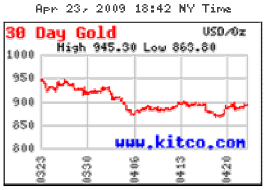
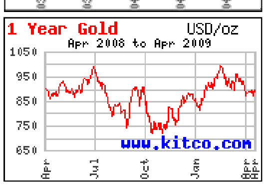
Commentary Listings
by Date
by Author
more articles by
Douglas E. Johnston, Jr





A Global Monetary Recap - 1944 to 2008

By Douglas E. Johnston, Jr
May 16 2008 2:34PM

http://www.kitco.com/

With the Federal Reserve's wide-ranging efforts to address the ongoing Credit Crisis through unprecedented money-creation activities, we are now likely witnessing the final phases of the U.S. Dollar's 64-year reign as the primary global reserve currency. Few Americans understand the implications of this dramatically unfolding global sea-change.

The U.S. Dollar was installed as the lynchpin of the international monetary system in July 1944 by and among the 44 Allied nations, and just as the end of WWII was in sight. At that time, the U.S. owned or controlled well over half of the world's wealth, and the Bretton Woods Agreement (named after the small town in New Hampshire where over 700 representatives of the leading industrialized nations met that summer) created the financial architecture whereby the U.S. Dollar, as backed by and exchangeable into gold at the rate of $35/oz, would function as principal 'reserve currency' in the post-war global monetary system. The dollar debuted in its newly-expanded role via the Marshall Plan and the reconstruction of post-war Europe, when the U.S. paid dollars into the accounts of foreign banks, both to maintain our overseas military bases as well as to rebuild war-ravaged economies. Very importantly, all crude oil transactions throughout the world were also designated to be priced in dollars, regardless of which nations participated in the oil trades. In many ways, the Bretton Woods Agreement can be seen as one of the great 'spoils of war' for the U.S., and the dollar's acceptance and dominance was subtly reinforced throughout the subsequent Cold War and afterwards by America's enduring global military supremacy – the so-called 'Pax Americana.'

Bretton Woods thus represented an enormous post-War economic advantage for America ever since, yet in mirror fashion it emerged as a major problem for the other countries, primarily because it created the possibility that the dominant U.S. could simply print money, and do so essentially at the expense of diluting the other nations' savings. Gold convertibility was to provide the discipline whereby the U.S., as keeper of the 'reserve currency,' would keep its budget in balance and the dollar as a sound reserve currency. That is, if other nations were uncomfortable with the U.S. spending policies which might dilute the value of their reserve savings, they could convert their dollar savings into gold. But Bretton Woods allowed the U.S. some convenient 'wiggle room.' Over time, the U.S. chose a predictable political path in ignoring key parts of the Agreement, often reminding the less-powerful Europeans who had saved them from the Nazis, who had won WWII, and who was now protecting them from the rising Soviet menace. In due course of the post-World War II era, the U.S. began to spend far beyond its means both for defense and foreign aid purposes, as well as for expanding domestic social programs.

By the 1950's the U.S. undertook the expensive Korean War, and then in the 1960s the U.S. began to spend in earnest for both the Vietnam War as well as for President Lyndon Johnson's 'Great Society' welfare and entitlement programs. These activities were essentially financed by creating new debt and/or new inflated dollars, and these efforts served to plant the seeds for significant dilution and debasement of the other countries' U.S. Dollar reserve accounts.

The era of ballooning U.S. deficit spending and rising inflation was well underway by the late 1960s. Over time, the Bretton Woods participants became increasingly frustrated about the debasement of their dollar reserve savings, and French President Charles de Gaulle even announced his intention to send a ship to the U.S. to exchange France's accumulated U.S. Dollars for gold at the official rate of $35/oz. By 1971, the other European nations were also increasingly uncomfortable, yet the dominant U.S. first downplayed and then later summarily dismissed their concerns through President Richard M. Nixon, when the U.S. officially and unilaterally suspended the gold-convertibility 'promise' of Bretton Woods. In officially closing the so-called 'Gold Window' on August 15, 1971, Nixon's Treasury Secretary John B. Connally rebuffed the Europeans with his now-famous quote: "The dollar is our currency, but it is your problem." So foreign central banks took it badly on both ends – they were unable to keep Congress and the U.S. from spending programs which were diluting their 'dollar reserve currency' savings, and they were also unable to redeem their dollars for gold as promised.

