The Future of the Dollar

By futureofdollar.com
Global Research, February 18, 2010
futureofdollar.com 17 February 2010

Region: USA
Theme: Global Economy

The World is concerned that the dollar cannot play the role of the main reserve currency any longer after the financial crisis sparked by the collapse of the U.S. mortgage market led to the worst global recession since the 1930s. The Government's stimulus packages, financial bailouts, the need to support liquidity in Treasuries, keeping interest rates at the lowest level under the circumstances of low economic growth, high unemployment and low tax collection make it print more dollars. This leads to a high risk of substantial inflation, or hyperinflation in a long-run.

With a $12.3 trillion national debt and $55 trillion in unfunded obligations for programs such as Social Security, Medicare and Medicaid, with total Federal Reserve and Treasury bailout commitments now at $11.8 trillion, of which $3.6 trillion has already been spent the U.S. need to take steps immediately to protect themselves from the potential loss of the purchasing power of their U.S. Dollars, inflation.us warns.

Although there is still no significant inflation data in the United States international stock and commodity markets grew abnormally within the last eleven months. Analysts called it the "flight from the dollar" or "diversifying risks."

There are many factors evidencing against the future of the dollar as a global reserve currency. In the present article futureofdollar.com pays attention to the crucial points of analysis after conducting an extensive research on the topic.

Part I

Weak Fundamentals of the U.S. Economy

Nobel Prize winner Paul Krugman states that "a country whose fundamentals are persistently and predictably deteriorating will necessarily have a [currency] crisis at some point." (1)

1. National Debt

In the middle of February 2010, President Obama signed into law the bill increasing the public debt ceiling from $12.394 trillion to $14.294 trillion. This is a second increase in the upper limit on the national debt in less than two months.

Last time, in December, House Majority Leader Steny Hoyer commented that the Congress simply had no other choice: otherwise the United States would have to default on their debt obligations what would be another catastrophe for financial markets. (2)

The Peterson-Pew Commission on Budget Reform stated that "the United States would almost certainly experience a debt driven crisis," that "could unfold gradually or it could happen suddenly, but with great costs either way." "The excessive debt would. . . affect citizens in their everyday lives by harming the American standard of living through slower economic growth and dampening wages, and shrinking the government's ability to reduce taxes, invest, or provide a safety net." (3)

2. Unemployment

This past January, the economy lost 20,000 jobs after loosing 150,000 jobs in December, and the unemployment rate was 9.7 percent. (4)

The unemployment rate fell from 10.0 to 9.7 percent in January. According to Reuters "a sharp increase in the number of people giving up looking for work helped to depress the jobless rate. The number of 'discouraged job seekers' rose to 1.1 million in January from 734,000 a year ago."

3. Budget deficit

IMF's Managing Director Dominique Strauss-Kahn noted at the 10th Annual Herzliya Conference in Tel Aviv that the global crisis had created a problem of fiscal sustainability for many countries that could take decades to fix because of the huge debts built up during the crisis, especially in developed countries. (5)

The United States reached a record budget deficit of $1.415 trillion in fiscal year 2009 that ended in September. (6) The deficit will probably again exceed one trillion dollars in the current fiscal year as it is already over $400 billion.

The excess of spending over revenue in the United States rose to $91.9 billion in December 2009, as opposed to a deficit of $51.8 billion in December 2008, the Treasury Department announced in its monthly budget statement. The U.S. has posted a record 15 straight monthly deficits. (7)

In the beginning of February 2010 Obama transmitted a $3.8 trillion budget for 2011 to the Congress with a record $1.6 trillion deficit. (8)

During the debate on the national debt the Senate "rejected a proposed bipartisan commission to recommend ways to reduce the U.S. budget deficit," Bloomberg reported. "The legislation would have required that the panel's recommendations be voted on by Congress without being amended." (9)

4. Financial sector

Recent Bank of America's and Citigroup's losses for the fourth quarter of 2009 and inability to repay the bailout funds without additional stock offering, Morgan Stanley's low profits, and J.P. Morgan Chase's retail division loss confirm a suspicion that the U.S. banks' economic conditions are not very strong putting in doubt health of the financial sector as a whole.

