization of economic decision-making typical in oil-driven economies reinforces centralized political power, discourages transparency of information and governance, and puts a brake on moves toward participation in political processes.

As security has improved, the attention of most Iraqis has shifted to their economic prospects. Discussion during 2008 and 2009 with GOI and private sector officials suggests that a constructive role from the US Embassy or other advisors would be welcome. An Iraqi banker told me he believes the economic situation will play a much larger role in determining political stability in Iraq than will any results from the March 2010 elections.

Money, banking, and the budget

Monetary policy was similarly inconsistent. Initially the Iraqi dinar (replaced by the New Iraqi Dinar in late 2003) strengthened from nearly 2000 to the US dollar to the 1400-1500 range. The Central Bank Law was drafted and adopted, presumably with advice from Coalition and IMF advisors, to prohibit Iraq from adopting a currency board. Nevertheless, from about February 2004 through September 2006, the Central Bank of Iraq stabilized the dinar against the dollar in upper-middle 1400 range, and introduced daily sales of dollars to meet demand. The International Monetary Fund (IMF) endorsed the stable dinar policy in its various country reports during that period. No less an authority on currency boards than Steven Hanke indicated that CBI then effectively operated as a currency board, but without calling it that.

Meanwhile, and potentially in contradiction to the CBI Law, the International Compact with Iraq (ICI), enthusiastically advocated by the US, and formally launched

in May of 2007, calls on Iraq "to pursue closer cooperation with and to consider accession to the Gulf Cooperative Council (GCC)." The stated objectives of the GCC include establishing a currency union. Monetary cooperation or currency union would facilitate regional financial integration and undermine the independence of Iraqi monetary policy – either by functionally converting CBI into a currency board, or by replacing the Iraqi currency altogether.

The Paris Club debt negotiations brought large write-downs in Iraqi government debt. To reassure creditors, the write-downs were made conditional on Iraqi acceptance of IMF conditions, the most important of which was gradually to raise prices of refined fuel to approximately regional levels. Other conditionality required audits of the state banks, greater Ministry of Finance (MOF) transparency, and reform of the tax system. A result was a greater role for the IMF in setting the tone of policy in the coming years.

The mandated fuel price increases were soon combined with an Iraqi government decision to restrict fuel imports, which led to a sharp increase in market prices, from around 2 US cents/ liter in late 2005 to often over $1/liter at black market stations by the summer of 2006 – well above the international open market price. A study by the Iraqi Central Statistics Bureau found that more than 40 percent of a typical Iraqi family's disposable income at that point went to pay for fuel.

The conditions of incipient civil war, fitful decontrol of prices on an array of goods, and rising oil revenues and government-to-government transfers, led to rising domestic prices, usually measured in the 20-30 percent (annually) range during 2003-2005. In 2006, the fuel price increases led the consumer price index to spike upward by more than 60 percent. During this period, the dinar was stable against the dollar, and the Central Bank freely supplied dollars to met demand in exchange for dinars -- which were then withdrawn from circulation. Iraq effectively adopted US monetary policy. Price inflation was a result of liberalization and of rising oil revenues – not a consequence of slack (easy) monetary policy.

CBI, presumably with IMF approval, then embraced an initiative to counter inflation by appreciating the dinar and sharply raising interest rates. The rising dinar did have some effect on prices, as it made for cheaper imports (which comprised more than 40 percent of GDP.) In the process, it favored the interests of government employees over private sector producers, whose profit margins were squeezed. Higher interest rates affect the price levels by discouraging extension of credit, and the decision to raise the CBI deposit rate gave banks a risk-free alternative to private sector lending. But as the volume of private sector lending was tiny, the boost in rates had little effect on prices. The IMF indeed acknowledged in its August 2006 *Country Report* that "the banking system is largely inert" and that "the effectiveness of interest rate changes in influencing inflation is thus very limited."

A perhaps more important motive for raising dinar interest rates, also outlined in IMF reports, was to discourage and reverse dollarization of the Iraqi economy. This IMF goal was consistent in spirit with the Iraqi CBI Law, which directed independent currency management -- but it opposed the declarations of the ICI, noted above, which embraced regional monetary and financial integration as conducive to private sector development.

Dollarization reduces the central bank's control over interest rates and the money supply – hence it must be avoided in a GOI policy mix that has implicitly favored government expansion over nurturing the private sector. As noted in the IMF Country Report for Iraq of September 2008, "The CBI recognizes that planned fiscal expansion poses a challenge to keep inflation under control and requires a tightening of its policy stance." In other words – the private sector will be squeezed to constrain potentially inflationary consequences from having the Ministry of Finance spend its then growing oil revenues. The results of these decisions at times became almost laughable. In 2008, as private sector activity was choked by dinar appreciation, GOI budgeted an array of subsidized credits, including lending facilities through the Ministries of Industry and Minerals and of Labor and Social Affairs for $1.5 B -- or more than the net extension

to the private sector through the banking system. Lending by government ministries is no less a boost to demand, and hence potentially to inflation, than is private sector lending.

The Fund also advocated an expanded tax base for increased revenue collection -a variation on what it recommends for almost all emerging market countries, whether or not they export crude oil. There are several reasons why this was a bad idea for Iraq. The most important is that, by a proportion that changes from year to year, usually more than 60 percent of GDP is collected as revenue for oil exports. The Iraqi government, or almost any government, should be able to meet social, infrastructure, and security obligations using less of the GDP than its oil revenues comprise– without additional taxes on the non-oil private sector! In fact, whenever GOI revenues increase more than slightly, their first use is usually toward hiring more public employees and raising their salaries -- which is hardly the way to build a market economy.

By late 2007, the security and political situation inside Iraq improved and – causally unrelated -- oil prices and export revenues increased. GOI dollar account balances in New York swelled to over $70 B. Coalition opinion coalesced around the view that the way to consolidate security gains was to get the Ministry of Finance to spend money faster. This was the most unified Coalition position on economic policy since the privatization and banking effort of 2003. The reasoning was that increased capital expenditure, and even higher outlays for current budgeting, would generate jobs and thereby increase satisfaction with the Iraqi government. "Budget execution" became a key item in discussion, and in formal directives. This theme pervaded the State-directed (and non-classified) Economic Annex to the annually-prepared Joint Campaign Plan in the Fall of 2008.

There were, however, seldom-remarked limitations to this approach. First, it lost sight of the Coalition's original goals in Iraq, which included creation of an alternative economic model emphasizing a market-based private sector (a goal still cited in official documents), not simply resuscitation of Iraq's pre-sanction era oil-export-driven economy. Second, and

related, Iraq had *two* dollar funds in New York: the MOF-controlled Development Fund for Iraq (DFI) which by then consisted mostly of oil revenues; and the CBI reserve fund – which by mid-2008 was at least half-again as large as the DFI.

Absent a dramatic decision to transfer reserve funds to the DFI, which both CBI and the IMF would properly have resisted, CBI reserve resources could not be budgeted. (As MOF drew down its account, it transferred dollars to the CBI in exchange for dinars to spend domestically.) The Central Bank's reserve build-up reflected in part weak demand for imports, and, hence, weak aggregate demand generally. While stepped-up spending from the smaller DFI would have increased demand, emphasis on it overlooks the more usual way of boosting economic activity, which is accelerated extension of market-based finance and credit (linked to easier monetary policy and more liquidity.) But any such demand expansion was deliberately constrained by IMF conditionality on exchange and interest rates described above – which conditions were tacitly, and sometimes openly, embraced by the US Treasury and State Departments.

In part because the Coalition was so focused on oil revenue and budget issues, we were caught off-guard when oil prices fell by some 75 percent in the late summer of 2008 – and missed an opportunity. Oil economy leaderships are most resistant to structural change when oil prices are high and budgets are flush. When prices and revenues fall, oil-exporting governments generally show more interest in reform, and in developing a market-driven economy. In the face of a sharp fall in oil revenues, Iraq had little to sustain economic activity. That would have been the time to advance the sort of financial sector development agenda outlined below. Reflecting an absence of a reform vision, the potential opportunity seems to have dawned on only a small number of advisors.

Reflecting this lack of organizational coherence, the State-drafted Economic Annex to the annual Campaign Plan assembles "bottom up" input from nearly everyone involved in economy-related issues, but offers little "top down" strategic direction. I identify below several critical areas of economic

development that are absent from the Annex. Treasury has focused on the Iraqi budget process and the banking sector. But according to accounts of private conversations, senior Treasury officials in Washington in late 2009 (and perhaps also at other times) dismissed development of the private sector in Iraq as not pertinent to US goals.

Recovery and diversification

We should, much to the contrary, emphasize why market development in Iraq is pertinent. Iraq has structural weaknesses typical of oil exporting countries. These include: a rising real exchange rate (especially when oil production or prices increase), which makes most non-oil-related industries uncompetitive in world markets; lack of diversification, leaving economic well-being subject to fluctuations in oil prices; and an underdeveloped private financial sector – a consequence of the habit of depending on the government for provision of credit. Economics research indicates that what generates growth is not the volume of investment but its efficiency – its effectiveness in creating real economic returns. Oil rich economies often have high MOF-driven levels of investment, but few of them have developed balanced economies with sustainable non-oil sector growth; indeed, this pattern describes what is alternately called the “resource curse” or the “Dutch Disease.”

The way forward is to diversify, which means to nurture goods and service industries that can compete in world markets, and/ or to compete with imports inside domestic markets. Government-led attempts to diversify often lead to “white elephant” investments, and to trade barriers set up to protect affiliated workers and products. Effective diversification requires a market-driven financial sector, one that can gradually allocate resources to where they can earn competitive returns.

Structural and longer-term considerations aside, and more immediately: in forum after forum, Iraqis in commerce, agriculture and contracting identify the inability to obtain credit as the largest barrier to doing business. Evidence

supports them. According to IMF data for 2006, Iraqi bank deposits and private sector lending are very limited, smaller relative to GDP than in most neighboring countries, much lower than in Iran or Pakistan, and lower even than in Yemen. And short- and long-term capital available through other market-based financial channels –factoring, leasing, mortgages, stock market, etc.– has been even more limited. (Americans might appreciate this by considering that the financial freeze-up in the US during September and October of 2008 created temporary conditions comparable to the ongoing shortage of finance in Iraq.)

The near-absence of private sector finance parallels another phenomenon, which is that few business initiatives succeed in Iraq without a government contract or subsidies. (We have implicitly recognized the latter in efforts of USAID to offer supporting finance for large and small start-ups, as well as contingent plans for the US to budget USD 25 M for an "enterprise" fund. Current Iraqi efforts to encourage a home mortgage market involve interest rate subsidies.) The essential test for any investment decision lies in whether expected return on capital exceeds the cost of capital. The inability of most enterprises in Iraq to obtain credit against receivables, equipment, or other collateral, except sometimes at steep rates, mean that the effective cost of working capital is very high. Meanwhile, economic demand is suppressed by interest and exchange rate policies -- hence expected returns are lowered. Financial sector deepening can reduce the cost of capital, boost liquidity, and increase prospective returns.

An empirical pattern is that countries with a high degree of central planning tend to have more corruption; this conclusion fits evidence of most Soviet and former Soviet republics, the bulk of socialist economies, and many whose economies are based on export of oil and other natural resources. A move toward market-based resource allocation is, accordingly, among the most useful steps we can take to reduce the level of corruption in Iraq. It would also be self-reinforcing, as less corruption encourages private investment, in a virtuous cycle.