With Nixon's official abandonment of the Bretton Woods gold-convertibility system, the global economy moved thereafter to a 'floating' exchange-rate system where currency rates were no longer fixed against each other and/or backed by gold. The currency world entered a new and more speculative 'Relativistic Age' where currency exchange rates instead varied constantly, depending on changing perceptions of the strength of one another's economies, and especially reflecting their comparative internal structures of interest rates. With the emerging need to 're-cycle' petrodollars following the Arab Oil Embargo of 1973, and with dollar fundamentals further weakened by continuing frequent U.S. trade and budget deficits since the Vietnam era, the global economy became increasingly awash in dollars by the late 1970s. With oil price shocks and deficit-spending combining to produce double-digit inflation by 1979, a 'dollar rescue' of sorts developed in 1980, when U.S. Fed Chairman Paul Volcker dramatically raised Fed Funds rates, eventually pushing the Prime Rate to 21 1/2% by late 1981. Volcker's Fed tenure represented a painful adjustment period for the U.S. economy, but it won the U.S. great praise around the world for bringing inflation under control. Unfortunately for dollar-holders, the Volcker Era did not last.

With escalating social and military spending through the Cold War, plus the dramatic increase in the 'Star Wars' military budgets during the Reagan Administration, the reasons occasionally varied but America's core political focus remained on greater deficit spending, more borrowing, and a resulting deterioration of the dollar's fundamentals.

The U.S., admired widely for decades as the 'Wealthiest Nation on Earth,' quietly transitioned from being a 'net lender' nation to a 'net borrower' nation in 1983. By 1985, U.S. Treasury Secretary James A. Baker III initiated the 'Plaza Accords' among the so-called 'G-5' countries, whereby foreign central banks coordinated to reduce dramatically the floating exchange rate of the dollar. Spending for defense and major declared wars through the 1980's transitioned after the collapse of the Soviet Union to spending for lesser undeclared wars against terrorism and various other perceived regional threats in Panama, Granada, Libya, and Somalia, and later in Afghanistan and Iraq. During the late 1980's and early 1990's, the U.S. Republican-led conservative movement produced another noteworthy rescue round of 'sound money' initiatives which had been championed by U.S. Speaker of the House Newt Gingrich, but these 'Balanced Budget' efforts were eventually abandoned under the relentless political pressures of spending to attract votes for defense and for continuing social programs.

The U.S. now ranks as the #1 borrower in the world, and our cumulative National Debt now stands at nearly $9.4 Trillion at this writing. The annual net deficits have risen ever faster since the World Trade Center Disaster in 2001, which produced the reactionary 'anti-terror' wars in Afghanistan and Iraq starting in 2001 and 2003. Since 2006, America's major trading partners and foreign lenders have been asked to finance these expanding deficits by investing in new U.S. debt at rates now approaching $1 Trillion per year. More recently the global Credit Crisis has produced an even faster rate of deficit money-creation by the Fed. With America's history of deficit spending, plus a weakening U.S. economy which no longer drives the global 'growth engine,' and now adding the final *coup de grace* of the exported sub-prime syndication contagion, foreign central banks have moved aggressively to diversify out of exclusively dollar-denominated savings. The dollar has clearly lost its core attraction as the reserve currency of choice of the world. With the successful 2001 debut of the Euro and its growing acceptance by major industrialized nations as an alternative currency, the tipping point of other countries' willingness to accept the dollar as the primary global reserve currency may be approaching.

America has now grown accustomed to borrowing from abroad to support its wars, its domestic programs, its comfortable lifestyle, and its dependence on foreign crude oil. Global investors have so far remained willing to lend to us based on our global economic dominance and the perception of the U.S. as a perennial safe haven for investments. But the cumulative borrowing over the past decades has now escalated to dangerous levels, especially compared to our dramatically weakening growth rates in comparison to other emerging economies such as China and India. International investors have grown less willing to finance America's spendthrift habits and reckless foreign policy. With current 'real' U.S. inflation rates of 9% or so easily exceeding the sub-4% interest rates earned on U.S. Treasuries, global investors clearly have more attractive other investment options to consider.