"Loan demand continued to decline or remained weak in most Districts." (10)

"A number of Districts reported that credit quality continued to deteriorate." (11)

5. Home Sales

Existing-home sales fell 16.7 percent in December 2009 "after first-time buyers rushed to complete sales before the original November deadline for the tax credit," the National Association of Realtors reported. (12)

According to the U.S. Bureau of the Census sales of new single-family houses declined 7.6 percent in December 2009, following a drop of 9.3 percent in November. Bloomberg noted that for all of 2009, sales declined 23 percent to 374,000, the lowest level since records began in 1963. (13)

6. Economic impact of U.S. international military operations

The cost of conducting wars in Iraq and Afghanistan pushed the budget into the red during the presidency of George W. Bush. The situation deteriorated after the beginning of the financial crisis when the government adopted measures such as stimulus packages, financial bailouts, the need to support liquidity in Treasuries, etc. Moreover, early in December 2009 it has increased its nonproductive expenses by approving 30,000 troops to be sent to fight in Afghanistan.

All economists agree that one of the basic nonmonetary reasons of inflation is the existence of significant nonproductive government expenses such as military expenses.

Chris Rupkey, chief financial economist at Bank of Tokyo-Mitsubishi UFJ Ltd. in New York, said Obama may have too much on his plate. "You can't fight a war, a financial crisis, a recession, and add health-care coverage to the uninsured at the same time," he said. "It is simply the recipe for disaster." (14)

However important goals of the war could be, military operations are, undoubtedly, very costly for U.S. citizens especially at the time of the financial crisis and growing deficits. Moreover, the situation is not getting better considering that around 40 percent of the war financing has been borrowed from abroad, Joseph Stiglitz, the Nobel Prize Winner, shows in his research "The Three Trillion Dollar War: The Real Cost of the Iraq Conflict."

Explaining why wars are expensive he points out that military expenditures are not only limited to direct operation costs but also include (the bigger part) human casualties, future disability costs, loss of income, increased oil prices, opportunity costs, veterans' social welfare, nonproductive spending, loss of confidence in the future economic situation, increase in the national debt, and so on.

"If we try to stay the course, we are going to spend more and more money," Stiglitz stresses. "The fact that we financed the war totally by deficits means that when 10 years from now we decide we want to repay that, which I don't know if we will, the amount that we will have to raise our taxes will be that much larger because the debt will be that much larger."

7. China's peg to the dollar

So far China is enjoying low yuan rate giving its exports competitive advantage in relation to those countries with appreciating currencies against the U.S. dollar.

As the result China is actually “stealing” jobs from many countries since with appreciating currencies their companies are not able to compete with Chinese producers.

In relation to the United States this means that the country should not count on sooner recovery. China’s peg to the dollar makes imports into the U.S. cheaper. This supports high level of unemployment in America. Unemployment prevents the growth of GDP and reduces revenues.

Part II

Lack of Coincidence

Defining major reasons of currency crises Paul Krugman states that the most important is a lack of confidence. The “investor lack of confidence – is a defining feature of a currency crisis,” he argues. (15)

Below are opinions of a number of people from different parts of the world whom many of us know quite well. Their opinions concern the U.S. dollar and the U.S. economy.

Nouriel Roubini, the New York University professor who predicted the financial crisis, said that the greenback may weaken for the next three years. (16)

Warren Buffett, a successful international investor: “There is the likelihood of significant inflation down the road.” (17)

Robert B. Zoellick, the World Bank President: “There is little the United States can do about the sinking value of the dollar except restore growth in its economy.” (18)

George Soros, a successful international investor: “Irrespective of the situation in the stock markets or condition of the economy we shall see further shift from the dollar into real assets in a long run.” (19)

Jim Rogers, a successful international investor: “Printing money to help the U.S. economy will weaken the greenback and Treasuries in a long run.” (20)

Joseph Stiglitz, Nobel Laureate in Economics: The greenback will continue to head downward for the time being, given the huge U.S. trade deficit and global trade imbalance. (21)

Fan Gang, a prominent economist and adviser to China’s central bank: “This crisis is a U.S. dollar crisis, which takes a relatively long time to clear up. The problem involves the U.S. currency and U.S. debt; eventually it has to be solved through U.S. dollar depreciation.” (22)

Yuri Luzhkov, City of Moscow Mayor, Russia: The world is on the brink of a radical devaluation of the American currency. Therefore, Russia has to abandon its dependency on the dollar as soon as possible. American currency reserves are supported by nothing and industrial production in this country is very low. (23)

The list of well-known people with similar thinking is endless. In its research futureofdollar.com faced a difficulty of finding successful investors, economists or foreign politicians with the opposite thinking. There are just a few of them. Most of them are the U.S. government officials whose job is to restore the confidence in the U.S. economy with a part of this job being speaking in ‘positive’ terms.

