

Economies and War

by George Friedman - June 13, 2022

The American economy, the largest and most dynamic in the world, is a geopolitical issue. And right now, it is in a predictable period of dysfunction. It's been compared – rightly, in my opinion – to the tumult of the 1970s. Unemployment reached 8.2 percent in 1975, inflation rates hit 14.4 percent in 1980 and interest rates were 11.2 percent in 1979. I bought my first house in 1978 at 19 percent interest. It was a hard time, and it was intimately linked to the Vietnam War.

Lyndon B. Johnson inherited that war and intensified it. The U.S. was facing an election in 1964 and another in 1968. By then, things in Vietnam were not going well. Arguably more important to Johnson was what he called the Great Society, a massive and very expensive attempt to wage war on poverty. He was faced with a choice between “guns and butter.” A massive social program and a full-scale war were incompatible, but Johnson was ideologically committed to the social program and couldn't abandon the war. He decided to do both. It was at that point that the economic crisis that would erupt in the 1970s began.

Guns and butter meant either massive borrowing, or massive loosening by the Federal Reserve. Everyone wanted to join Johnson in having his cake and eating it too. The result was both money printing and borrowing, creating massive inflation and weakening of the dollar.

Richard Nixon was elected later, inheriting not only the Vietnam War but also an economy that seemed to be out of control. In August 1970, he did two things nearly simultaneously: He imposed a freeze on prices and wages for 90 days, and he abandoned the gold standard, which had been established by the Bretton Woods Agreement. That agreement obligated Washington to convert dollars to gold at \$35 an ounce. The sudden freeze on prices immobilized the economy, and abandoning the gold standard made the dollar more volatile. Broadly speaking, it decreased in value and led to inflation.

The unemployment rate rose because laying people off was the only way to manage expenses. Interest rates and inflation rose. It appeared that everything was out of control, but the real blow was yet to come. In October 1973, with Nixon wallowing in the Watergate scandal, Egypt and Syria caught Israel by surprise in a stunning and unexpected attack. The U.S. held back from supporting Israel, but as Israel started to run out of artillery shells and other necessities, the U.S. began to airlift supplies in. Arab oil producers responded by placing an oil embargo on the United States and

Israel's other supporters, particularly in Europe. It was a stunning blow to the U.S. economy, where oil prices not only rose but oil became unavailable. Gas stations that had fuel had lines of cars a half mile lined up. Oil was an essential commodity, and it was unavailable. Inflation surged. Unemployment soared as businesses closed. Interest rates rose as banks protected reserves. The oil embargo continued for months among some producers. It's not excessive to say that the American and other economies were heading toward meltdown. The political maneuvers that had impacted the U.S. economy over previous years now seemed modest.

What began with the Vietnam War accelerated with the Arab-Israeli War. The real pain did not come until the early 1980s, when a new political paradigm confronted the idea that inflation and high interest rates not only affected private life but drastically constrained investment and in turn opened the door to Japanese exports. A shift in the tax code that increased investment and decreased consumption solved the problems created first by war and then by politics. Ronald Reagan happened to be president and carried out policies that he had no choice but to carry out. What started with guns and butter ended in the capital that drove the technology boom.

It is easy to blame Johnson and Nixon, but they executed policies demanded by the public. The public wanted the problems solved at no cost to them. Since that was impossible, the political system generated the illusion of a solution. That illusion satisfied short-term public demands, the demands that frequently end in greater pain than they imagined.

In other words, war begat an unintended consequence. Another war imposed an extraordinary hardship but led to an upheaval in the political system. As I have written elsewhere, this is how our culture works. In our era, the end of the cycle began with COVID-19, which had the same disruptive effect as a war and created the same raging anger. This has been followed by another war, Ukraine, which is having a massive effect on the global economic system. Inflation is surging and interest rates rising.

If my model follows course, the political system will not be able to solve the problems before the end of the decade. We will of course blame the politicians for what happens, as that is an American tradition. The irresistible process creates the pain, and the miracles demanded by the public will make things worse. The politicians will be blamed. But it clears out the system and readies us for the future.

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