A unifying theme of Coalition advice should be to advance a multi-dimensional effort to create a market-driven financial sector and adopt modern property rights. Were Iraq to move in this direction, it would become possible to generate sustainable (non MOF-funded) employment. Three foundations of this policy would be:

- A monetary framework based on a stable dinar and interest rates anchored on regional and international levels, and, hence, conducive to financial sector integration;
- Developing alternatives to domestic bank finance, including foreign banks, factoring of receivables, trade IOU's, equipment leasing, use of civil servants as guarantors, etc.; and
- Enhancing property rights, which would facilitate issue of mortgages against land, as well as encourage longer-term perspectives on the part of investors and owners.

Other Coalition-led initiatives have landed in the rocks because they were undertaken without the context of such a strategy. Two examples involve the Iraqi Stock Exchange (ISX) and the Iraq Foreign Direct Investment Law (FDI Law). The ISX is kind of initiative that should contribute to building a financial sector. But an Iraqi banker tells me, "It is a shadow, it is not reality." To this point, only a small amount of long-term capital has been raised through new share offerings over the ISX. It is unlikely that much will change here until other kinds of finance become more available. Where working capital and medium term loans and leases are scarce, we are unlikely to see significant commitments for long-term capital. The ISX would also benefit from monetary and currency reforms that would facilitate Iraq's integration into external financial markets.

The FDI Law has been criticized as a barrier to investment for lots of reasons, but the most frequently cited is that, as passed in 2006, it did not permit foreign investors to buy land. A legislative revision to permit non-Iraqi land purchases was recently adopted and broadcast with fanfare at the Iraqi Investment Conference in Washington DC in October 2009.

Subsequently, the revision was declared invalid in an Iraqi court because it was in conflict with other Iraq law that did

not permit land purchases. (Incidentally, it has been a puzzle why the land ownership issue got so much attention; in most emerging market environments, foreign investors are content with long-term leases.) Disquiet over the land issue reflects deeper confusion over issues of contracts and other authority in Iraq. Property law in Iraq is not only confusing, it is based on principles different from those in nearby countries. It will have to be addressed as an area for fundamental reform and revision, not a something where an isolated legislative adjustment can introduce structural change.

A third example might be the "capacity building" efforts now underway in various ministries. We of course want better government performance -- but the role of government ministries in oil-export economies sometimes has little to do with performance. Public sector jobs are instead a "benefit", almost an entitlement, distributed as revenue becomes available. Only as Iraqis' expectations about the role of government changes can we expect to see a "performance ethic" take root. It is likely that our capacity building efforts will bear limited fruit if they are grafted onto the fairly narrow set of development objectives now in place.

Monetary policy

In early 2009, the IMF and CBI relented in their focus on reducing inflation as the oil price collapse and the international recession took hold. But for several months in 2007, the central bank paid commercial banks 20 percent or more for risk-free dinar deposits at a time when the dinar was appreciating against the US dollar – and dollar rates were typically in single digits. Given those risk-free returns, Iraqi banks had even less reason than otherwise to lend to the private sector. The high rates were also a barrier to generating any sort of non-bank finance, including factoring and leasing, as bank lending costs tend to become standards for other financial transactions. (It is true that almost nothing was done at the time to encourage such non-bank activity, but that too represents a lack of strategic foresight.)

It is fashionable among economists to advocate that central banks target domestic price stability ("inflation targeting"), which implies monetary policy "independence" in management of a separate currency and, hence, assumes fluctuations in the exchange rate. This fashion has clearly guided CBI and IMF policy in Iraq. On its face, an independently managed local currency was a strange policy choice for Iraq. Most nearby oil-exporter economies linked their currencies to the dollar, and probably none were free-floating. By what economic logic should an area with the GDP about the size of that of the New York City borough of Queens adopt its own currency and have its own monetary policy?

There are a variety of reasons why developing countries often choose to forego monetary independence in favor of linking their exchange rates to major international currencies. One is that most developing countries lack forward markets in foreign exchange, which would allow importers and exporters to hedge exchange exposure. A second is that many governments limit foreign exchange exposure by domestic banks, for valid, prudential reasons -- but doing so prevents banks from being active dealers to stabilize the exchange rate. Flexible exchange rates are thus perceived by many governments as a cause of instability. A third reason, especially relevant here, is that most developing countries lack financial markets in their own currencies that can provide access to short- or long-term capital. Some firms in developing economies are able to access offshore dollars or euros, but doing so in the context of floating exchange rates exposes them to un-hedge-able currency risks.

Given the strategic emphasis that should go to financial sector development, the third point alone suggests a serious flaw in the inflation targeting rationale. In the case of Iraq, replacement of inflation-targeting by hard-linking the dinar to an external standard would help Iraqis access well-developed external financial markets, and hence not be limited to the very thin markets inside Iraq. Considerable evidence indicates that financial deepening in emerging markets – outside of the largest, e.g. China, India, Brazil – is closely linked to

dollarization, or other use of international currencies. Other evidence over dozens of small economies with floating exchange rates shows a pattern of increased reliance on credit from multilateral lenders including the World Bank, IMF, and Asian and African Development Banks, etc., despite the near flood of private sector capital that moved to better integrated economies (Hinds, 2007).

Nobelist Robert Mundell told a Fund interviewer in 2006 that he believed the IMF played a "divisive role" by encouraging countries to move to flexible exchange rates, thereby "balkanizing the monetary world into a ridiculously large number of tiny currency areas" (IMF, 2006). Mundell told me in an email in about June 2006 that he thought it a serious mistake for Iraq to have an independently managed currency. Even Milton Friedman, the pied-piper of flexible exchange rates theory, proposed in the 1970s that Yugoslavia, a country with a scarcely-developed financial sector, should fix its currency to an outside standard -- the deutschmark.

A strict version of this contrary view advocates that developing country central banks should give way to currency boards, which link domestic monetary policy directly to that of an external key currency. An even stricter version urges developing countries to replace their domestic currencies with an international currency – usually the dollar or the euro. In the case of Iraq, either, or, perhaps, both versions of hard-linking would be compatible with a switch later to a GCC-led currency union, a goal in which the Iraqi dinar would presumably disappear.

Financial sector development

Iraqi commercial banks make few SME (small and medium enterprise) loans, which reflects a variety of structural factors, including lack of capacity to analyze risk, inadequate legal support for secured transactions, and unreliable financial statements. In part to overcome these obstacles, collateral requirements are often set very high, which further discourages lending. The state-owned commercial banks Rafidain and Rashid have large deposit bases, but are

essentially out of the game as long as concern about foreign attachment of their assets based on Saddam-era claims persists. Also, the IMF recently estimated that the state banks need injections of about $13 B of additional capital – which hardly seems likely in the current budget environment.

We cannot count on bank lending to increase greatly in the near future – although we should proceed with capacity-building initiatives. USAID training efforts, as well as support for the Iraqi Bank Guarantee Corp. (an effort to pool bank resources in support of medium-term lending) get good marks in discussion with private sector Iraqi bankers. Similarly, bankers are hopeful about DOD/ Brinkley Group)-sponsored training efforts. Constraints include lack of oversight capacity and inadequate prudential regulation -- without which more extensive lending would endanger deposits and potentially invite financial instability.

The late Ronald McKinnon, an international development and macroeconomist at Stanford University, suggested alternative finance channels:

> [D]eposit-collecting banks [in transitional and emerging market economies] may have little experience in aggressively seeking out borrowers who can pay… yields that accurately reflect high social productivity of the investments they are undertaking. Indeed, the whole process of seeking out small and innovative entrepreneurs in industry and agriculture outside the urban enclaves may be quite foreign to the banking system's previous experience - particularly in the socialist economies…
>
> [I]n the initial stages of the transition to a more open capital market, reliance on nonbank sources of finance and on self-finance might well be preferred… Indeed, large commercial banks may be the wrong institutions for small-scale loans, and an informal credit market that includes rural credit cooperatives, the factoring of ordinary trade credits, and traditional moneylending could well remain important for many years, as in the Taiwanese example (McKinnon, 1993).

Foreign banks should be encouraged, both for the almost automatic integration they provide with external financial

markets, and for the talent and learning opportunities they can bring to the domestic Iraq market. Yet a difficult legal and regulatory environment awaits them. Would-be investors are likely to encounter an unfriendly 1983 Company Law (even though a friendlier CPA-era Company Law is "gazetted;" that is, made formally binding), while the CPA-era Central Bank Law lacks implementing regulations. Appropriate administrative changes to support the CPA-era laws should be adopted with urgency.

In the case of Iraq, there are further alternatives to consider (and this is a process that should involve Iraqis and discover Iraq-specific solutions.) Bank lending volumes in Iraq are small – large "flow" items in the Iraqi economy are oil-revenue-linked, which means government contracts and civil servant salaries and pensions. We should look for ways to use such cash flows to nurture market-based finance. The regulatory and legal issues in developing such channels are usually simpler than those involved in collateral-based lending and in establishing sound prudential oversight.

In the near-term, we might encourage MOF to collateralize L/C's through private banks to facilitate credit in support of GOI contracting – without access to letters of credit, less capitalized contractors cannot bid for any but small contracts. In one step, MOF action to support L/C's for contractors could both boost private banks and help small firms begin to build banking relationships.

We could – as proposed to me by a senior CBI official – recommend revision of the civil service statute so that government employees would be permitted to engage in commercial activity, and specifically so they may be authorized to guarantee bank loans and other types of credit. (One USAID lending program has made use of civil servants as loan guarantors, usually on a small scale – but this might serve as a prototype for larger programs in the future.) This revision would have the added benefit of effectively bringing civil servants, who tend to be relatively well-educated, into the market economy.

Alternatives to traditional bank lending might also include equipment leasing and structured commodity

finance. Equipment leasing can offer access to long-term finance – rarely offered by banks -- by allowing farmers or others to obtain capital equipment. It is relatively safe and legally uncomplicated for the lessor, as equipment can be reclaimed in the event of non-payment. For leasing to be a viable option will require change in the Law of Industrial Development, which requires that companies *own* equipment as a condition for registering. It may also require a change in the Agricultural Cooperative Law, which has discouraged farms from operating on a for-profit basis. In some countries, including Pakistan and Uganda, government entities have been set-up or adapted to facilitate leasing. At some point, it might be profitable for an international equipment manufacturer to provide machinery leases (for example, as a John Deere subsidiary has done in Mexico).

Business people in Mosul proposed to me in early 2008 that we take steps to establish a grain exchange. Structured commodity finance – packaging of warehouse receipts, for example – can provide post-harvest finance in agriculture. An initiative would begin by providing improved storage facilities for newly harvested grain and other commodities; next would come product grade standardization, hence commoditization. This framework would set the ground for introducing warehouse receipt financing in an economy where other kinds of market-based lending to farmers have been nearly absent. Such financing, based on collateralizing goods already produced, and then placed in safe warehouses, and standardized, can much increase the competitiveness of producers. It can also proceed despite general weakness in the banking sector. In some cases it will be easier to use farm associations – of which I believe there are now more than 200 in Ninewa alone -- as transaction counter-parties, rather than individual farmers.