The Credit Crisis has added a greater sense of urgency to the dialogue of the continuing role of the dollar. Since August 2007, the Fed has battled the sub-prime and derivative credit crises with a wide array of new 'fiat' money-creation weapons - now aggressively expanded to include new 'liquidity injections,' swaps, bond auctions, the Exchange Stabilization Fund, the Plunge Protection Team, the Bear Stearns direct lending rescue, 'Term Securities Lending Facilities,' collateralized purchases of credit card, auto loan & student loan portfolios, plus even hints of the Fed engaging in outright corporate recapitalization activities. These emergency Fed actions, often in concert with the European Central Bank and the Bank of England, have temporarily stabilized a chaotic scene, but at the expense of adding even further to the escalating weaknesses in the dollar.

The Fed's recent spectacular levels of 'instantaneous' money-creation should produce additional major dollar-dilution and forward inflation - and these deepening problems arrive after the dollar has **already** lost 50% of its value against the Euro since 2002 alone. The world economy appears to be witnessing something akin to a developing 'death-spiral' of the dollar, as OPEC nations now seek to raise their dollar-based oil prices to keep ahead of increasing U.S. inflation rates, while these reactionary price increases only escalate a still-further up-cycling of inflation. Since 2002, the dollar prices of other worldwide commodities including metals and key raw industrial materials, as well as critical wheat, corn and rice food staples, have likewise risen 3 to 7-fold in concert with oil. While monetary inflation lies at the core of any price inflation, rising global standards of living, tightening supplies, power & water shortages and the occasional influences of Mother Nature in many of these markets may all serve to exacerbate these developing inflationary trends.

With the added emergence of the sub-prime crisis and the exporting of these infected mortgage portfolios and their derivative problems around the globe, the rest of the world is even more wary of dollars and dollar-denominated assets. But if not the dollar as the global reserve currency, what else? Commodities in general plus the precious metals group of gold, silver and platinum in particular have witnessed major run-ups, as investors look to buy 'things' rather than 'U.S. Federal Reserve Obligations' as more attractive alternatives to the steadily weakening dollar. Over the past few years, world markets have also seen the emergence of 'Sovereign Wealth Funds,' whereby individual nations have dedicated their trade and payments surpluses to funds investing in Euro-denominated assets, public companies and various commodities as alternatives to weakening dollar-denominated assets and other paper currencies. China, for example, has moved aggressively in Africa, South America and elsewhere to secure major raw materials contracts, as well to buy the companies which produce them. Other Middle Eastern, OPEC countries and emerging nations have similarly created sovereign wealth funds in their national interests, and many have used them as away to diversify out of dollars.

The activities of the U.S. Fed since August 2007 promise a continuation of the inflationary trends noted below, and there appears to be another major upswing in inflation just ahead as the Fed's massive money-creating actions since August 2007 work their way from Wall Street and into the global financial system.

Representative Commodities Price Comparisons 2003 vs 2008

2003		**2008**
$2.25	Corn	$6.10
$3.20	Wheat	$8.50 (U.S. stockpiles now lowest since WWII)
$3.00	Rice	$21.00 (Primary food source for 1/3 of the world's population)
$27.00	Crude Oil	$125.00
$4.60	Silver	$17.00
$340.00	Gold	$885.00
$1.05	Euro	$1.55

The Arab world has occasionally expressed its concerns about the falling dollar, and a few specific Arab states have attempted in recent years to 'de-couple' crude oil from being priced in depreciating dollars. Aspiring powers take note, invariably the U.S. has responded subtly (and indirectly) by sending Vice President Dick Cheney and yet another carrier to the Persian Gulf. But China and our other major trading partners are also unhappy with being 'forced' to accept trade dollars and convert them into steadily-depreciating U.S. Treasuries. Our major trading partners and the OPEC nations currently invest nearly $1 Trillion in new financing each year to support our ever-growing trade and spending deficits, and the severe troubles on Wall Street have deepened their concerns about investing in depreciating dollar assets. With the Bush Administration still enforcing an out-of-balance game of geopolitical hardball, something has to give, and possibly soon.

