The Yuan vs. the Dollar vs. Gold: One Step forward by China, One Step back for America?

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Global Research, June 06, 2015

Theme: Global Economy

Each step forward by the Chinese to make a foothold for the yuan is one step backwards for the grip the dollar has held over the globe. This topic has several nuances to it, let's take a look from several vantage points. As a spoiler, any "steps back" in today's fiat currency world are steps toward a break in confidence. Call it deflation or hyperinflation, a break in the confidence of fiat currency will end with many currencies being replaced, this is a major part of your coming "re-set".

The first and most obvious is we live in a world with an economic and financial pie of a given size at any point in time. Each deal, each transaction and each "platform" that is done or created by the Chinese for using yuan instead of dollars means the size of the pie "slices" change. Any increase in the usage of yuan means a smaller slice for the use of dollars. Yes, theoretically the pie gets larger over time and we'll get to this shortly, I am simply saying here that in a static system, more yuan usage means less dollar usage.

The next logical step is to equate the usage of a country's currency with "power". As any currency becomes more popular for usage, the confidence in that country also increases and vice versa. In today's world (but not for long?), fiat currencies with no backing are free to create. In the case of the dollar since 1971, more usage (via petro-dollar reinvestment) allowed for more "creation" of dollars and thus the power generated from the "privilege" to print. This so far is simple logic and merely a description of how our monetary world works.

China has done many things over the last several years with an eye to moving their currency, the yuan forward. They have purchased massive amounts of gold to be held as reserves, we will very soon find out how much they have accumulated as they announce for their entrance into the SDR. China has also set up two dozen "currency hubs" all over the world in major cities. They have done this to aid in the conversion of local currencies into and out of yuan. Clearly this move will aid and grease the gears for trade done with China. It will also aid in currency movements looking to "buy" yuan if deals are contracted to settle in yuan. In essence, China is simply "making it easy" to purchase and use their currency. They have also set up credit facilities such as the AIIB and new exchanges for gold, the SGEI. China is actively seeking "new customers" and trade partners along the "Old Silk Road" as they can see the writing on the wall …as well they should since they are the ones doing the writing!

If you look at nearly everything China has done in recent years from a financial and economic standpoint, it can be seen they are preparing the yuan to become a "major" and international currency. They have requested the yuan to become part of the IMF's SDR which gives us an approximate time guideline. Whatever percentage the yuan gains of the SDR pie will come at the expense of the dollar's piece. The flip side of the coin is the U.S., what exactly has the U.S. done in recent years to "promote" or make it easier to use dollars? This is a simple case of losing market share!

Now, let's look from a different angle. Any economic (financial) system is either increasing in size or decreasing. It may be increasing at an increasing rate or the rate is slowing. The system may also be decreasing at an increasing rate, or the contraction is slowing. In a fiat system where debt is the underlying asset holding up values and ultimately the currency itself, debt outstanding (growth) by definition MUST increase in the long run and it must grow at an increasing rate. This is an "absolute" because there does not exist the "dollars" today to pay future interest, they simply do not exist …"yet". The only way they will ever come into creation is by creating more debt or using the electronic printing press. In the words of Richard Russell, "it is either inflate or die!".

Let us now look at the "die" part. If (when) China makes the yuan convertible and international, this will immediately take "market share" away from the dollar. This is where it gets interesting because there is a major fork in the road, it is called the debate between the "inflationists and the deflationists". One theory is that any decrease in dollars outstanding (and being used) will cause existing debt to default and create an unending cycle of default. This the deflationists say will actually make "dollars" worth more. The inflationists say this can never happen because the Fed will simply "print" more dollars and thus ruin the value of existing dollars via common hyperinflation.

Let me say this, I disagree with both arguments! First, as for the deflationists, let's assume (and I do) we have hundreds of trillions in defaults. What, if anything will be left standing of the financial markets? With the derivatives outstanding, which banks exactly will still have their doors open for you to retrieve your now "more valuable dollars"? Will ANY financial institution still be solvent? And going one step further, when this collapse comes, won't the business climate turn highly negative …which will slow tax receipts to a trickle …and make it impossible for the Treasury and other agencies to make good on their debts and other promises (unless they just conjure up more out of thin air)? Finally, aren't "dollars" ultimately backed by the "full faith and credit" of the United States"? Aren't dollars now "used" based on the "confidence" in the U.S. Treasury since they are not convertible into anything else? Flipping to the inflationist side, they say the Fed will simply print more and create hyperinflation. I say they have ALREADY hyperinflated the currency by allowing the system to reach, and pass the "debt saturation" level. They have already put the seeds into the system!

What I believe we will see is what we have always seen as a final result of fiat currencies, a collapse of confidence. Call it what you want, call it a deflationary collapse or call it hyperinflation, the end result will be "confidence" in the U.S. dollar will collapse. It will be shunned in international trade and will take MANY more dollars (if at all) to conduct transactions. What is coming is a "monetary event" triggered by a very human emotion, "fear". Fear that the dollars you hold will not be accepted when you go to spend them!

To finish, let's add gold into the equation. We have only seen true "deflation" once in the last 100 years in the U.S.. We entered deflation in the 1930's and if you listen to Harry Dent, owning dollars was the number one place to have money. This is simply NOT SO. Yes, having dollars was "good", having dollars in a bank was "not so good" because many banks simply closed their doors and the dollars were lost … the insolvencies occurred BECAUSE of the deflation. Going one step further, FDR devalued the dollar versus gold from $20.67 to $35 per ounce. Please remember, back then dollars did not have value because they "were dollars", they had value because they were RECEIPTS FOR GOLD. Gold was the asset, gold was "the money", dollars were the derivative of gold!

As it was in the 1930's, ever before and ever since, gold is money. Any future "deflation" that occurs will be "against" or IN terms of gold! Ask yourself this, in a financial collapse, "what will be safe"? Will your bank, broker or insurance company be safe, or even still solvent? Will our over indebted government be safe? Will the pieces of paper or digital credits issued by this "safe" government and held by your "safe" institution …really be safe? Or, will gold, which is readily accepted and even HOARDED by the rest of the world be accepted, sought after and thus both liquid AND safe? This is THE most important question and one that will affect the rest of your entire financial life! It's not that hard of a question, only a little common sense and a small dose of logic will get you there!

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Bill Holter writes and is partnered with Jim Sinclair at the newly formed Holter/Sinclair collaboration. Prior, he wrote for Miles Franklin from 2012-15. Bill worked as a retail stockbroker for 23 years, including 12 as a branch manager at A.G. Edwards. He left Wall Street in late 2006 to avoid potential liabilities related to management of paper assets. In retirement he and his family moved to Costa Rica where he lived until 2011 when he moved back to the United States. Bill was a well-known contributor to the Gold Anti-Trust Action Committee (GATA) commentaries from 2007-present.