People in this group either believe that:

*the recession is over and the U.S. economy will have a sharp rebound, or
*that the dollar will remain the primary reserve currency for a long time because during this last financial crisis investors found the dollar a safe haven, or
*that there is no inflation threat relying on the U.S. government data, or
*simply stating that “we will sink or swim with the dollar.”

For instance, Barack Obama is confident that the dollar is “extraordinarily strong” because investors are confident in the ability of the U.S. to lead a worldwide recovery. (24)

The Chairman of the U.S. Federal Reserve Ben Bernanke believes that U.S. asset prices aren’t out of line with underlying values, and central bank policy will ensure that the “dollar is strong.” (25)

The U.S. Treasury Secretary Timothy Geithner forecasts that the dollar will remain the world’s “dominant reserve currency.” (26)

Therefore, we came to a conclusion that, unfortunately, the U.S. economy and the dollar are losing confidence. The U.S. government must work even harder now to restore it.

Part III

Diversification Out of the Dollar

It is hard to argue that the future of the dollar nowadays significantly depends on such developing countries as China, India, Brazil, Russia, and others. These countries accumulate very large dollar reserves and the U.S. debt.

Let’s explore their recent positions regarding the U.S. dollar with an attempt to predict its future.

1. China

Already for an extended period of time China was quite aggressive in diversifying its reserves and protecting from weakening dollar, recommending its private sector to do the same.

The Chinese Ministry of Finance said in the beginning of September 2009 that it would issue 6 billion yuan worth of government bonds in Hong Kong, a major step to internationalize its currency at a time of concern about the dollar. (27)

Same month China bought the equivalent of $50 billion of the first bond sale by the International Monetary Fund, a purchase that might raise Beijing’s standing in the fund and help the government’s quiet campaign to expand the reach of its currency. China took the unusual step of paying for the IMF bonds with 341.2 billion yuan — which is not traded on global markets — rather than dollars. (28)

The country signed currency agreement with Argentina and agreed to credit South Korea, Malaysia, Indonesia and Belarus with its own currency. (29)

In the mid-September 2009, the International Monetary Fund announced that it was going to sell 403 tons of gold. Chinese central bank showed its willingness to buy the whole offer. (30)

The People's Bank of China showed its intention to decrease its dollar reserves. Chinese authorities will increase their euro and yen reserves. (31)

China and Brazil established international payments in national currency of the Republic of China. Zhuhai Geli corporation received a transfer of several million yuan from San Paolo in the fall of 2009. (32)

Foreign investments of Chinese companies rose in the 3d quarter of 2009 reaching $20,5 billion. The number is almost three times higher as opposed to the last year statistics for the same period of time, as data of the Chinese Ministry of Trade showed. (33)

The country was seeking to expand its African oil reserves by bidding for up to a sixth of Nigeria's crude reserves constituting approximately 6 billon barrels. Valuing near $30-50 billion Chinese offer is higher than that of the current owners. China has been buying oil resources around the World for the second year already. (34)

Chinese companies may invest about $ 4,4 billion into Peru's mining sector within the next three years, said Bloomberg referring to the statement made by the Prime Minister of Peru Javier Velasquez. (35)

Nearly 44% ($14,3 billion) of the total volume of China's investments within the first nine months of 2009 were coming into mining and production sector. Representative of the Asian Development Bank noted that investing in the mining sector by purchasing stocks corresponded to a long-term strategy of the country to achieve resource security. (36)

China Investment Corporation (CIC), a sovereign wealth fund responsible for managing part of Chinese foreign exchange reserves, "has been quietly accumulating stakes in resource firms including Canada's Kinross Gold Corp. and Potash Corp. of Saskatchewan according to a filing with securities regulators." (37)

CIC chairman Lou Jiwei "recently said that CIC would focus on investing in emerging markets in 2010. In October, the CIC chairman said the fund had allocated $110-billion for foreign investments and had already deployed about half of that." (38)