Factoring of receivables could offer an alternative for short term enterprise finance, first, by simplifying collateral requirements, and, second, by shifting credit risk away from small sellers to larger, better-known buyers. A 2006 World Bank study concluded that factoring of receivables might "be a powerful tool in providing financing to high-risk

informationally opaque borrowers… and particularly important in financial systems with weak commercial laws and enforcement and inefficient bankruptcy systems." An Iraqi lawyer has identified two legal steps that might help to facilitate factoring. First, recognize factoring as a sale and purchase; second, change the Central Bank Law to permit banks to engage in factoring. Once the legal framework has been adjusted, GOI might adapt one of a number of state-owned finance entities to serve as a platform for factoring in Iraq. An effective factor would essentially become the equivalent of a large credit information exchange.

All of the alternative finance channels suggested here are interest-rate-sensitive, and none could have been viable during the period of anti-lending monetary policy. Relaxing of that stance make the present a good time for financial sector initiatives. Yet IMF reports and directives neglect mention of such nonbank channels – as do State and Defense Department and USAID planning documents. None of the suggestions above are included in Campaign Plan Economic Annexes.

The essence of the suggestions above is in using some imagination to find ways to use assets to generate finance. Iraqis in the private sector, CBI bank, the legislature, and even in the al-Maliki Administration have ideas for generating financial networks. The importance of the suggestions here is not in the details, but in understanding that US leverage might be used to leverage of reform-seeking and market-oriented Iraqis.

Property rights

Property rights are critical to expanding financial opportunities, because land is the most important loan security around, especially for long-term mobilization of capital. Less than 5 percent of agricultural land in Iraq is held in freehold (or fee simple), which is bankable, that is, acceptable as collateral for lending. The remaining agricultural land is owned by the state, and is held either in *tessaruf* (an often tribe-related use right) title, which has

modest legal protection, or as leased or distributed government land, which has less. With rare exceptions, banks do not accept *tessaruf* or distributed land as security for lending.

Poorly developed property rights close off at their root many potential opportunities to develop or provide finance. Land rights gains added importance in oil rich countries, because mobilization of land finance facilitates economic diversification, and can offer a source of wealth independent of the oil sector and of government officials generally.

To be effective, we (and Iraqis) will also have to address complicated patterns of ownership, especially for *tessaruf* titles. Even if *tessaruf* titles were bankable, banks would be uninterested in security with scores or hundreds of owners. For large ownership blocs, we might convert joint into corporate ownership (as proposed in a State-funded Business Development Zone funded project in 2006.)[1] Other legal forms could work better for smaller holdings.

Several well-informed Iraqis have told me that establishment of property rights would be taken as concrete evidence that the powers of the government were limited – and that they believe this would create an "extremely important" barrier against a return to authoritarianism. It would boost GOI's legitimacy, and, on balance, increase national cohesion.

To now, little has been accomplished regarding rural and agricultural property rights. (We have begun to address some urban land rights issues as they might affect housing construction.) In fact, effective property rights cannot be introduced overnight, and Iraqis must build their own consensus on the best way to proceed. A Ministry-level Iraqi in Baghdad told me in early 2008 that he considered the agricultural land issue to be pivotal, and wanted to take it up with members of the Council of Representatives, and with the

[1] According to what I have been told informally and second-hand, Hernando de Soto, the Peruvian-based property rights advocate, learned of the 2006 proposal and deemed it an important innovation.

Prime Minister. But he vented frustration that he had gotten no encouragement from anyone at the US Embassy or elsewhere in the Coalition in support of his efforts – and he insisted that nothing could be accomplished without that support. As far as potential odds-enhancers in our approach, non-bank finance is “low hanging fruit.”

Conclusion

Ricks notes in his recent book on Iraq policy during 2006-2008, *The Gamble*, that the impetus for change in military strategy from conventional war to counterinsurgency came from a retired general officer (Jack Keene), and some interested Washington think-tanks, led by the American Enterprise Institute. The senior tier of active duty military officers at the Joint Chiefs and the Pentagon continued to back what Ricks and others considered a losing strategy. Even as GEN Keene’s active-duty allies Petraeus and Odierno implemented a strategic turnaround, many ranking officers resisted it. Ricks may insufficiently credit on-the-ground support for and implementation of counterinsurgency methods among mid-level officers during much of 2005 and 2006; but there could be no strategic success until the approach was endorsed at senior levels, and reinforced with increased manpower.

It is tempting to draw a parallel in economic strategy. We have on-the-ground advisors, some of whom have spent years in Iraq, who understand the paucity of accomplishment thus far. Some advisors understand the financial sector, land, agricultural, and monetary issues – but have not been able to impact strategy. Military officers working on non-combat operations at times have an almost palpable impression that something is missing. My sense is that we generally do not have the *wrong* strategy on economic development; rather, what we have is a lot of projects, and almost no strategic direction.

For example, I have been told on a number of occasions that the State Department was actively opposed to raising the visibility of the property rights question. Then one day in the

Autumn of 2007, I heard Ambassador Crocker speak to welcome a conference on agriculture in which he casually commented that Iraq would not reform its agriculture until it sorted out property rights issues. As it happens, property issues were not even on the agenda for that conference. And they were not mentioned in subsequent Economic Annexes – which were presumably drafted under the Ambassador's oversight.

On another occasion I asked a senior USAID official working on private sector and banking issues if his group had given any attention to factoring of receivables as a mechanism for providing short-term finance to small and medium enterprises. He seemed momentarily taken back, then he said he had not heard anyone mention factoring for the last twenty years. Factoring is used in much of the developing world for short-term enterprise finance – and it should be included in our strategic thinking in Iraq.

The strategic vacuum is not confined to US agencies. As an illustration, the World Bank has drafted a large number of papers during the last decade on factoring, leasing, and rural finance. Yet in my dealings with World Bank officials in Iraq, they appeared to be unaware of this work by others in their own organization, and in any event wanted instead to concentrate on – and limit efforts to -- the long-standing task of restructuring Rafidain and Rashid Banks.

We have for years given lip service to market-based finance, building a private sector, and agricultural reform. But it is not serious to discuss market-driven finance and private sector development without some attention to monetary policy and property rights.

It is late, but perhaps not too late. The decisions early in 2009 to reduce CBI administered interest rates and to stabilize the dinar make it possible to plan the next steps, which should include working with GCC countries toward establishing a common currency and monetary policy. The decision to lower interest rates itself begins to melt away what had been a large obstacle to development of any sort of finance, in or outside of banking channels.

A consequence in part of the Paris Club debt agreements is that US Government agencies, led by the Treasury, came to see their role as that of carrying out IMF mandates – which have thus set the tone for economic policy. But the Fund tends to emphasize dis-inflation, fiscal constraints, liberalization of controlled prices, and restructuring of state-owned banks and enterprises. As important as these are, they should be considered within a context of development, or what the World Bank and others have called "second-generation reforms" -- including financial deepening, property rights and a legal environment that would better protect investors' rights. Such reforms, nearly absent from Mission plans, are not usually the province of the IMF; someone else should have come forward. It is time to act on what the US Army would call "lessons learned."

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11 Economic development in Iraq: Bad advice, misdirected policy *

International Monetary Fund (IMF) advice has played high-profile role in Iraq's economic policy, particularly since negotiation of the Stand-By Arrangement (SBA) of December 2005. Yet the Fund's analysis is inadequate as a compass for economic policy. It has had little to say about market-based finance, and it reiterates the Coalition logic that has favored government-led spending over private sector development.

The IMF was established to address financial crisis, particularly those involving balance of payments issues, and not to offer across-the-board advice in support of long-term development. (The World Bank was intended to offer such advice, as well as long-term credit, but its profile in Iraq has been relatively low.) Yet the Fund's advice to Iraq – for example, in the IMF Country Report of December 2008 -- is misdirected even in the areas of monetary and fiscal policies

* Paper was published in Iraqi policy journal Dialogues, October 2009, with minor changes.

where it should be most reliable. And some of its directives may hinder long-term development.

The most dismaying aspect of the Report - in which it is consistent with several previous IMF Reports - is that it does not challenge the implicit decisions made by the Government of Iraq (GOI), and apparently endorsed by Coalition advisors, to treat the government sector as the engine of growth in Iraq, to the neglect and even at the expense of market-sector financial development. But we must, if we are to meet short- or long-term economic goals, respond to the manifest frustration among Iraqis in commerce and agriculture about limited access to finance and credit. Anyone looking to the IMF Report to understand or seek remedy for this situation, however, or even acknowledgement of it, will be disappointed.

Obstacles to economic development in Iraq include political instability, lack of security, corruption and non-responsive government; hence they run deeper than bad advice from Coalition advisors or the IMF. But, as we look ahead, consideration of the latter's advice offers a starting point.

Monetary policy

The Fund's mandates on monetary policy (below) have been at the heart of its directives. In the face of high unemployment and unemmployment and constrained credit availability, Central Bank of Iraq (CBI) and IMF priorities have improbably focused on countering inflation and reversing dollarization. From late summer 2006 to March 2009, monetary policy consisted of deliberate dinar appreciation and administered high interest rates. In approximately February of this year, the Fund reached agreement with CBI to reduce interest rates and to stabilize the US dollar value of the dinar.

Mandate: Iraq should keep inflation under control. This is laudable on the surface. Yet Iraq in the years since 2003 has suffered only in part from inflation as usually understood. Government of Iraq (GOI) debt has not been monetized, and,

during 2004-2006, the period of maximum internal price increases, the dinar was tied to the US dollar through daily CBI dollar purchases. Iraq has seen post-Saddam price decontrol and war-linked shortages – both of which induce shifts in relative prices and do not reflect money-driven inflation of prices in general.

Coalition policy, especially during 2007 and much of 2008, was to encourage Iraq to spend oil revenue, with the object of increasing economic activity and employment. It is hardly a surprise that increased revenues and spending can also have inflationary consequences – as indeed they did in many oil producing economies during that period. The mistake in Iraq was to respond to inflation generated in the public sector by blocking private sector financial innovation.

The most important piece of anti-inflation monetary policy was the ongoing appreciation of the dinar, which put downward pressure on import prices. The policy of appreciating the exchange rate to control prices had the first-order effect of favoring consumers -- many of them employed as civil servants by GOI -- at the expense of private sector producers.

The second piece was deliberately high interest rates -- through the channel of a high CBI deposit rate -- with the purpose of choking off financial sector lending by giving banks a profitable, risk-free alternative. The decision to raise interest rates made little sense as an anti-inflationary measure, as market-based lending activity is so limited. Based on CBI estimates, less than 1 percent of GDP flows into new bank loans to the private sector. Indeed, the IMF Country Report for Iraq, Aug 2006, acknowledged this with the comment that "the effectiveness of interest rate changes in influencing inflation is... very limited." According to those in or close to the Iraqi banking sector, the rise in interest rates in 2006 struck at several avenues of potential lending. USAID sources have indicated that their effort to encourage small-and-medium enterprise lending was essentially shelved by the high interest policy. High interest rates also discourage conservative borrowers, and thereby encourage banks to extend more risky, sometimes speculatve loans.

Given the goal of diversification of the Iraqi economy, restriction of private financial sector development should surely *not* have been the target for Iraqi monetary policy. What made the policy almost laughable is that GOI offered an array of subsidized credits, including lending facilities through the Ministries of Industry and Minerals and of Labor and Social Affairs for $1.5 B -- or more than net extension to the private sector through the banking system. Lending by government ministries is no less a boost to demand, and hence potentially to inflation, than is private sector lending.

Mandate: Iraq should have positive real interest rates. This is misguided on several counts.

