Requiem for the Faith-based Greenback

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> The great dollar sell-off has begun in earnest, although to a large extent, it is being concealed from the public.

Wary currency traders have been expecting a dollar-slide for months but were nervous about the possibility of widespread panic. Everyone from Bill Gates to Paul Volcker has predicted that the current trade deficit of $800 billion (7% of GDP) would inevitably produce a weaker dollar, so it is only natural that China, Japan and other foreign lenders would begin to cut back on their purchases. The danger to the United States, however, remains extreme. If the transition doesn't go smoothly, it could precipitate a run on the dollar and trigger economic pandemonium. No one wants to see the world's economic powerhouse pirouetting through the ether in flames. By the same token, no one wants to be the last man holding onto stockpiles of scrip that are diminishing in value.

The delicacy of the situation explains the sudden appointment of Henry Paulson as Treasury Secretary. Paulson is a brainy insider who has the bone fides to manage a very tricky "retreat" from the dollar. America's economic future will depend heavily on his ability to steer the ship of state through troubled waters.

As we said, there was no doubt that China, Japan and others would eventually reduce their dollar-holdings as America's debt continued to mount. What is surprising though is that a sell-off did not occur earlier when Bush enshrined his reckless tax cuts and profligate spending as "permanent". The administration's fondness for living beyond its means has never been in doubt, now greenback will pay the price for Bush's excessiveness.

Of course, Bush is not the main scoundrel in this morality play. The Federal Reserve has weakened the dollar enormously by engineering one monetary-coup after another. Greenspan's "cheap money" policy has created massive equity bubbles that appear whenever interest rates are absurdly low. When the stock market crashed in the late 90s, millions of working class people lost their retirement and life savings overnight, while wealthy insiders walked away unscathed. Undaunted by the economic carnage he produced, Greenspan again lowered interest rates to a ridiculous 1% in 2001 which created a $9 trillion housing bubble, "the largest equity bubble of all time" (says "The Economist"). Now, as interest rates inch higher, the housing industry is lumbering towards the power-lines and certain death. The effects on the world economy will be catastrophic.

Under Greenspan, the money supply expanded at an unbelievable rate. "From 1982 to 1992, it went from a "modest" 8% year-on-year expansion. However, from 1992 to 2002 it moved into overdrive with the deregulation of global markets with a year-on-year expansion of more than 12%. Since the 2002 post 9/11 crash, the money supply has been expanding at greater than 15%"; more than doubling in less than a decade. ("Fiat and Credit" Nigel Maund)

Now there are signs that foreign lenders are tired of the weakening dollar and are reducing their stockpiles of greenbacks and dollar-denominated securities. The Gold Forecaster reports in its recent article "The US Dollar and its Prospects":

“Last month saw the U.K. and Caribbean Banks buy a disproportionately large amount of U.S. Treasury assets. It appears that this is part of an international dollar liquidity management program. If this is correct the two centers will buy even more from now on, as other foreigners reduce their purchases of the U.S.dollar.”

This means that China and Japan have begun to reduce their purchases of US Treasuries but, surprisingly, some mysterious third party has begun to pick up the slack.

Who is crazy enough to increase their dollar-holdings when most analysts are predicting a loss in value?

Apparently, the Bush administration (along with the Federal Reserve) is purchasing its own debt (Treasuries) to control the rate at which the dollar declines. It’s a good strategy, but it can’t last forever.

If the dollar began a sudden nosedive, central banks around the world would quickly ditch their stockpiles and ignite a global-economic firestorm. By purchasing its own debt, the US hopes to engineer a “soft landing” while maintaining its status as the world’s “reserve currency”.

As the world’s reserve currency, the Fed can simply print money which the rest of the world accepts as payment for its manufactured goods and resources. It’s the slickest deal on earth. As one admiring currency-trader said, “It’s like having a mint in your own backyard.”

The system was put in place after the vast devastation of World War 2 and has made the Federal Reserve the de-facto steward of the global economic system. Nearly 70% of the reserves in foreign central banks are either dollars or dollar-denominated securities. This is as close to a monopoly as it gets.

The expansion of the dollar is the greatest fiat-money experiment in history. The awesome power of the greenback extends to all markets, and yet, is completely disconnected from the traditional means of measuring value, like the gold standard.

