

## **DOOMSDAY FOR THE US DOLLAR: POST MORTEM FOR THE WORLD'S "RESERVE CURRENCY"<sup>1</sup>**

**Mike Whitney**©

Paul Volcker is worried about the future of the dollar and for good reason. The Fed has initiated a program (Quantitative Easing) that presages an end to Bretton Woods 2 and replaces it with different system altogether. Naturally, that's made trading partners pretty nervous. Despite the unfairness of the present system--where export-dependent countries recycle capital to US markets to sustain demand---most nations would rather stick with the "devil they know", then venture into the unknown. But US allies weren't consulted on the matter. The Fed unilaterally decided that the only way to fight deflation and high unemployment in the US, was by weakening the dollar and making US exports more competitive. Hence--QE2.

But that means that the US will be battling for the same export market as everyone else, which will inevitably shrink global demand for goods and services. This is a major change in the Fed's policy and there's a good chance it will backfire. Here's the deal: If US markets no longer provide sufficient demand for foreign exports, then there will be less incentive to trade in dollars. Thus, QE poses a real threat to the dollar's position as the world's reserve currency. Here's what Volcker said: "The growing sense around much of the world is that we have lost both relative economic strength and more important, we have lost a coherent successful governing model to be emulated by the rest of the world. Instead, we're faced with broken financial markets, underperformance of our economy and a fractious political climate.....The question is whether the exceptional role of the dollar can be maintained." (Bloomberg)

This is a good summary of the problems facing the dollar. And, notice that Volcker did not invoke the doomsday scenario that one hears so often on the Internet, that China--which has more than \$1 trillion in US Treasury and dollar-backed assets--will one day pull the plug on the USA and send the dollar plunging. While that's technically true, it's not going to happen. China has no intention of crashing the dollar and thrusting its own economy into a long-term slump. In fact, China has been adding to its cache of USTs because it wants to keep its own currency weak and maintain its hefty share of the global export market. Besides, China didn't become the second biggest economy in the world by carrying out counterproductive vendettas against its rivals. It's going to stick with the strategy that got it to where it is today.

Still, as Volcker points out, there are real threats to the dollar, and they're getting more serious all the time. For example, if the deficits continue to balloon as they have recently (\$1.3 trillion in 2010) or if Fed chairman Ben Bernanke follows QE2 with QE3, QE4, QE5 ad infinitum, then foreign investors and central banks will begin to lose confidence in the US's ability to manage its finances and they will begin to ditch the dollar. That will increase the cost of funding government operations by many orders of magnitude. In fact, it looked like something like that was happening just last week when President Obama announced his approval for extending the Bush tax cuts. The markets figured that extending the cuts would swell the deficits which would force the Treasury to issue more debt. That triggered a flight out of USTs that sent yields up sharply. The bond market suffered its biggest 2-day selloff since 2009. The incident provided a snapshot of what's in store when the economy begins to recover and the government has to pay higher rates to service the debt.

---

<sup>1</sup> Global Research, December 14, 2010, URL: [www.globalresearch.ca/index.php?context=va&aid=22402](http://www.globalresearch.ca/index.php?context=va&aid=22402)

In any event, the one-two punch of bigger deficits and QE cannot help but push the dollar lower, but that does not necessarily imply that the dollar will lose its top-spot as reserve currency. It's more complicated than that. Here's how economist Menzie Chinn summed it up when he was asked how it would affect the US economy if the dollar lost its position as the world's reserve currency:

*"If the dollar does indeed lose its role as leading international currency, the cost to the United States would probably extend beyond the simple loss of seigniorage narrowly defined. We would lose the privilege of playing banker to the world, accepting short-term deposits at low interest rates in return for long-term investments at high average rates of return. When combined with other political developments, it might even spell the end of economic and political hegemony."*

Maintaining reserve status is the great imperative, because reserve status is the cornerstone upon which the empire rests. Lose that, and the whole superpower phenom begins to teeter. So, quirky, untested policies, like QE, are not initiated without a great deal of thought. (and apprehension) The Fed tries to anticipate what could go wrong and work out an exit strategy. Kevin Warsh, who is a member of the Board of Governors at the Fed, gave a good rundown of the potential problems with QE in an article in the Wall Street Journal. Here's an excerpt:

*"The Fed's increased presence in the market for long-term Treasury securities also poses nontrivial risks. The Treasury market is special. It plays a unique role in the global financial system. It is a corollary to the dollar's role as the world's reserve currency. The prices assigned to Treasury securities--the risk-free rate--are the foundation from which the price of virtually every asset in the world is calculated. As the Fed's balance sheet expands, it becomes more of a price maker than a price taker in the Treasury market. And if market participants come to doubt these prices--or their reliance on these prices proves fleeting--risk premiums across asset classes and geographies could move unexpectedly. The shock that hit the financial markets in 2008 upon the imminent failures of Fannie Mae and Freddie Mac gives some indication of the harm that can be done when assets perceived to be relatively riskless turn out not to be."* ("The New Malaise", Kevin Warsh, Wall Street Journal)

This is an astonishing admission for an acting member of the Fed. Warsh is basically conceding that the Fed is price-fixing on a global scale ("more of a price maker than a price taker") and he worries that this could undermine confidence in the bond market. The danger, as he sees it, is that investors will see through the ruse of government guarantees (like those for Fannie and Freddie) and exit the asset class altogether sinking the dollar on their way out. This is the grimmest scenario I've seen yet, but it seems much more plausible than the "China will dump its Treasuries all at once" theory.

The administration's support for Bernanke's "weak dollar" policy is evident in the way that Obama keeps reiterating his promise to double exports in 5 years. This simply can't be done without ripping the dollar to shreds, which appears to be Obama's intention. QE will lower the dollar's value against a basket of currencies which will make US exports cheaper than the competition. Bernanke sees it as a way to narrow the output gap and lower unemployment by cranking up the printing presses. Foreign trading partners see it as beggar-thy-neighbor monetary policy at its worst, and they are deeply resentful. They'd rather see Congress do what it's done in the past, and push through a second round of fiscal stimulus to boost demand. They don't care about how big the US deficits are as long as they are used for a good purpose. And pulling the world out of a global slump is a good purpose. But that's not going to happen because

the new GOP majority wants to implement their madcap "austerity" scheme which will bankrupt the states and dismantle popular social programs. They're as committed to "starve the beast" as ever, and they're convinced it's a winning strategy for retaking the White House in 2012. But belt-tightening reduces demand which makes American markets less attractive for foreign products. If the US economy continues to underperform, there will be less reason for foreign investors and central banks to stockpile dollars. The Fed's QE, Obama's export strategy, and the GOP's plan for debt consolidation are creating ideal conditions for an unexpected plunge in the dollar.

But there are other problems facing the dollar besides falling value and droopy demand. As Volcker says, "We have lost a coherent successful governing model to be emulated by the rest of the world. Instead, we're faced with broken financial markets, underperformance of our economy and a fractious political climate." Indeed. Public confidence in US markets has steadily eroded as one scandal follows the other and the people involved are never held accountable. So far, not one CEO or CFO of a major investment bank or financial institution has been charged, arrested, prosecuted, or convicted in what amounts to the largest incident of securities fraud in history. In the much-smaller Savings and Loan investigation, more than 1,000 people were charged and convicted. As Volcker points out, the system is broken and the old rules no longer apply. The small gains that were recently made in Dodd-Frank financial regulation, are now under attack by the new majority in congress. The GOP has pledged to either roll back entire provisions of the bill or do what they can to make the law unenforceable. Here's a quick look at two of the Republican leaders who will be leading the effort to "defang" Fin-Reg:

*"A heated battle is underway between Rep. Spencer Bachus, R-Ala., who is in line to become the next chairman of the House Financial Services Committee, and Rep. Ed Royce, R-Calif., who is challenging him for the post currently held by Democrat Barney Frank of Massachusetts....More than half the \$1.25 million donated to Royce's Road to Freedom political action committee (PAC) over the last two election cycles came from banks, auditors and insurance companies, according to the Center for Public Integrity."*