1) The problem arises when negative interest rates exist as a consequence of financial repression -- which includes usury restrictions, compulsory credit allocations, and high reserve requirements. Iraq suffers little financial repression these days, so the analysis is mis-directed. The correct objective is to make sure that loan rates reflect the scarcity cost of capital (which may not be the same as a positive real interest rate.)

2) The IMF chooses "core inflation" as the relevant indicator. But "headline inflation" generally showed a lower rate of price increase during the period in question. A CBI official has told me that a WPI (wholesale price index), were it available, would also likely show a lower rate of increase. Measured against such alternative standards, lower nominal interest rates in Iraq might have been positive in real terms.

3) As noted above, many price increases in Iraq are non-monetary in origin, hence tight money, which targets the banking sector and investment decisions, misses the point.

4) Where an exchange rate is linked to an external standard (for example, the US dollar), the smaller country essentially gives up control of its monetary policy to the larger country, which implies that interest rates will be equivalent to those in the larger country, but usually with some premium added. Were a smaller country with functional financial markets deliberately to have interest rates above that level (in order to keep real interest rates positive), it would attract capital, thereby creating an interest parity violation, which

might result in a destabilizing capital inflow. During the 1997-1998 financial crises, interest parity violations in several countries contributed to destabilizing capital inflows.

5) In the case of Iraq, these issues are fairly hypothetical as there is very little bank lending, and most Iraqis avoid use of banks for deposits as well.

Mandate: CBI should counter dollarization. The IMF's premise here is that an economy with a GDP of less than $100 B – less than 1 percent that of the US, perhaps the size of the economy of Massachusetts less metropolitan Boston -- should have its own currency, and should discourage its citizens from using other currencies.

Much recent literature indicates a close connection between choice of monetary regime and financial deepening (the ability of the financial system to intermediate resources, which can also be measured by the level of such monetary aggregates as M2 or M3 relative to GDP.) Financial deepening is a pre-condition for expansion of bank lending, indeed, for financial sector development. Manual Hinds, long affiliated with the World Bank, noted in a recent study that most financial deepening in emerging markets occurs in dollars or other foreign exchange, not in domestic currencies.

> It is evident from a [statistical table measuring financial deepening among emerging market economies] that taking away the dollar deposits makes a big negative difference in the financial depth of the regions. Moreover, on average, the financial depth of the developing world did not increase noticeably during the [1996-2001] period. Practically all financial deepening was attributable to... spontaneous dollarization (Hinds, 2007).

This brings us to a fourth reason sometimes advanced (although not, to my knowledge, by the IMF) for high interest rates: concern that lower interest rates would lead to a drain on deposits. Yet this argument indicates the dead end onto which recent policy had fallen. The only way to attract bank deposits was to set interest rates at a level too high to support lending. The way to spring this trap would be to encourage

integration of Iraqi financial markets (and interest rates) into regional and world markets.

If we acknowledge that high interest rates and a rising currency hinder financial integration, then it becomes doubtful that Iraq needs or benefits from having its own currency and monetary policy; most European economies do relatively well without them. The IMF should advise Iraqis about the costs of having their own currency and monetary policy, rather than cheerlead for such policies.

It is probably safe to reject the arguments offered in favor of current monetary policy in Iraq as either irrelevant or the opposite of the truth. We need a multi-dimensional approach to building a financial sector; lower and market-driven interest rates must be a critical piece of it.

Financial sector

Now let's shift to the Fund's advice on the financial sector, which consists of one short paragraph on restructuring the state-owned banks, and another on prudential regulation for all commercial banks. Everything included here is accurate enough, but it omits any sense of urgency about the need to develop financial access in Iraq, and it ignores approaches outside of conventional banking. Iraqi commercial banks make few SME (small and medium enterprise) loans these days, which reflects a variety of structural factors, including lack of capacity to analyze risk, inadequate legal support for secured transactions, and unreliable financial statements, as well as high interest rates. In part to overcome these obstacles, collateral requirements are often set very high, which further discourages lending. We cannot count on bank lending to increase by much in the near future – although we should proceed with initiatives in this direction. The state-owned commercial banks Rafidain and Rashid have large deposit bases, and could become a source of finance; but they are essentially out of the game until they get injections of new capital recently estimated by the IMF at about $13 B – which hardly seems likely in the current budget environment.

Ronald McKinnon, international economist at Stanford University, has observed:

> "[D]eposit-collecting banks [in transitional and emerging market economies] may have little experience in aggressively seeking out borrowers who can pay... yields that accurately reflect high social productivity of the investments they are undertaking. Indeed, the whole process of seeking out small and innovative entrepreneurs in industry and agriculture outside the urban enclaves may be quite foreign to the banking system's previous experience - particularly in the socialist economies...
>
> "Then in the initial stages of the transition to a more open capital market, reliance on nonbank sources of finance and on self-finance might well be preferred... Indeed, large commercial banks may be the wrong institutions for small-scale loans, and an informal credit market that includes rural credit cooperatives, the factoring of ordinary trade credits, and traditional moneylending could well remain important for many years, as in the Taiwanese example..." (McKinnon, 1993).

Alternatives to bank lending might also include equipment leasing, civil service loan guarantees, structured commodity finance, or letters of credit issued on behalf of small government contractors. Factoring of receivables might offer an alternative, first, by simplifying collateral requirements, and, second, by shifting credit risk away from small sellers to larger, better-known buyers. (The IMF is not alone in neglecting nonbank lending. There is almost no mention of it in US State or Defense Department or USAID planning documents.) Iraq may, of course, proceed on its own with development of these non-bank channels, even as IMF reports neglect them.

Not only banking, but every sort of trade (commercial IOUs) and structured commodity finance is interest rate dependent. We are not likely to get very far with developing bank or nonbank finance unless deliberately high interest rates come down further.

Sought-after diversification of the Iraqi economy will occur only as a consequence of financial sector development, which will facilitate market-based deployment of resources. Indeed, GOI spending will sometimes have an opposite effect, by overwhelming the marketplace with low interest or essentially free distributions of resources.

Taxation

The Fund advocates an expanded tax base for increased revenue collection -- a variation on what they recommend for almost all emerging market countries, whether or not they export crude oil.

There are several reasons why this would be a bad idea in Iraq. The most important is that, by a proportion that changes from year to year, typically more than 60 percent of GDP is collected as revenue for oil exports. We are encouraging the Iraqis to develop a private sector, and to reduce the weight of decision-making by the central government. The Iraqi government, or almost any government, should be able to meet its social, infrastructure, and security obligations using less of the GDP than oil revenues comprise!

One of the arguments for added taxation is that in the event of a downturn in oil revenues Iraq might require backup revenue sources. The flaw in this reasoning is that when oil revenues turn south, domestic activity declines so that other revenue sources are also likely to yield less, hence the non-oil revenues provide little cushion against such cyclical changes.

More specific to the argument here is that, given the underdeveloped financial sector, retained earnings are a critical source of finance for Iraqi enterprises. It is therefore economically inefficient to tax corporate income. Closely related, we want to boost economic diversification, therefore we should avoid taxing the non-oil sector activities we wish to encourage. This case becomes stronger where taxation on private sector production is used to pay for increases in public sector salaries, which is usually the first place GOI puts revenue windfalls.

The case *against* a sales or value-added tax is weaker - the latter can bring some transparency in corporate cash flows, while either one targets consumption rather than production. But the case in *favor* of either is equally weak: GOI should not need the revenue.

Inferences for the way ahead

The near-absence of finance parallels another phenomenon, which is that few business initiatives succeed in Iraq without a government contract or government subsidies. (We have implicitly recognized the latter in efforts of USAID to offer supporting finance for large and small start-ups, as well as contingent plans for the US to put up USD 25 M for an "enterprise" fund. I understand that current Iraqi plans to encourage a home mortgage market are likely to involve interest rate subsidies.) The essential question for any investment decision lies in whether expected return on capital exceeds the cost of capital. The inability of most enterprises in Iraq to obtain credit against receivables, equipment, or other collateral, except at very high rates, raises the cost of working capital, while reducing expected returns. Financial sector deepening can reduce the cost of capital, increase liquidity, and increase prospective returns.

The decisions earlier this year to reduce quasi-administered interest rates and to stabilize the dinar leaves rates higher than they would be in the event of further integration into external financial markets. Nevertheless, the improvement is considerable, and melts away what had been a large obstacle to development of any sort of finance, in or outside of banking channels.

The IMF tends to focus on monetary and fiscal policy, price liberalization, and restructuring of state-owned banks and enterprises. All of these should instead be considered within a context of institution building, or what the World Bank and others have called “second-generation reforms,” including property rights and a legal environment that would better protect investors’ rights. In the same mode, “capacity building” efforts now underway in various ministries will bear

little fruit if they are grafted onto the fairly narrow set of development objectives now in place.

But even on the narrow terms in which they have been offered, IMF directives have had unfortunate policy consequences.

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12 The economy of Kyrgyzstan: Framework and policy proposals

Here is a summary framework to show how the economy of the Kyrgyzstan works, the weaknesses that result, and how we might bring improvements over time. The Kyrgyz economy works in a way that has much in common with other CIS[1] economies. This makes its shortcomings relatively easy to identify and understand. Because of extensive interactions between Kyrgyzstan and other CIS countries, however, these shortcomings may be more difficult to overcome than some have estimated.

Description

CIS countries have been described as having "virtual" economies, a word suggesting that real output, real goods, and money play a smaller role than in other economies. Instead, IOUs of almost every sort arise and are traded and passed on to meet obligations.

[1] CIS = Community of International States; CIS included Russia and most successor states to the Soviet Union.

Most economics and finance textbooks offer little discussion of economies that operate by such mechanisms. That is, most textbooks posit that economies use money or monetary credit for *all* transactions. And many foreign advisors in CIS countries (most of whom are not professional economists) suppose that here, too, the economy is based on money and, hence, that widespread use of in-kind payments may somehow complicate the model without fundamentally altering it. Frustration sets in as their advice is rejected, or as it is accepted, yet, somehow, never quite implemented.

But most CIS economies, including that of Kyrgyzstan, do *not* operate as if money were involved in all transactions. A virtual economy works according to different principles. Let us first note some of the manifest characteristics that distinguish such a system.

- Taxes are often paid in-kind, or not collected at all
- Inter-enterprise transactions are often settled in-kind
- Massive government arrears
- Inter-enterprise arrears
- Wages are often paid in-kind, or left in arrears

The build-up of IOUs, combined with the lack of a common unit of account in barter transactions, often result in imprecise information and record-keeping. Not surprisingly, the institutional infrastructure, including the government, adjusts to facilitate the continuation of the system. Consequently, virtual economies usually demonstrate several other functional characteristics:

•State budgets have little validity as planning mechanisms; central government acts as ad hoc referee, distributing favors and seeking new revenues as the need arises

•Agents of government (tax, customs) are not rule-bound, but behave arbitrarily

•Contract rights are weak; there is little predictability of legal outcomes

A "virtual" economy thrives on lack of transparency. Social acceptance of the virtual economy is based on maintaining a web of illusions -- that salaries and pensions will be paid, that transactions will be settled, and that taxes will be collected.

To bring the point to an immediate issue in Krygyzstan, we can perhaps see why the State Property Fund (SPF) management opposes adoption of International Accounting Standards (IAS) for state-owned enterprises. IAS would require more specificity in accounting for subsidies, interest payments, and in-kind payments and receipts. The consequences might be very disruptive. One senior official at the Ministry of External Trade and Industry volunteered to us that proper accounting methods at the SPF would reveal "massive insolvencies".