"In addition to its $3.5-billion interest in Teck, CIC has a $652-million stake in Brazilian iron ore and nickel giant Vale SA, a $4.7-million interest in copper miner Freeport-McMoRan, and a $9.1-million holding in steel producer ArcelorMittal." CIC has also acquired stakes in a number of high-profile brand name companies in North America such as Research In Motion Ltd., Apple Inc., News Corp., and AIG Inc. (39)

2. India

IMF sold 200 metric tons of gold to India in the beginning of November 2009. The $6.7 billion sale is "the biggest single central-bank purchase that we know about for at least 30 years in such a short period," said Timothy Green, author of "The Ages of Gold." "The only comparable event was the U.S.'s steady purchases in the 1930s and 1940s." (40)

3. Brazil

Brazilian Central Bank president Henrique Meirelles said the country is considering the gradual elimination of the U.S .dollar in trade with China, Russia and India. (41)

In October 2009, the Brazilian Central bank announced that an agreement was reached with Uruguayan economic authorities to apply the so called SML system in bilateral trade operations. (42)

Brazilian Finance Minister Guido Mantega said that Brazil would spend 10 billion US dollars on buying International Monetary Fund bonds to boost the fund's resources. This "radical change" will help Brazil to diversify its resources, he added. (43)

4. Russia

The Central Bank of Russia increased the share of Japanese yen and Swiss franc in reserves in the middle of 2008. Japanese yen currently accounts for around 2 percent of Russia's reserves. The franc's share is smaller because of the limited liquidity.

Russian reserves consist now mainly of the U.S. dollar and the euro. However, it is quite possible that Russia will add Chinese yuan in there, said Alexei Kudrin, Russian Finance Minister. The lack of convertibility of the China's currency and of the free movement of capital was the main current obstacle. (44)

Brazil and India are interested in settling bilateral trade with Russia in national currencies, said Alexander Potemkin, an advisor to the Russian central bank chairman, echoing Moscow's drive for more use of national currencies and less of the U.S. dollar. "There was an initiative within the framework of the BRIC. These countries intend to create the conditions for direct payment for trade in national currencies," he said. He also said that Russia had a reach experience of reciprocal payments in national currencies with China. He estimated that settlements in yuan and rouble already account for around 2 percent of Russia's trade with China. (45)

Moscow also discusses trade in national currencies with other countries including Turkey and Vietnam. (46)

Russian central bank first deputy chairman Alexei Ulyukayev said in November 2009 that Russia was going to add the Canadian dollar to its gold and forex reserves in the next few months, but its share would be insignificant. (47)

5. Other countries

In April 2009 the Latin American leaders signed into effect a new South American currency, to be called the 'sucre'. ALBA leaders (representing Venezuela, Cuba, Bolivia, Honduras, Nicaragua, and Dominica) say the sucre is necessary to help defray the regional effects of the world economic crisis by substituting their trade in dollars with a new alternative currency. The ALBA countries and their allies plan to use the virtual sucre by early 2010. (48)

In the second quarter ending in June 2009, central banks around the world invested 63 percent of their new cash reserves into euro and yen, and put only 37 percent into dollars. (49)

Kuwait, Saudi Arabia, Qatar and Bahrain signed in June 2009 an accord to create a joint monetary union council, a prelude to establishing a Gulf central bank and launching a monetary union and single currency. The remaining two members of the Gulf Cooperation Council (GCC), the UAE and Oman, did not sign after deciding to withdraw from the project. The GCC states have set 2010 as the target to launch the monetary union and single currency, but many experts believe that target is too ambitious and unrealistic. (50)

The International Monetary Fund sold 10 metric tons of gold to the central bank of Sri Lanka for about $375 million. The purchase is part of Sri Lanka's plan to diversify its reserves and it has been gradually accumulating the metal in the past nine months. "Gold is a good anchor and hedge to have in these volatile circumstances," said Nivard Cabraal, the bank's governor. "We think it's a good time to buy." (51)

In the beginning of January 2010 Canada announced that it might sell about 1 billion euros of 10-year bonds, its first issue of debt in the European currency in more than a decade. This strategy will help attracting new investors, while debt denominated in U.S. dollars is becoming less popular among the creditors given the declining value of the U.S. currency. (52)

It is obvious that the trend of the diversification out of the dollar persisted through the whole year of 2009.