Bachus... too, has deep financial ties to the industry, which contributed more than half the \$2.7 million in PAC money he received in the past four years. ("Defang and Delay—Wall Street Plans to Neuter FinReg", Merrill Goozner, The Fiscal Times) There's no doubt that Royce and Bachus are in Wall Street's pocket and are ready to do their bidding. Whatever inroads were made on the main issues-- Too Big To Fail, resolution authority, central clearinghouses and capital standards for derivatives, securitization, funding for the Consumers Financial Protection Agency (CFPA) etc.---will either be sabotaged or challenged by financial industry agents working from within the congress and senate. Here's a blurb from a post by Zach Carter who hangs some big numbers on congressional influence peddling:

*"A full 90 members of Congress who voted to bailout Wall Street in 2008 failed to support financial reform reining in the banks that drove our economy off a cliff. But when you examine campaign contribution data, it's really no surprise that these particular lawmakers voted to mortgage our economic future to Big Finance: This election cycle, they've raked in over \$48.8 million from the financial establishment. Over the course of their Congressional careers, the figure swells to a massive \$176.9 million.... When it comes to dealing out economic damage, no special interest group has been able to wreak more havoc than Big Finance..." (Crony Capitalism: Wall Street's Favorite Politicians", Zach Carter, ourfuture.org)*

Wall Street is the epicenter of global corruption; the world's biggest sewer. Its multi-trillion dollar Ponzi-mortgage scheme brought down the global financial system which was hastily resurrected by blanket Fed guarantees on fraudulent bonds and securities generated by undercapitalized financial institutions. But as bad as the bailout was, the Fed's ongoing meddling in the equities markets is even worse because shows to what extent the markets are being juiced. Consider this excerpt from an article on Bloomberg on Monday that shows the connection between the Fed's purchases of US Treasuries (QE) and the predictable surge in stock prices:

*"Nine of the S&P 500's 10 main industry groups, led by shares of financial companies, rose more on days when the Fed opened its checkbook for, or announced results of, what it calls Permanent Open Market Operations. The group of 81 banks, insurers and investment firms, including New York-based JPMorgan Chase & Co. and Wells Fargo & Co. of San Francisco, climbed an average 0.32 percent, compared with a 0.04 percent drop on non- POMO days...."*

FX Concepts LLC, the world's largest currency hedge fund, buys higher-yielding assets such as stocks and the Australian dollar when the Fed is purchasing bonds, said John R. Taylor, who manages about \$8 billion as chairman of the New York-based firm. The days have become "incredibly important for the market," Taylor said. ("Stocks Rally With Bernanke Bond Purchases as QE Buys S&P 500", Bloomberg)

This phenomenon has long been a topic of debate on economics blogs, but now that it's in the mainstream, people are likely to sit up and take notice. Bernanke's money is going in one end and coming out the other in the form of "frothy" stocks. Just like high-frequency trading, dark pools, off-balance sheets operations, shadow banking, securitization, and the billions in unreported mark-to-fantasy toxic assets; this latest discovery by Bloomberg will further confirm that Wall Street is a murky underworld of insider trading, criminal activity and Fed-sanctioned grand larceny.

### **Doomsday for the Buck**

The dollar's days as reserve currency may be coming to an end, but it won't be because China decided to jettison its pile of US Treasuries. Oh, no. It will be because austerity measures in the US reduced demand for imports making it less necessary to trade in dollars. And, it will be because Obama's "weak dollar" policy led to the demise of Bretton Woods 2 which kept interest rates low by recycling capital into the US. And, it will be because Congress and the White House were incapable of fixing the financial system, reigning in Wall Street, or restoring credibility to the markets. These are the real reasons the greenback is toast. As Volcker opines, "We're faced with broken financial markets, underperformance of our economy and a fractious political climate" because we no longer have "a successful governing model" that the rest of the world admires. Absent radical restructuring and a new regulatory regime, the dollar will be unable to maintain its "exceptional role" as the world's reserve currency.

It's only a matter of time.