Similarly, we gain insight into why the State Tax Inspectorate resists conversion to IAS-compatible tax filings and, in some instances, refuses even to accept them.

Acknowledging issues like these in his recent State of the Union Address, President Boris Yeltsin explained that Russia had become stuck halfway in its transition from the planned and command economy to a normal market economy.

Concesquences

Nevertheless, the question may be asked: What is wrong with having a "virtual" economy? Why should Kyrgyzstan, or other CIS countries, be encouraged to use a more textbook-like, or “Western” framework? The answer is that maintaining a virtual economy in CIS countries exacts an enormous price in misallocation of resources, in economic stagnation, and in on-going prevalence of poverty. Consider some consequences of maintaining the virtual economy in Kyrgyzstan:

- Enterprises and governments can never get enough cash; interest rates are therefore sky-high.

This is the key point. Where cash is scarce -- because budgets and contracts are based on the illusion that more will be produced or delivered that the economic system can possibly support -- the cost of obtaining cash becomes prohibitively high. This weakens the government's ability to issue treasury securities in order to finance social needs of the population. Most enterprises are forced to scramble for cash in order merely to survive; little is left over to finance expansion. Indeed, in a scarcely growing economy like

Kyrgyzstan's, one doubts that *any* enterprises can earn returns on investment sufficient to offset today's interest rates. Other consequences follow:

- Investment level is anemic; the economy stagnates.
- There is no profit test for the continued functioning of enterprises; most verge on insolvency, but stay in business through juggling of IOUs.
- Individuals gain advantage through corrupting system, rather than through generating market-based profit. This creates a group of "connected" and powerful who have a vested interest in keeping things mostly as they are.
- Large amounts of effort and resourcefulness are (in a systemic sense) wasted in bartering and in trading IOUs.
- There is no effective banking system; banks do not enter long-term relationships with insolvent companies.
- Efforts to develop stock markets will meet only limited success.
- Foreign investors do not want to purchase shares of insolvent companies; nor do they invest in a system where rules are arbitrary and profit is either discouraged or confiscated.
- Currency is weak; this fundamentally reflects the inability of Kyrgyz and other CIS industries and services to offer competitive value in trade with the rest of the world.

In Russia itself, the progress of "virtual" transactions has had the further effect of weakening the central government in Moscow, which is now limited in its ability to collect taxes, provide social services, or make wage payments in the regions. In consequence, regional governments have manipulated the growing use of non-cash transactions to enhance their own power.

Propesed policy measures

Given the manifest costs of the current system, one might anticipate a determined effort to implement change. In fact, however, the virtual economy provides a kind of built-in safety cushion. After the crisis in Russia last summer [1998], for example, economic life continued with less disruption

than many outsiders expected. People who are not compensated in the national currency do not care what the international value of that currency is. Also, for as long as enterprises maintain the illusion of profitability, they are able to keep people on their payrolls -- even if actual salary payments are minimal.

To deal with the consequences of large numbers of bankruptcies will require adequate funding of social and unemployment relief. However, most who would lose their jobs currently work for insolvent enterprises. Therefore, the systemic cost of maintaining their welfare were they made redundant would be low or even negative; that is, the systemic gain of liquidating insolvent enterprises would more than offset the cost of providing a safety net. Also, a recent empirical examination of evidence (Barents Group, March 1999, *Privatization and Performance: Evidence from Kyrgyzstan*) indicates that privatizations in Kyrgyzstan during 1993-1995 did not result in an aggregate increase in joblessness; layoffs by some enterprises were offset by greater dynamism and new hiring in others. [Frankly, I wonder about this result. From what I learned later, Kyrgyz widely believed that "privatization" frequently amounted to insider looting.... CJ, 2020].

Another impediment to solution is that the issue extends beyond Kyrgyzstan. Cross-border trade within the CIS is often conducted in-kind rather than in-cash. At this point, we need an effort to envision an alternative future. Many CIS countries are resource rich: for example, Russia, Kazakstan and Azerbaijan have oil and gas; Uzbekistan is a major cotton producer. Kyrgyzstan is relatively resource poor (although a recovery of commodity prices and an improved investment climate would bring significant exploitation of some minerals.) Kyrgyzstan therefore has little choice but to concentrate on improving its domestic environment to encourage commerce and investment.

It might become a sort of market-based "off-shore" production and financial center for other countries in the CIS. Over time, it should also seek to trade more with non-CIS countries, as that would reduce the relative volume of market-

distorting in-kind transactions; it will also be in Kyrgyzstan's interest to trade with more economically dynamic parts of the world. WTO membership marks a good first step in this direction.

As we commit ourselves to introducing a real market economy in Kyrgyzstan, policy change should emphasize five areas: contemporary accounting standards, privatization, banking sector reform, legal administration and transparency, and tax administration. Accounting and legal transparency should make it harder to maintain the environment in which arbitrary state action expands. Successful privatizations of large state-owned companies will bring demands for cash-based transactions, and provide raw material for growing stock market activity. The mix of accounting reform and improved tax administration will gradually force the "shadow" economy into daylight. The overriding goal should be to create a new commercial culture.

All of these have been targets for donor-funded technical assistance projects in Kyrgyzstan, and the World Bank, the International Monetary Fund, the Asian Development Bank, and others have at times set progress in each of the areas as a precondition for disbursement of concessionary-rate credits. Yet progress has been disappointing. Indeed, the effect of concessionary credits has perhaps been to provide the hard cash that adds legitimacy to the governments that sit at the center of virtual economies in Russia, Kyrgyzstan, and elsewhere.

Here is a broad outline of appropriate reforms:

1. Accounting Standards

- State-owned enterprises convert to IAS
- State Tax Inspectorate accept returns in IAS format
- Bankruptcies and restructurings should be encouraged, to introduce more efficient use of assets

2. Privatization

- Kyrgyz Energo
- Kyrgyz Telecom
- Other State-owned enterprises
- End re-nationalizations; e.g., gas, liquor

3. Banking Sector
- Consolidations/ Capital strengthening
- Examine single currency reserve and deposit insurance rules
- Maintain market in government securities

4. Legal
- Case Reporting: access to all commercial and civil decisions must be open and public
- Commercial transaction enforcement mechanism, including collateral enforcement, must be strengthened
- Administrative Procedure Law; establish and enforce

5. Tax Administration
- Administrative overhaul of record-keeping to broaden tax base and ensure fairness; the issue, again, is "transparency"
- Systematic training and testing of STI (State Tax Inspectorate) employees
- Tax rates should be lowered, while tax base should be broadened

13 Missing political front in Afghanistan *

President Barack Obama's decision to authorize military action on the part of US forces in Afghanistan after the end of 2014 reopens strategic questions often thought to have been closed. Despite the peaceful transition of power to Ashraf Ghani, who is perceived as a moderate reformer and internationally-minded, as President, the war is not going well. Reports indicate that Afghan Army and Police casualties in 2014 were the highest since the 2001 intervention, and civilian casualties, the majority of them inflicted by the insurgency, were the highest since the United Nations began reporting them in 2009.

In Iraq, a military "surge" in 2007 initially brought an upward spike in Coalition and Iraqi casualties, but it was followed by a decline that lasted for several years. In contrast, the parallel surge in Coalition forces in Afghanistan in 2010 and 2011, according to Department of Defense (DoD) data,

* This article was published in Small Wars Journal during January 2015. I have made only minor changes in the text here, and have included a brief Afterward. [Retrieved from].

resulted in no durable downturn in the volume of security incidents (DoD, 2012; p. 151).

Senior US and other Coalition leaders routinely identify lack of legitimacy of GIRoA (Government of the Islamic Republic of Afghanistan) as the greatest danger to a successful mission outcome. The shortfall in legitimacy derives from obvious corruption, clientelism, dependence on warlords and unsavory power brokers, and a culture of impunity for human rights and financial crimes. It also follows failure to include traditional tribal and religious leaders. The government's writ often does not extend far beyond Kabul. Even if the new President turns out to be as directed, motivated and "clean" as many hope, he will be able to surmount only a portion of these legacies. To some extent, he is bound for non-Pashtun support to his Vice-President Abdul Rashid Dostum, the Uzbek leader, who by reputation was one of Afghanistan's most violent warlords; and the delay in forming a Cabinet indicates that Chief Executive Abdullah Abdullah has a separate agenda. In any event, transformative action from the new administration would likely stir considerable opposition.

Policy vacuum

However much International Security Assistance Force (ISAF) leaders acknowledged GIRoA's legitimacy gap, they seemed not to know what to do about it.[2] Afghan scholar Thomas Barfield has described counterinsurgency (COIN) in Afghanistan as "a military operation without a political front" (Barfield & Nojumi, 2010). Karl Eikenberry, former US Commander and later Ambassador to Kabul, criticized the surge strategy in 2009. He subsequently explained in *Foreign Affairs* that it was based on "spectacularly incorrect" premises, including: 1) that the COIN goal of protecting population was clear and would prove decisive; and 2) that foreign support and assistance would substantially increase GIRoA's capacity and legitimacy. But rather than offer an alternative to the failed COIN effort, Eikenberry then generalizes that we

[2] On January 1, 2015, NATO's ISAF mission was succeeded by the Advisory Resolute Support Mission.

should try to learn from our mistakes (Eikenberry, 2013; p.61). Retired Army three-star general Daniel Bolger, who was active in Iraq and Afghanistan, acknowledges that we have "lost" in both, and says US generals failed repeatedly to reconsider basic assumptions, and "failed to question our flawed understanding of our foe or ourselves." Then, however, he punts: far from suggesting a way to proceed in Afghanistan, he volunteers that younger officers will in the future "figure out" how to fight such wars (Bolger, 2014a, 2014b).

Robert Gates, US Secretary of Defense during 2006-2011, recounts (and bemoans) a strategic dead-end. He reports that President Obama lost confidence in Coalition war strategy during General McChrystal's tenure as ISAF Commander in 2010, and again the next year during General Petraeus's tenure. Gates adds that Obama asked him in January 2011 to develop a strategy to "work around" President Karzai in Afghanistan and General Kayani in Pakistan, but he leaves the impression that no such a strategy was ever provided (Gates, 2014; pp.483, 557). Succeeding Commanders Allen, Dunford and Campbell have been occupied with transition of control to the ANSF (Afghan National Security Force) and winding down the US involvement. Rather than seek new understanding of Afghanistan's complexities, their Commands have been marked by drawing back from engagement with Ministries and others ISAF staff label as "non-priority." In about February 2014, a senior civilian in General Dunford's office, frustrated by my questions about missed opportunities, blurted out that "no one cares." He had in mind unnamed parties in Washington, not anyone in Dunford's office in Kabul.

What has seldom wavered, from the Bonn Conference of December 2001 through plans for disengagement at the end of 2014, is the diplomatic- and donor-agency-driven commitment to the vision of Afghanistan as a democratic, pluralistic state where the central government's credibility is felt even in distant provinces. This is the way the 2004 Afghan Constitution is written, it is the gist of the Tokyo Mutual Accountability Framework (TMAF) for donor conditionality, and it is even in the language of military planning documents.

However, such observers as Barfield and former Ambassador and Special Envoy Peter Tomsen have sharply questioned this view (Barfield, 2011; p.55. Tomsen, 2011; p.646); and Henry Kissinger has similarly described nation-building in Afghanistan as "inherently implausible" (Kissinger, 2011). The highly regarded Report of the Wilton Park Conference (2010) offered:

> Other [participants] noted that success does not necessarily lie in Western notions of what a state should look like. The current predatory behavior of many people within the [Afghan] state apparatus suggests that the international community *should be looking to all forms of political governance in the country, including structures which do not conform to Western expectations* (Italics added).