A new stable global 'reserve currency' is needed to correct these global trade, exchange and financing imbalances, and to replace the faltering U.S. Dollar. What is needed is a new 'reserve currency' which also provides a more stable medium of exchange, and this concept is apparently in the works. The globally-accepted Euro now constitutes a qualified new 'reserve currency' candidate, but it also can be undermined by political spending flaws. In April 2008, global billionaire financier and currency speculator George Soros commented at the European Policy Studies think tank, "I don't think that the Euro can replace the dollar, and a system with two major reserve currencies is not a stable system….The Euro, while it is obviously an alternative, is not a truly attractive alternative, and therefore there's a general flight from currencies." Soros continued on National Public Radio in May: "**We are in the midst of the worst financial crisis since the 1930s…**In some ways, [this crisis] resembles other crises that have occurred in the last 25 years, but there is a profound difference: The current crisis marks the end of an era of credit expansion based on the dollar as the international reserve currency…A new paradigm is needed." Gold and precious metals may help to shape that new paradigm of replacing and/or backing faltering paper currencies.

Gold has been prized as money by virtually every major civilization in world history, and it has utilized as a stable reserve currency many times before in European, British and American history. As a rare and virtually indestructible metal, gold has served repeatedly over the centuries virtually a class by itself as an effective medium of exchange, yet it has also been periodically abandoned, ignored or shunted aside by politicians who resent its fiscal discipline when they want to spend more money to attract votes, or to pay for perceived military, terrorist or financial threats. The last 37 years since the demise of Bretton Woods has constituted just one of those periods where gold was rejected or ignored, but as usual it keeps resurfacing as an unmistakable store of value which cannot be printed out of thin air by governments. With the Fed's pursuit of spectacular money-creation policies which will unmistakably lead to the further undermining of the dollar, gold again lies waiting in the wings to return to its time-tested role as a stable medium of exchange and reserve currency.

Nothwithstanding the official 'disdain' toward gold in recent decades, neither the U.S. nor the Europeans have ever truly abandoned it. Enormous gold reserves have remained quietly and unobtrusively on the balance sheets of the Federal Reserve Bank, the Bank of England, the European Central Bank, the International Monetary Fund, and the Bank for International Settlements, and a reactivation and revaluation of gold, such as occurred during the Great Depression in March, 1933 under President Franklin D. Roosevelt, may offer a true solution to the unfolding global Credit Crisis. In March 2008, shortly after the Bear Stearns bailout, former Dallas Fed Governor Robert McTeer commented notably on CNBC, "Gold is the ultimate store of value in any financial system." It may now take one more inflationary wave or another financial crisis of unknown dimensions to finish the job and to usher in a new global era, perhaps restoring gold convertibility to the global reserve currency equation.

What lies ahead? The world economy and balance of trade among major trading partners with China and the OPEC countries are seriously out of alignment, and a financial crisis and resulting re-alignment seems inevitable. The foreign central banks have now joined the Fed in spectacular money creation to inflate past the sub-prime problems, and a stronger prospect remains for a global inflationary upheaval, a major re-alignment of global currencies, and probably a period of harder times for America. The U.S. will likely need to shift from being a 'consuming nation' back to an era of Americans as thrifty savers.(Retailers take note.) Just imagine what will happen to the U.S. economy when we are no longer able to 'induce' foreigners to provide us $1 Trillion per year in deficit financing as we are doing today, and when that incremental $1 Trillion is not here to turn over a few times each year inside our economy.(Retailers and everyone take note.) There will very likely be a period of painful adjustment for the U.S. as we are forced to tighten our belts and to modify the era of 'U.S. as Net Consumer to the World.'

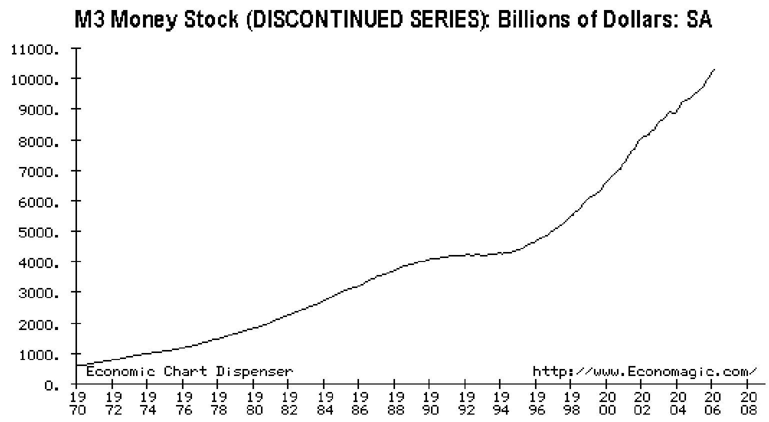
Notwithstanding the recent more hopeful attitude on Wall Street, the August 2007 Credit Crisis which began with overvalued mortgage portfolios will likely continue throughout 2008 and beyond. The multi-trillion dollar 'housing bubble' was built on steadily increasing housing values, yet real estate markets will clearly see declining home values for some time ahead. There is a significant likelihood, reinforced by the Fed's recent expanded actions to buy up distressed auto, credit card, and student loan portfolios, that the sub-prime contagion is spreading to other sectors. The pressure may be off in the short term, but the fundamental problems of downward-spiralling asset portfolios and 'mark-to-market' accounting valuations still loom. As housing values erode and defaults & foreclosures increase, more massive loan portfolio write-downs, along with potentially even greater losses in the financial derivatives arena, lie just ahead in the shadows.