Part IV

Way Out

Peterson-Pew Commission on Budget Reform suggests that "the United States must show its creditors that it is serious about stabilizing the federal debt over a reasonable timeframe. Both spending cuts and tax increases will be necessary."

Most of the economists would suggest that the anti-inflation strategy of the United States should include:

* suppression of inflation expectations and stimulation of savings;
* reaching balance between budget receipts and expenditures;
* increasing the mass of commodities; and
* strengthening national currency by establishing an unconditional priority of inflation targeting over other government programs (such as military expenses, unemployment rate regulation, influencing the national currency market, etc.).

Will the U.S. assume such a pain by reducing spending and fighting the deficits? Probably not, taking into consideration the words of Sir John Templeton, the John Templeton Foundation, who said in 2005: "The psychology all over the world is that people will not re-elect leaders who want them to be thrifty. The voters will elect the government that spends more money." (53)

Many analysts are pretty sure that the weak dollar policy is beneficial to the U.S. Therefore, whatever the authorities say, there will be no resistance to dollar depreciation on their part.

Most experts already doubt that the solution of the problem depends much on the U.S. and call for global measures. "We must reform the international monetary system," Yu Yongding, a former Chinese central bank adviser, stated in mid-November 2009. "A good monetary system should make us confident. But we don't have confidence in the U.S. dollar now," he added. (54)

George Soros, a global financier, is convinced that we "need a new currency system and actually the Special Drawing Rights do give you the makings of a system," he told the Financial Times.

The Future of the Dollar

The future of the dollar is in jeopardy now as it is evident from the article.

This subject is the primary focus of futureofdollar.com. We follow latest developments in this area and provide our readers information from reliable sources.

This analysis is prepared by http://www.futureofdollar.com

Notes

(1) Paul Krugman, Currency Crises, 1997;
(2) Reuters, December 17, 2009;
(3) budgetreform.org, December 14, 2009;
(4) U.S. Department of Labor, February 5, 2010;
(5) IMF, January 31, 2010;
(6) The Department of the Treasury;
(7) Merco Press, January 13, 2010;
(8) Bloomberg, February 1, 2010;
(9) Bloomberg, January 26, 2010;
(10) Jan 2010 Beige Book;
(11) Ibid.;
(12) NAR, January 25, 2010;
(13) Bloomberg, January 27, 2010;
(14) Bloomberg, January 8, 2010;
(15) Paul Krugman, Currency Crises, 1997;
(16) Bloomberg, February 4, 2010;
(17) FOX Business Network, June 24, 2009;
(18) The Economic Times, November 13, 2009;
(19) Reuters, October 26, 2009;
(20) Bloomberg, October 28, 2009;
(21) The Korea Times, October 28, 2009;
(22) Reuters, December, 2009;
(23) RB.ru Russian Business, September 1, 2009;
(24) Bloomberg, March 24, 2009;
(25) Bloomberg, November 17, 2009;
(26) USA Today, March 25, 2009;
(27) DealBook, September 7, 2009;
(28) The Associated Press, September 3, 2009;
(29) The New York Times, September 4, 2009;
(30) CommodityOnline.com, September 21, 2009;
(31) RosBusinessConsulting, November 6, 2009;
(32) NEWSru.com, October 28, 2009;
(33) Bloomberg, 26 October 2009;
(34) Vedomosti, 28 September, 2009;

(35) Bloomberg, 25 November, 2009;
(36) ChinaPro.ru / Vedomosti, 25 November 2009;
(37) The Globe and Mail, February 8, 2010;
(38) Ibid.;
(39) Ibid.;
(40) Bloomberg, November 3, 2009;
(41) Merco Press, October 29, 2009;
(42) Ibid.;
(43) Bloomberg, October 4, 2009;
(44) Bloomberg, October 24, 2009;
(45) Reuters, November 25, 2009;
(46) Ibid.;
(47) Reuters, November 2009;
(48) Venezuelanalysis.com, April 17, 2009;
(49) CNBC, October 14, 2009;
(50) ArabianBusiness.com, October 11, 2009;
(51) Bloomberg, November 25, 2009;
(52) Bloomberg, January 5, 2010;
(53) NewsMas;
(54) Bloomberg, November 17, 2009.

Articles by:
futureofdollar.com