But without a path to achieve such centralized credibility, US and Coalition efforts have focused instead on development, including on institutional capacity building, and on military operations and training. A shortfall of political legitimacy, in contrast, can be addressed only be demanding change, that is, by confronting Kabul on reform and realignment of domestic power, and by energizing groups or forces heretofore dormant. This means reducing the President's power to appoint provincial and district officials, while increasing the role of provincial and district councils; weakening warlords residual powers, while energizing moderate elements among traditional tribal leadership; and, in a country with an Islamist insurgency, finding ways to reinforce religious moderates. But we typically refrain from such hardball diplomacy – and have instead posited that institution-building, or foreign assistance more generally, will itself create legitimacy (Biddle, 2013; p.56). Such Coalition premises reflect strategic confusion.

If the Ghani-Abdullah administration is able to boost the central government's acceptance among Afghans, it will be good news indeed; but the US and Coalition should no longer stake the outcome of the mission on having that happen. GIRoA's growing national visibility in the decade after 2001, far from bringing stability to other regions of the country, did

much to re-energize the rural and Pashtun insurgencies, including of the Taliban. Peaceful periods in Afghan history, for example from 1929 into the late 1970s, saw weak central governments that left effective autonomy to the regions. In contrast, both the modernizing Amanullah government of the decade before 1929 and the various Communist governments after 1978 failed, and provoked harsh counter-movements. The presumption should be that GIRoA must first enhance its credibility as a provider of security, dispute resolution and non-corrupt administration, and only then seek to extend its authority.

Some recent history

The US needs to think like a superpower, rather than like a hired army on the verge of withdrawal. Much of what might have been accomplished during the past quarter-century did not require ground troops; and the fact that forces are being withdrawn does not cause US interests in Afghanistan to vanish. A superpower ought to be in a position to influence outcomes, to shift international financial support, and to leverage credibility in international fora.

Former Ambassador and Special Envoy Peter Tomsen argues that the US has enabled the wrong Afghan leaders and groups ever since the Soviet departure in 1989 (Tomsen, 2011; passim). During the anti-Soviet war of the 1980s, the CIA used the Pakistani Inter-Services Intelligence (ISI) as a conduit for supplying the Afghan Mujahideen. Following the Soviet exit, the US, through the CIA, essentially outsourced its Afghan policy to the ISI. The ISI was (and largely remains) under direction of hardline jihadists, and has consistently provided resources to strongly Islamist leaders and factions in Afghanistan. It was not a necessary consequence of US support for the earlier anti-Soviet war that US resources during the 1990s would be pitted against moderate and less sectarian Afghan groups. Journalist Charlotta Gall reports, for example, that “the vast majority of mujahideen were moderate and did not support terrorism” (Gall, 2014; pp.122-123).

An Afghan civil war raged from 1992 until the Taliban, to whom the ISI had shifted support, acceded to power in Kabul in 1996. The ISI initially supported demagogue Gulbuddin Heckmatyar and consistently opposed more moderate alternatives, including prominently the Tajik Ahmad Shah Masood in the North and independent-minded Pashtun leaders including Abdul Haq, who sought to organize tribes through traditional Jirga (tribal council) settings. As a result, such leaders received only droplets of financial support from the US through the civil war and the period of Taliban rule to 2001. The civil war itself undermined traditional tribal leadership to the advantage of the sort of warlords who rise in power vacuums.

Western interests were damaged early. Tomsen cabled to Washington as early as 1991 that if Pakistan allies Heckmatyar or Abdul Rassoul Sayyaf were to reach Kabul, then Arab terrorist organizations would relocate their bases to Afghanistan, from which they might "stoke Islamic radicalism" in central Asia and the Middle East (Tomsen, 2011, pp.451-452). The civil war era government, headed by Burhanuddin Rabbani and seeking allies -- and acting with the approval of the ISI -- admitted Osama Bin Laden and Al-Qaeda following their expulsion from the Sudan in 1996. In predictable sequels, Al Qaeda and the Taliban assassinated Masood and Haq as the most viable threats to their power in 2001.

Afghan governance frameworks, and US selection of allies, have improved only slightly since 2001. At the Bonn Conference that December, Hamid Karzai, understood to be a moderate Pashtun, was anointed as leader by US diplomats, with the intention that he would lead a state-building effort. But King Zahir Shah, who had been in exile in Italy since the 1970s and was a natural unifying figure for Afghans by then exhausted from decades of Communist and Islamist governors –was given a few minutes on the podium, then shown the exit. The US Defense Department, working at some cross-purpose to the State Department – not to mention cross purpose to President George W. Bush's call in April 2002 for a new "Marshall Plan" -- then undermined Karzai's position by

advancing massive resources on various warlords during 2002 and 2003, among them Ismael Khan, Mohammed Fahim, Dostum, and Gul Agha Sherzai. Deputy Defense Secretary Paul Wolfowitz argued that DoD's warlord-centered policy recognized Afghanistan's natural region-by-region autonomy (Rashid, 2008; ch.7. Tomsen, 2011; p.597).

Unfortunately, the DoD-led American policy undermined both centralized state-building *and* recovery of regional stability. Much of the Taliban's original appeal lay in the alternative they offered to the warlord chaos and depredations of the civil war period. But as Karzai was frequently deserted by US backers, he turned to many of the same warlords, his erstwhile opponents, for support at least a *modus vivendi*. The US embrace of warlords in the years after 2001 neglected, and further weakened, potential networks of traditional tribal leaders and village elders -- which might otherwise have become moderate and influential allies of the new Karzai government (Tomsen, 2011; pp.646, 656-657, 662). In consequence of these ill-advised moves, the Taliban were on the way to recovery by 2006.

Karzai's role shifted from potential reformer to *de facto* power-broker-in-chief, from strategic nation-builder to tactical deal-maker. He maintained enough authority to be able to balance interests of warlords, tribal leaders, his own political appointees, and legislators. While he was keen to protect his warlord base, he also wanted to be able to bring pressure against the same people; for example, the Amnesty Law, passed in 2007 and gazetted in 2010, protects those who might be accused of past crimes, but without shutting the door to all legal redress. Karzai's transformation was a large setback. The US sought course correction with a fairly open effort to defeat Karzai in the 2009 presidential election. Karzai, who by then had become vocally anti-American, doubled down on his working alliance with various regional power-brokers, and was re-elected with the help of a massively corrupt vote count (Gates, 2014; pp.358-359). But while the international community's modernizing agenda was undermined, GIRoA has neither shown interest in boosting traditional tribal and religious leadership, nor been willing to

loosen control over budget or appointment power in provinces and districts. (Foreign assistance agencies reinforced GIRoA's centralizing effort with their preference for administration through Kabul.) The base of support for the ISAF effort, and for GIRoA, has palpably narrowed.

Where to go from here

Perhaps the most basic rule of war strategy is to expand the breadth of one's support, to boost allies, and to discourage uncommitted forces from joining the enemy. The US has done nearly the opposite since 2001 – undermining host country allies, even turning them against us, and ignoring potential new allies.

It is late, but perhaps not too late. The US and Coalition allies have a long-term interest in the stability of Afghanistan: a restoration of Taliban control might make the country again a haven for jihadist activity; and Taliban advances will likely weaken GIRoA, and strengthen regional warlords. A return to warlord rule would mean domestic interference and influence-seeking from most regional neighbors. Whatever Afghanistan's internal dynamics, the US and Coalition allies should also undertake more persistent efforts to involve foreign powers – most of which have ethnic or religious minorities mirroring those in Afghanistan -- in finding a regional balance that will endure (Cowper-Coles, 2011; p.200. Kissinger, 2014; pp.321-322).

Emphasis on military support and development aid efforts inside Afghanistan reflect the weight of defense and foreign assistance bureaucracies in Washington and other Coalition capitals; but they have thus far had limited strategic results. The only way forward for Afghanistan's domestic troubles is to build the political front long neglected, in order to put ourselves on the side of and to nurture forces for moderation and stability. The Coalition's course should be to use influence on an array of issues to increase GIRoA's legitimacy in some areas and to reduce its presence in others. Here are some specifics, based in part on meetings with GIRoA officials during 2013 and 2014.

Tribal Engagement. Senior people at the Ministry of Borders and Tribal Affairs (MBTA) repeated a theme in a variety of ways: tribal leadership can play a crucial role in creating social adhesion, and thereby in undermining insurgent appeal. (Abdul Haq's leadership more than a decade earlier, noted above, was based on the same premise – and led to his assassination.) They told us that insurgents (Taliban, Haqani Network, etc.) cannot gain a foothold where tribal networks and loyalties are strong. Where decisions are made by tribal shuras (consultative councils), "extremists would not be part of the culture." More expansively, we were told that tribal jirgas – which bring together leaders of smaller groups on a district, provincial, or even regional basis, in order to reach consensus – can help us to achieve broader goals. These might include: bringing the Taliban into peaceful processes; enhancing border security; and even discouraging production and consumption of poppies.

Westerners tend to think of tribal structures as a barrier to the kind of modernizing, open societies they wish to encourage. But a different, and often superior, strategy is to build on a foundation of tribal leadership, with its built-in legitimacy, and then to absorb tribal leaders and customary law into newer administrative and legal structures. African legal scholar Charles Mwalimu argues that this absorption strategy has worked to advance both constitutionalism and human rights protection in a number of countries in Sub-Sahara Africa – and has certainly been more effective than approaches that sought to discard such traditional structures (Mwalimu, 2009; pp.79ff).

We heard repeatedly that the Coalition "was not dealing with the real leaders of Afghanistan" – that is, for its strategic engagement, the Coalition has largely confined itself to dealing with officials in Kabul, many of whom had little standing among Afghans, while neglecting tribal and religious leaders. (In this, we were warned, the US has replayed the Russians' error from the 1980s.) Further, the practice of seeking warlords' backing directly rather than dealing through tribal elders was a serious mistake. The pattern changed to some extent during 2010-2011 when Commanding General

McChrystal sought broader engagement, but such discussions mostly ended not long after his departure. Officials at the Human Rights Commission told us that "real" tribal leaders are respected, and are a key to exercising soft power. President Karzai, they told us, often avoided dealing with tribal leaders because they had the potential to break up his patronage network – and certainly *not* because he was a "modernizer." On the other hand, Karzai did frequently deal with his preferred tribal leaders, and to the point of circumventing the Ministry of Interior and other GIRoA structures.

Unlike the situation elsewhere, for example in Iraq, where a few tribal leaders sit atop of large hierarchies, traditional authority in Pashtun Afghanistan is scattered among almost innumerable tribal and clan groupings. To have a strategic impact – to become part of a political front – they have to be brought together. Going forward, we should look for ways to encourage tribal jirgas -- perhaps with advances to MBTA from military or diplomatic budgets -- and we should encourage such government departments as the Independent Directorate of Local Governments (IDLG) and the Ministry of Rural Rehabilitation and Development (MRRD) to engage the MBTA – as a conduit to tribal leadership -- in their sub-national framework initiatives.

Engaging Religious Leadership. For its optics, engagement with Afghan religious leadership might be sensitive, as Islam has come to be associated in Western minds with extremism, and many younger mullahs have offered support to insurgent groups. Indeed, we heard a credible account of a past US Ambassador to Kabul who told the Minister of Hajj and Islamic Affairs (MHIA). "If I work with you, they [US leaders in Washington] will put me in handcuffs."