It’s clear that Bush believes that the dollar can survive “devaluation” if the US is able to control the vast oil resources in the Middle East. Foreign countries will be forced to use the dollar in their oil purchases regardless of the staggering trade deficits. The dollar’s value will continue to be pegged to oil while its future will increasingly depend on the military’s success in Iraq and, potentially, Iran. Needless to say, the results are far from certain.

Even if the administration’s plans in the Middle East succeed, there are stormy times ahead for the greenback. The United States has reached an unsustainable level of debt in government, business and personal finances. Personal savings are down, mortgage payments are up, and credit card debt is higher than ever. The entire country is mired in swamp of red ink for which there is no easy remedy.

James Shepherd, President of JAS MTS Inc. puts it this way:

“A perfect storm is developing and much of this danger has to do with debt. …When a saturation point of debt and leverage is reached, even a minor dislocation can cause a dramatic collapse….Debtors are always punished more severely in a declining economy because, as activity subsides, they are less able to service their debt and the value of the assets that have collateralized are also falling. Once those that own real estate realize that their neighbors cannot service their mortgages and are forced to sell at almost any price, thereby driving down the perceived value of their own property, the conditions necessary for a full-fledged debt-driven meltdown will be in place… a severe recession - is about to sweep over the landscape and blow away those who are not prepared."

The predictions of Warren Buffett, Chairman of Berkshire Hathaway, are equally sobering:

"There are deep-rooted structural problems that will cause America to continue to run a huge current-account deficit unless trade policies either change materially or the dollar declines by a degree that could prove unsettling to financial markets. Indeed, without policy changes, currency markets could become disorderly and generate spill-over effects, both political and financial." (Quotes form Dudley Baker, "Ominous Warnings and Dire Predictions of World's Financial Experts")

"Could the falling dollar lead to "political turmoil", as Buffett suggests?

The Organization for Economic Cooperation (O.E.C.D.) has joined skeptics at the IMF in predicting that the dollar will fall by 35% to 50% in order to balance current account deficits. These are modest predictions given the enormous amount of debt the US has accumulated in just the last 6 years. ($3 trillion) Consider how life for the average American will change when gas is $6 per gallon rather than $3; when groceries skyrocket to twice their normal price, and when life-savings are cut in half overnight.

The greenback is now facing its greatest challenge due to its massive account imbalances, reckless mismanagement, and erosion in confidence. The only way the dollar can slow its downward slide is by maintaining its stranglehold on the oil trade. Currently, oil is sold exclusively in dollars which allows the US to float trillions of greenbacks through the system without fear of them being cashed in. Unfortunately, there's rebellion among the vassals. Iran (5.4% daily world oil output) Venezuela (5.2% daily world oil output) and Russia (15.3% daily world oil output) are all threatening to abandon the dollar in their oil transactions which would send hundreds of billions of dollars back to the US and plunge the country into a deep recession. If this mutiny succeeds, the dollar will vanish in a poof of black smoke.

Abolishing the M-3

In late March, 2006 the Federal Reserve ceased publishing the M-3, the indicator of how many dollars are currently in circulation. This removes all the reliable data on the dollar's value. Now, the public has no way of knowing what is going on with its own currency. This lack of transparency will be disastrous for the dollar as the use of money is predicated on confidence. By making their activities as opaque as possible, the Fed has undermined the publics' trust and added to the anxiety in the markets.

America's biggest lenders in Europe and Asia are now expected to calculate the value of the dollar without the statistical tools they need to make a reasoned judgment.

That does not inspire confidence.

How long will countries continue to loan money to a nation that takes a "trust me" attitude, especially when the government is as widely distrusted as the Bush administration. The removal of the M-3 may seem like a short-term fix to obscure the machinations of the Fed, but over time it will be seen as a costly mistake.

Paulson to the Rescue

Newly-appointed Treasury Secretary Henry Paulson has been given the daunting task of closing ranks with the Federal Reserve and supervising an “orderly devaluation" of the dollar. There's great concern that a “sudden disorderly adjustment” will precipitate a run on the dollar, traumatizing the markets and sending the economy into a tailspin. Regrettably, there are no easy choices; the dollar is losing air, and fast. The accumulated weight of unfunded tax cuts, extravagant military expenses, personal debt, and global trade imbalances have taken a wrecking-ball to the greenback and left little room for hope. Paulson’s job is to turn the dollar’s downfall into a “controlled demolition” rather than a full-system meltdown.

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