With the Bear Stearns rescue precedent, the imminent threat facing Wall Street financial institutions appears to have been abated, at least for the moment. The emerging reality is that the Fed has transformed a short-term crisis threatening a group of large financial institutions into a longer-term and eventually more destructive inflationary spiral to be borne by the average taxpayer, and where the average American's meager savings may be all but wiped out in the end. A weakening economy with declining home prices and credit availability, coupled with strongly increasing prices for food, gasoline and the necessities of life promise trouble ahead. Our European friends may know just what these things mean from their hyperinflationary experiences in the 1930's, and they know just how severe those consequences may be for all of us.

If the Fed consistently creates new liquidity and money to wallpaper over our problems, the dollar cannot help but be debased even further. Notwithstanding any occasional confusions as to the true causes of inflation, massive money creation on Wall Street inevitably will produce price inflation in the heartland. Dollar holders should clearly beware, as the Fed has clearly opened wide the floodgates of the inflation dam upstream, and a flood of money may soon engulf the financial landscape. Purchasing power will slip underwater first, and unwary fixed dollar savers may likely drown in this unfolding scenario.

The Fed may have telegraphed that massive money-inflation was coming in March 2006, when it abruptly discontinued its weekly release of the widely-followed Money Supply data. As John Lee's chart indicates below, M3, the widest measure of the U.S. money supply data, had increased over 1500% from 1970-2006. With the Fed's Credit Crisis responses since last August, these numbers have likely accelerated even further, and by some estimates the money supply growth is now running as high as 10 times even the prior 2006 rates. The U.S. Labor Department's Bureau of Labor Statistics 'official' March 2008 CPI-U inflation rate of 3.98% (which somehow carefully omits the 69% increase in food prices over the past year as well as soaring energy costs) almost surely understates real 'on the street' inflation by a very wide margin. Even more troubling to the statistical purists who follow official inflation indicators, the U.S. Commerce.

Department and BLS recently announced key staff cutbacks in their critical data production areas. Although the core statistics may now be more difficult to find, the average American can see and feel the new reality of inflation, and there promises to be plenty more ahead where that came from. The Fed's recent massive money-creation on Wall Street will produce even greater price inflation on Main Street in due course, and perhaps surprisingly soon.



A picture is worth a thousand words and the chart above is no different. There is 1,500% more paper money today than there was in 1970. (Chart and comment courtesy John Lee, CFA/www.goldmau.com)

Competitive economic infrastructures have now been built in Japan, China, India and elsewhere, and the U.S. no longer controls global resources as it once did. But the U.S. still has options and opportunities, and no country has broader or deeper resources, or does a better job of implementing new ideas and concepts and technologies than we do. It is very possible that an entirely new and more stable global economic system may soon re-emerge, featuring a new U.S. energy policy as well as pioneering U.S. nanotechnology and biotechnology developments as commercial centerpieces. Given the inherent weakness of floating paper currencies which can be created virtually at will by pandering, ambitious or reactionary politicians and their allied central banks, the solution to budget deficits, global trade imbalances and overall economic stability could very well include some form of renewed official currency convertibility into gold. Gold has represented sound money for thousands of years, and its rightful place may be re-emerging as a beacon of stability in a world which grows more wary and sea-sick of the floating U. S. Dollar with each new crisis. Uncle Sam has captained the global reserve currency ship alone for 64 years, and the sea-change replacement of the U.S. Dollar may lie just ahead.

Douglas E. Johnston, Jr.
May 15, 2008 – Deep River, LLC

****

Doug Johnston is a entrepreneur/investor and the Managing Partner of **Deep River, LLC**

TOP