That premise is wrongheaded, to say the least. Mullahs have a natural leadership role in an Islamic society, and they, more than anyone else, are in a position to affect views and practices on human rights, the status of women, the role of education, the practice of Islam, and – especially -- the doctrinal credibility of Islamist insurgents. Outgoing MHIA leadership was especially interested in these matters; indeed,

they expressed much dismay at what they considered the frequent uninformed practice of Islam in Afghanistan. One point of MHIA influence is in overseeing training of mullahs, including choice of learning materials and selection of religious teachers. A source of leverage could be payment of stipends to cooperative mullahs; this practice is frequent in other Moslem countries, including in the Levant; in Saudi Arabia, a carrot-and-stick approach helped to restore order after spectacular extremist attacks a decade ago. For example, at $60 dollars/ month for 17,000 mullahs, $1 million/ month (a drop in the bucket against a war budget) might buy a lot of influence.

MHIA could have been a natural ally for the US and the Coalition, one with the potential to deliver a great deal of soft power. But – again, except for some contacts during McChrystal's tenure – it has been neglected, and below the Western radar. With the new Ghani-Abdullah Administration, change is underway in leadership at MHIA, as in most Ministries. Enough is at stake that the US and allies should not leave this succession to chance, and should look for active engagement with the next leadership.

Engage the Human Rights Commission. While bringing traditional leadership into governance is critical, we should also look for ways to improve the legitimacy of the centralized structure in Kabul. The Afghan Independent Human Rights Commission (AIHRC) was established in 2002 pursuant to the 2001 Bonn Conference, and is outlined in Article 58 of the Afghan Constitution. The opinion of many AIHRC officials is that President Karzai, through his appointments, sought to weaken the Commission. He certainly had reason to do so, as AIHRC has investigated war crimes and lesser rights violations from the 1990s, often including those committed by the warlords who came to comprise Karzai's base of support. With assistance from foreign human rights NGOs, the Commission, probably in 2012, completed – but has not released -- an 800-page *War Crimes Mapping Report*. In part because of the political sensitivity of this investigation, and concern that Afghan political counterparts might be

undermined, or threatened, the US State Department has stayed clear of meetings at policy levels of AIHRC.

Once again, US policy has been misdirected, as AIHRC could offer crucial support toward meeting Coalition objectives. The post-2001 role of many civil war participants, often accused of serious rights violations from the 1990s, has been a large barrier to establishing GIRoA's legitimacy. In our discussions, AIHRC officials indicated that they would advise that the Afghan government is now too weak to release the *Mapping Report,* or to introduce any criminal proceedings based on the investigation. Were GIRoA to take such action, they told me, those named in the *Report* might retaliate with extensive violence, which would have the potential to push Afghanistan back into civil war.

But what AIHRC should be able to do is vet human rights records of candidates for political and administrative positions. AIHRC officials told us that "a credible government is a government without warlords." President Karzai did not wish such second-guessing of his choices for provincial or district governors, or for Ministerial positions. Neglect of closer collaboration with AIHRC has been a large gap in the Coalition's years-long anti-corruption initiative – not to mention its effort to increase GIRoA's legitimacy. If GIRoA (with Coalition encouragement) could screen out even some of those whose credibility is heavily compromised, we could begin to undermine the post-2001 Afghan culture of immunity for human rights and financial crimes. It could be much more effective than allowing such people into official positions, then looking for case-by-case evidence of wrong-doing.

A couple of high-profile occasions are illuminating. AIHRC did not vet Presidential candidates for the 2014 election. In consequence, of the top five candidates, one was Qayum Karzai, President Karzai's half-brother; and two were warlords understood to be Karzai's political allies, one of whom, ISI-ally Sayyaf, has been accused of large-scale war crimes. The warlords apparently had in mind to gain some bargaining leverage in the formation of a post-Karzai cabinet. A more active role by the Commission could have made for a higher-quality Presidential field – and it might have kept Dostum off

the winning ticket. (The other two of the leaders, Ghani and Abdullah, presumably would have been vetted fairly easily.) In another incident, Karzai overcame objections from the Coalition to release 65 insurgent detainees in early 2014. AIHRC officials told us that, had they been invited into the process, they had sufficient information on insurgents' human rights violations to have set up a further obstacle to their release.

Sub-National Governance. Afghanistan historically has been a land of different languages, geographic separations, and difficult travel. While GIRoA should find ways both to increase its credibility among Afghans, and to find subnational and tribal allies, it does *not* need to bring all groups and factions into a national governmental structure; indeed, such an inclusive Afghan structure has never existed. But governance can continue outside of the formal structure of GIRoA. The best the Coalition should hope for, going forward, is that armed conflicts will be low-grade and localized. A goal should be to induce some insurgents to pursue their objectives through political channels. Successful innovation in sub-national governance measures could contribute to answering the highest strategic question: how to shift some competition with insurgent groups from the military to the political arena – even in the face of ongoing inability of GIRoA and insurgent leaders seriously to negotiate.

Insurgents who seek to influence local events have little reason to compete for a voice in subnational councils as they now exist, because their power is so limited. Provinces and districts are blocked by Article 42 of the Afghan Constitution from raising their own revenue, which must instead come from Kabul. Currently, all governors are appointed by the President – which makes uncertain their responsiveness to provincial concerns. It would be consistent with the Constitution to have governors selected by elected provincial and district councils. We could insist on a larger role for provinces and districts in spending choices as a condition for ongoing external budget support. And we should look for a

way for provinces, and perhaps for districts, to raise revenue, if necessary through legal or constitutional changes.

Building sub-national governance structures with real powers has the potential to degrade the Taliban's military wing. Barfield, with co-author Nojumi, merits quoting again:

> While non-Pashtuns are particularly opposed to granting Taliban a role in the national government, they have few objections to their serving in local positions if they are popular there. Those who come to hold such positions would have far less incentive to remain loyal to the Pakistan-based Taliban leadership, particularly its goal of seizing power nationwide, because it would conflict with their own local interests. Similarly, the need to deliver services and patronage to their own districts would increase their cooperation with Kabul and its international allies, which can provide such aid (Barfield & Nojumi, 2010; pp.9-10).

Coalition leadership has not yet grasped this nettle. For example, the Tokyo Framework, which sets conditions for continuation of foreign non-military assistance to Afghanistan, calls for "de-concentration" of power, rather than for "de-centralization." The former provides for some sharing of decision-making with Kabul, but offers little push for subnational autonomy. While it apparently reflected the wishes of some around President Karzai, it was also favored among donor agencies used to dealing with centralized administration. As more than one Afghan has explained to us, IDLG creates the appearance of decentralization, while preventing it from actually happening. More rudely, IDLG has been called Karzai's coordination post for countrywide patronage. The institutional deference that many in the international community have shown to IDLG suggests strategic confusion.

Some reporting suggests that incoming President Ghani seeks a more substantial role for subnational governance. On an optimistic scenario, such an initiative could over time weaken the Taliban and other insurgents.

Conclusion: The incoming administration

Despite the drawdown of foreign troops, the strategic dynamics of the conflict have changed little – although the Taliban's position on the ground appears to be improving. And no matter what the Coalition does, or how effective the new GIRoA Administration becomes, we should not expect a rapid change in the military or political balance. The key to stabilizing Afghanistan over the next few years lies in the political dimension – and this paper walks through four elements of what might become a political front. All of them push against what President Karzai's priorities were – or what they became after his remake as power-broker-in-chief.

The Ghani-Abdullah government may see things differently. They are not beholden – or are much less so – to Karzai's power-broker network. Neither campaigned for President as a de-centralizer, but they may move in this direction now, particularly as international interest in and material support for Afghanistan slacken – and as the limits of GIRoA's writ become clearer. At the same time, they may look for ways to strengthen moderate tribal and religious leaders. Similarly, neither said much about the Human Rights Commission, but both might now show more interest in laying building blocks for a more responsive and legitimate government. Should the new Administration turn in these directions, they will surely face opposition from domestic factions dependent on GIRoA's *status-quo*. Indeed, scuttlebutt has it that Karzai himself now serves as a gathering point for recalcitrant factions. The role of the US and the Coalition must be to use statecraft, including aggressive diplomacy, to help to overcome such opposition. The US might even move away from a decades-long pattern of undermining moderates and shrinking the domestic coalition.

Afterward (May 2022)

In August 2021 the US drew down its remaining forces from Afghanistan, roughly according to terms negotiated in the Spring of 2020 under then Secretary of State Pompeo. Other NATO powers and allies followed suit. After two decades of

war by NATO without a political front (as Thomas Barfield described it), the Taliban restored the 2001 *status quo ante* without giving Washington a "decent interval." Admiral Stavridis, the NATO Supreme Commander during 2009-2013, by most accounts an accomplished scholar-warrior, in 2021 offered some after-action criticism of US and NATO strategy, or lack of it.

> [W]e must learn and understand the history, culture, and languages of any country in which we seek to intervene – be that militarily or economically. In Afghanistan, we failed to fully do so, and our hubris and arrogance did not serve us well.

I was in Kabul as a DoD civilian at roughly the same time Stavridis was in Brussels. I found it breath-taking, and discouraging, that the US was fighting a war, and spending at least tens of $billions each year, without making much effort to get expert opinion on the dynamics of the country whose history we were trying to change. To make it worse, both our soldiers and our diplomats served short tours in-theatre, usually not much more than a year, before being rotated out – surely no way to have expertise or understanding on the ground. Stavridis continued with his retrospective:

> At the start, we were wishing for … more nimble special forces, explosive ordnance disposal technicians, counter-insurgency experts, translators, and central Asian historians. [But] the venerable A-10 "warthog," a troops-in-the-field support aircraft that flew low suddenly counted for more than a glamorous F/A-18 Hornet. In short, the services had to reinvent, reorient, and rethink every aspect of combat…
>
> In retrospect, we should have trained an Afghan fighting force that would have looked more like the Taliban – light, swift, less reliant on heavy logistics and exquisite intelligence, and air power (Stavridis, 2021).

In microcosm, Stavridis' 2021 essay recaps what was clear to others years earlier about the disconnect between the US-led effort and the political and cultural dynamics on the ground in Afghanistan (eg, Whitlock, 2021). In the kinetic dimension, as Stavridis indicates, the US and NATO were fighting according to their conventional war doctrines. His

current view underlines my argument above, from 2014-2015, that a cogent, objectives-driven strategy in Afghanistan might have brought a better outcome.

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14 How to leave Afghanistan *

I talked in about 2010 in Afghanistan with a cogent 30-something Indian, then managing a USAID project, who was openly skeptical about the NATO mission there. He said, "I want the US to be the world's superpower." With a scowl, he added "I don't want it to be China. But if you keep getting into stupid wars, you won't be [the world's superpower]." His vision was comparable to that of the Biden Administration, which urges that the US should lead its democratic allies, mostly through the soft power of example, against what has been an authoritarian tide.

Foreign policy Realists in the US – led these days by John Mearsheimer and Stephan Walt – are mostly right about Afghanistan. As a regional hegemon in the western Hemisphere and an essential offshore power elsewhere, the

[1] A nearly identical version of this paper was published in Advances in Social Science Research Journal, July 2021; the brief Post-script is added in June 2022. My understanding of Afghanistan has benefited from frequent discussion over the years with Lynda Roades and Jeff Bordin, both of whom worked for much longer than I in-theatre.

