Dollar Collapse Update: “Obama Demands Pay in Euros!”

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The “dollar debate” on the Internet has been ferocious and emotionally-charged, but sadly lacking in logic. To oppose the “dollar will crash” theorists is like arguing a woman’s right to choose with the fist-waving throng assembled outside an abortion clinic. The results are equally disappointing. To say that “minds are already made up and the issue is settled”, is an understatement. For many, the dollar’s transition from the world’s reserve currency to a Wiemar era Deutschemark is not a question “if” but only of “when”. One reader summed up the distrust that’s felt for anyone who dares to challenge the prevailing dogma like this:

“Mike…..Your article on October 19th 2009 titled “The Dollar will NOT crash,” made all of us in this part of the world who respected your views and opinions feel disturbed and appalled….Then my friend explicated and reminded me, “From the time of Chaim Weizmann’s solicitous and guile behavior towards the politicians, the media and the newspersons, the powerful Zionists lobby had perfected the art of falsity and misrepresentation.”

Uh, okay. So, now opposing the dominant theory not only proves that one is a fool, but also a tool of the “Zionist lobby”?

This is why struggling writers always keep the refrigerator stocked with a hearty malt.

No one can deny that the dollar COULD crash or that it faces stiff headwinds in the years ahead as the fiscal deficits continue to pile up. But let’s not overreact. Japan’s deficits are twice the size of GDP and bond yields are still hovering below 2 percent. In other words, the Japanese are fighting deflation, so no one is particularly worried about inflation. That’s as it should be. In the US, deficits are a paltry 12 percent of GDP, and already people have their knickers-in-a-twist. Even deficits soar above 100 percent ($14 trillion) it’s unlikely that they’ll crush the dollar. But–on the other hand– if the government suddenly stops spending money and running huge deficits; unemployment will skyrocket, banks and businesses will default, foreclosures will rise, and the economy will slip back into a very severe recession. The myth that “You can’t solve a debt problem by creating more debt” is pure bunkum. That’s for people who want to balance the budget at all costs, regardless of its effect on working people. The goal should be to get the economy back on its feet and worry about the red ink later.

Here’s Paul Krugman explaining why the Fed is engineering a weaker dollar:

“Although there has been a lot of doomsaying about the falling dollar, that decline is actually both natural and desirable. America needs a weaker dollar to help reduce its trade deficit, and it's getting that weaker dollar as nervous investors, who flocked into the presumed safety of U.S. debt at the peak of the crisis, have started putting their money to work elsewhere.

But China has been keeping its currency pegged to the dollar — which means that a country with a huge trade surplus and a rapidly recovering economy, a country whose currency should be rising in value, is in effect engineering a large devaluation instead.

And that's a particularly bad thing to do at a time when the world economy remains deeply depressed due to inadequate overall demand." (Paul Krugman, "The Chinese Disconnect" New York Times)

So, if China is so worried about their massive investment in dollars, (as everyone seems to think) then why aren't they letting their currency rise so the dollar can weaken? It's because they are more concerned about sustaining demand then problems with the greenback. They're showing they have more confidence in the dollar than most Americans.

It is true that the dollar has dipped 15 percent since summer, but so what? That just means that people are less scared now then they were after Lehman Bros. collapsed. Here's a clip from the Economist explaining it all:

"The simplest explanation for the currency's decline is based on risk aversion. On the days when risky assets fall, the dollar tends to go up. When risky assets rise, the dollar falls. The dollar has fallen fairly steadily since March, a period which has seen stockmarkets enjoy a phenomenal rally. Domestic American investors may be driving the relationship, repatriating funds in 2008 when they were nervous about the state of financial markets and sending the money abroad again this summer because of a perception that the global economy is reviving." ("Down with the Dollar" The economist, Oct, 2009)

As time goes by, the relationship between stocks and the dollar will change, but for now, the rule is still holds.

So why is this debate about the dollar so important?

Because the majority of people believe that the real problem is the deficits, and not the economy. That's just flat wrong, and it creates political opposition to more stimulus, which we need. Blame it on the media for convincing people that we are in a recovery and that "green shoots" are sprouting up everywhere. It's pure fiction. The country could still wind up in a Depression when the stimulus wears off. And it's wearing off very quickly. (The effects of the stimulus will peak in the Third Quarter)

Consumer credit is contracting at a year-over-year rate of 5 percent. Household balance sheets are in tatters, savings are up, spending is down, and unemployment is headed for 10 percent. Record foreclosures, delinquencies, bankruptcies, and defaults are sucking credit from the system making it harder for the Fed to keep the economy sputtering along. If the Fed cuts off the bloodflow of monetary stimulus, the patient will slip into a deep coma.

Here's a likely scenario of what could take place in the next few months:

Even though the signs of severe deflation are visible everywhere, investors short the greenback and the dollar plunges to $1.60 per euro. That increases public angst which sets off a firestorm on Capital Hill. The Congress forces the Fed to stop its quantitative easing

(QE) program (which has already pumped over $1 trillion into US Treasuries and mortgage-backed securities) and long-term interest rates spike overnight. This puts downward pressure on the housing market and the slump deepens. More jobs are lost, more banks and financial institutions default, perfectly good businesses cannot role over their debt and call it quits, prices fall across the board, the stock market retraces its March lows, and the economy ends up in the ditch.

Think it can't happen?

Bernanke's problem, is that all the tools at his disposal are blunt instruments. It's like performing kidney surgery with a meat cleaver. Dropping interest rates and printing money can stave off deflation, but it also pushes stocks higher than anyone really wants. That leaves traders on the sidelines waiting for a market correction before they jump back in. The same is true of the dollar. Sure, Bernanke wants a cheap greenback to spark exports and reduce household debt, but when the dollar plunges to $1.60 per euro, then the sh** hits the fan and the public outcry forces him to change directions. If the dollar falls any further, the Fed will have to shut down the printing presses altogether and watch while the boat capsizes. The problem is more political than economic.

US policymakers should drop this nonsense about the dollar and deal with the underlying problem itself; lack of demand. That means the focus should be on wage growth and full employment. If that means printing up a couple more trillion; then get to it! Getting people back to work and paying them decently should be job one.

(Note: Title was taken from a comments line on a previous article from Dmark)