US has readily defined interests in the Eurasian landmass. It is in the US national interest to prevent another power from becoming a hegemon in Europe, the Far East, or perhaps around the Persian Gulf. As Germany and Russia are in sustained demographic decline, there is now little hegemonic threat in Europe. As oil production from outside the Middle East increases, and as replacements for oil-based energy are in the wings, the US has less reason to be concerned about any power becoming dominant in the Persian Gulf. China, massive though it is, is also in demographic decline: but China remains the one power that could become a hegemon in its region, thereby challenging vital US interests in the 21st century.[2]

The US became involved in Afghanistan around 1980 as part of a international effort to contain the Soviet Union, and again after September 2001 in a reactive effort to hit back at Islamist terror. The recent wars in Afghanistan and in Iraq were complicated by the premise – mostly illusory[3] -- that the US could intervene with military force to re-make traditional Moslem societies into liberal democracies. Neither war had or was intended to have anything to do with countering Chinese power. From a perspective either of the US national interest or of an effort to advance an anti-authoritarian agenda, the Afghan war has been a deadweight from the beginning.

Neighboring countries – including Pakistan, India, Iran, Russia and China – will scramble for position in a post-NATO Afghanistan. Pakistan is likely to want "strategic depth" in the form of an Islamist leadership in Kabul; India and Russia will have different ideas. A guideline for offshore powers like the US is to stay clear of conflicts in locations that have little relevance to their security interests. Unless an improbable turn of events in Afghanistan would greatly boost China's geopolitical position, the US interest (and that of European and offshore Asian allies) will be to stay – offshore.

[2] Mearsheimer (2014) argues that *any* regional hegemon – not just the US -- would act to avoid emergence of a peer competitor.
[3] Mearsheimer (2018) calls it "delusion" in the title of his book.

Nevertheless, there are costs in leaving, in what will with some probability be a collapse of the government the US and its allies have been defending and funding for nearly 20 years. A Taliban takeover will likely mean hundreds of thousands or even millions of refugees into Pakistan, Iran, Tajikistan and Uzbekistan – with hard to anticipate impacts in those countries. It will mean a rollback of progress for women and girls across Afghanistan. (The most encouraging sights I saw around Kabul during my deployments were of elementary or middle school girls appearing in groups on city streets, wearing matching uniforms.) It may shift domestic resistance against the Taliban back to re-energized Tajik and Uzbek warlords in the north and west of Afghanistan, and possibly even to equivalents in the Pashtun south, similar to the case during most of the 1990s; another prospect is that the Taliban will have no militarized domestic opposition at all. If time is as short as it may be, it will be difficult to process US visa papers for Afghan translators and others who assisted the war effort during the last two decades.

The optic is terrible; but in a cynical world, it might not matter. On balance, French prestige and power likely benefited following DeGaulle's withdrawal from Algeria in 1962, just as US power and prestige soon recovered from leaving Vietnam in 1975. In both cases, the exiting power left behind tens of thousands, or more, who had taken their side during hostilities. Most of America's friends around the world believe its post-9/11 wars have been fools' errands, and will look past an ugly Afghan exit.

It may be too late for a better outcome. Pakistan policy continues to provide succor and refuge to the Taliban and other extremist groups. The Afghan administration in Kabul has not established legitimacy beyond slivers of the population. Extreme versions of Islam have long had sway in large portions of the country. I am told that US intelligence has gathered data indicating there is much popular support for a return to Taliban rule; a comforting conclusion for Americans is that the Afghans will have brought it on themselves.

But the US has long been enmeshed in Afghanistan's prospects. It would have been possible for the US to have intervened more effectively in 2001, or even earlier during the anti-Soviet war in the 1980s and in the civil war of the early 1990s. In fact, during the 1980s and into the 1990s, the US mostly outsourced its Afghan policy to the jihadist-dominated Pakistan Inter-Services Intelligence (ISI), thereby undermining support, for example, for the anti-Soviet and anti-Taliban forces led by Ahmad Shah Masood (Tomsen, 2011; passim). (Pakistan leaders have always seen their security threat as coming from India, never from the Soviet Union. US diplomats were usually placated by the charade that Pakistani leaders shared American anti-Soviet sentiments.) After September 2001, the US intervention went back and forth between trying to create a viable national government in Kabul and undercutting that strategy by supporting anti-Taliban regional warlords who had survived from the domestic wars of the 1990s.

Alongside support for a central government, a coherent US and allied strategy during the past two decades would have built on traditional tribal culture and indigenous Afghan opposition to extreme versions of Islam. It would have embraced tribal leaders and moderate clerics. Afghans I knew described such people as "the real leaders of Afghanistan", and added that the US-NATO effort was over-looking them, unaware of them. A better approach would have sought also to nurture provincial government responsibilities, an alternative to near-total reliance on building a centrally-administered nation. The US might also have engaged the Afghan Human Rights Commission, better to have isolated those with unsavory backgrounds from holding senior government positions or participating in elections.[4]

Afghan President Ashraf Ghani (2021) wrote in *Foreign Affairs* in May, subsequent to the Biden Administration's decision to withdraw by September. He proposed that the Taliban might moderate its views, and that perhaps Pakistan

[4] For details, see "Missing Political Front in Afghanistan," included in this volume.

would broker some compromise settlement. He hopes that NATO-trained Afghan troops will be up to the task. On a second reading, it is hard to take Ghani's arguments seriously; he wants the unexpected to happen, perhaps via a foreign intervention, and is trying to say diplomatically correct things. He mentions none of the agenda items from the previous paragraph. One gathers the impression that leaders in Kabul have viewed traditional tribal and religious leaders as domestic opponents.

Prior to departing Afghanistan in 2014, I met with the Minister and/ or Deputy Minister at the Ministries of Borders and Tribes and of Hajj and Islamic Affairs. At both, I was told emphatically of interest in getting US political and modest material support. They wanted to resume initiatives opened by General Stanley McChrystal in 2009 and 2010 – prior to his dismissal for unrelated reasons – but which were neglected under successors Petraeus and Allen. The cost to the NATO-led coalition of providing such support would have been low measured in both personnel engagement and money. Months earlier, I was told by a senior person at the State Department that self-described "realists" there had decided not to meet with anyone from the Human Rights Commission. The State official even encouraged me to try on my own to have such a meeting, as I eventually did – as a DoD civilian, I might have such a meeting without the implicit diplomatic message that a State Department contact would imply. A senior person at the Hajj/ Islamic Affairs Ministry told us that a ranking US official advised him it would violate unwritten US policy to make common cause with an Afghan cleric, even a moderate one.

A cogent war strategy requires gathering in as many allies as possible – not freezing them out. In fact, an agenda that emphasizes working with traditional leaders, expanding subnational governance, and taking rights issues seriously could have boosted the national government's legitimacy. It would have been a step away from the neo-conservative (or neo-liberal) effort to instill Western-style democracy in untilled soil. It would have been a more "realist" – less illusory -- path to stabilization, if not exactly to nation-building. Absent a NATO-led military presence, Afghan leadership may

consider anew potential power relationships in their country; they may yet pursue such an agenda.

Shortly after the Ministerial meetings, I talked with a senior person in Commanding General Joseph Dunford's office to share my impressions. I suggested that our policy might become more imaginative and politically-informed. That person finally told me – in what I took to be more than a deflection -- "The problem is, no one cares." I commented that, coming from the Commander's office, and considering that the US still had tens of thousands of soldiers in-theatre, that was a "revealing" remark. He then implied that someone in Washington had lost interest. If we consider the years of upbeat reports before and since from the US military on the war's progress, it is hard not to conclude that senior officials have been either ill-informed or deliberately misleading.

The US and allied countries will continue to have some sway over developments in Afghanistan. Money will continue to flow, although in smaller amounts; with or without NATO, the US may maintain residual military capacity occasionally to act in-theatre. The US has and will have potential leverage, although it has thus far scarcely used it. Parallels with the US disengagement, and near-implosion of Afghanistan, during the 1990s are more than coincidental. Support can be contingent on adoption of a politically cogent agenda, and on including provincial and traditional leaders who have thus far been left on the sidelines. We should encourage an active role for the Loya Jirga, an assembly of tribal leaders, in negotiations with insurrection leaders. What should be the pressing question now is whether Afghans can develop a political front to counter what Taliban-linked groups will soon offer – and whether NATO and the US can do anything to influence Kabul's agenda.

The prospects for Afghanistan are not good. But within the corners of a Realist geopolitical framework, NATO and the US can begin to improve the odds.

Post-script (June 2022)

An Afghan contact tells me there is resistance to Taliban rule led by Masood's son in two northern provinces, and smaller resistance in other northern and perhaps western provinces. I have no information on their prospects.

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ISBN: 978-625-7501-75-0 (e-Book)
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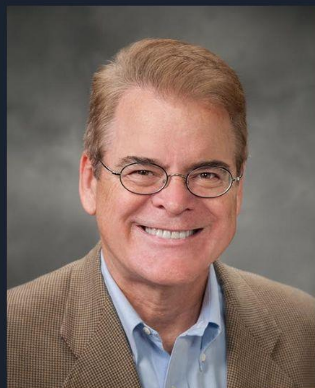

Clark Johnson

Dr. Johnson has written frequently on monetary and development economics, and on topics in diplomatic history, in the Journal of Economics and Political Economy, the Small Wars Journal, the Journal of Social and Administrative Sciences, and Advances in Social Sciences Research Journal, among others. A collection of his articles is published here in open-access format as Uncommon Arguments on Common Topics (June 2022). His Gold, France, and the Great Depression, 1919-1932 (Yale, 1997) received an award from the Association of American Publishers – and has been called the best one-volume account of events that led to the Depression.

Johnson was a senior expert in finance and governance for the United States Department of Defense (DoD) in Afghanistan during 2009 to 2014. He was team leader and senior economist for MPRI, a DoD contractor in Iraq during 2008-2009, on a project to assist post-conflict transition and economic recovery. He later published critical accounts – included here -- of US policy in both wars. He was an economist for the US State Department in Iraq prior to that, and an independent contractor/ economist for USAID, the US Treasury, the British DfID, and the Asian Development Bank going back to 1996; venues included Saudi Arabia, Kosovo, Kyrgyzstan, and Israel-Palestine. He taught financial or international economics at the University of Maryland in Saudi Arabia, the American University in Kyrgyzstan, and Boston University.

Johnson completed a PhD in diplomatic and economic history at Yale University in 1994. He worked on his dissertation with Harry Miskimin, Willem Buiter, and (informally) Robert Mundell. He previously earned a BA in philosophy from the University of Massachusetts (Amherst), and a MBA in corporate finance at UCLA. He is fluent in several languages. During 1981-1987, he was employed at Chase Manhattan Bank where he was promoted to second vice president, and as a vice president at Citibank; he worked in money markets, options, and foreign exchange.

In 2018, Johnson was a Democratic candidate for the Massachusetts State House; but for unfortunate filing errors, he believes the race was winnable. He is an economics advisor at Trade Engine LLC, an IT development firm based in Wyoming. He has been a high school tennis coach, most recently for two seasons at the Chinese Immersion charter school in Hadley, MA. Johnson's daughter, Elizabeth Loss Johnson, PhD, recently joined the faculty of Feinberg Medical School in Chicago.

KSP Books

e-ISBN
978-625-7501-75-0
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