U.S. Dollar Concerns

The current and ongoing characteristics of US economic situation are "textbook" (pre)conditions to substantially depreciate a currency. These (pre)conditions include, but are not limited to:

- Very low interest rates
- Truly outsized interventions (including "money printing");
- Ongoing large budget deficits and deficit spending "as far as the eye can see."
- Substantial federal debt; depending upon specific estimate used, at multiples of GDP when viewed on an accrual basis
- Many exceedingly large asset bubbles - and future implications
- An economic system highly vulnerable to financial insability

As I've discussed in previous posts, perhaps the main reason for the complacent attitude toward future U.S. Dollar levels is that the U.S. has never experienced substantial economic problems brought on by currency weakness. It appears as if many people will worry about a significantly lower U.S. Dollar if – and when – it occurs.

There are many problems with this approach. Based on various fundamental and technical analysis factors, I believe that should the Dollar fall substantially from these levels – as I expect – the decline will prove rather intractable – i.e. once it falls, it will stay lower and "reversing the slide" will prove very difficult.

A substantial Dollar decline will have many ill-effects, and will likely be akin to opening a "Pandora's Box" of various economic and financial problems. This currency weakness will create an entirely new set of severe economic problems and challenges, in addition to other problems that will almost certainly coexist at the same time of the Dollar's decline.

While undoubtedly many people will expect any Dollar decline to be gradual and thus "manageable," such an expectation will unfortunately prove too optimistic.

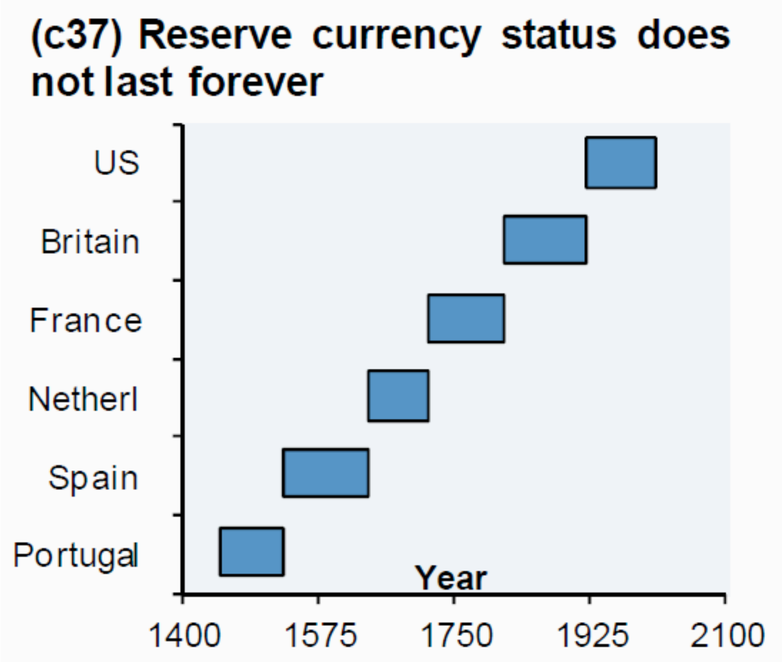
Is the Dollar REALLY Losing Its Reserve Currency Status …
If So, What Will REPLACE It?

Yes, The Dollar Is Losing Its Status as Reserve Currency

The average life expectancy for a fiat currency is less than 40 years.

But what about "reserve currencies", like the U.S. dollar?

JP Morgan noted last year that "reserve currencies" have a limited shelf-life:



As the table shows, U.S. reserve status has already lasted as long as Portugal and the Netherland's reigns. It won't happen tomorrow, or next week … but the end of the dollar's rein is coming nonetheless, and China and many other countries are calling for a new reserve currency.

Remember, China is entering into more and more major deals with other countries to settle trades in Yuans, instead of dollars. This includes the European Union (the world's largest economy).

And China is quietly becoming a gold superpower, and China has long been rumored to be converting the Yuan to a gold-backed currency.

Why China Doesn't Want the Yuan to Become the Reserve Currency

But a switch to a totally-different system – say, a gold-backed yuan – would cause enormous disruption and chaos. China – which has been a long-term planner for thousands of years – doesn't want such a sudden change.

Moreover, housing the world's reserve currency is a huge **burden**, as well as a privilege. Venture Magazine notes:

The inherent burden of housing the world's reserve currency is that the U.S. must continue to run a balance of payment deficit to meet the growing demand. However, it was this outstanding external debt that caused investors to lose confidence in the value of the reserve assets.
Michael Pettis – the well-known American economist teaching at Peking University in Beijing – explains:

A world without the dollar would mean faster growth and less debt for the United States, though at the expense of slower growth for parts of the rest of the world, especially Asia.

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When foreigners actively buy dollar assets they force down the value of their currency against the dollar. **U.S. manufacturers are thus penalized by the overvalued dollar and so must reduce production and fire American workers**. The only way to prevent unemployment from rising then is for the United States to increase domestic demand — and with it domestic employment — by **running up public or private debt**. But, of course, an increase in debt is the same as a reduction in savings. If a rise in foreign savings is passed on to the United States by foreign accumulation of dollar assets, in other words, **U.S. savings must decline**. There is no other possibility.

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By definition, any increase in net foreign purchases of U.S. dollar assets must be accompanied by an equivalent increase in the U.S. current account deficit. This is a well-known accounting identity found in every macroeconomics textbook. So if foreign central banks increase their currency intervention by buying more dollars, their trade surpluses necessarily rise along with the U.S. trade deficit. But if foreign purchases of dollar assets really result in lower U.S. interest rates, then it should hold that the higher a country's current account deficit, the lower its interest rate should be.

Why? Because of the balancing effect: The net amount of foreign purchases of U.S. government bonds and other U.S. dollar assets is exactly equal to the current account deficit. More net foreign purchases is exactly the same as a wider trade deficit (or, more technically, a wider current account deficit).

So do bigger trade deficits really mean lower interest rates? Clearly not. The opposite is in fact far more likely to be true. Countries with balanced trade or trade surpluses tend to enjoy lower interest rates on average than countries with large current account deficits — which are handicapped by slower growth and higher debt.

The United States, it turns out, does not need foreign purchases of government bonds to keep interest rates low any more than it needs a large trade deficit to keep interest rates low. Unless the United States were starved for capital, savings and investment would balance just as easily without a trade deficit as with one.

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Only the U.S. economy and financial system are large enough, open enough, and flexible enough to accommodate large trade deficits. But that **badge of honor comes at a real cost to the long-term growth of the domestic economy and its ability to manage debt levels**.
For the reasons outlined by Pettis, China – which has the world's 2nd biggest economy (or 1st … depending on the measure used) – doesn't want the burden of housing the world's reserve currency.

As such, China is pushing for a basket of currencies to replace the dollar as reserve currency.

Indeed, China – as well as Russia, the U.N. and many other countries and agencies – have called for the "SDR" to become the new reserve currency. SDR stands for "Special Drawing Rights", and it is a basket of 4 currencies – the US dollar, Euro, British pound, and Japanese yen – administered by the International Monetary Fund.

Jim Rickards – one of the leading authorities on currency, having briefed the CIA, Pentagon and Congress on currency issues – says:

China is not buying gold to create a new gold standard; rather it is aiming to make the Yuan more attractive, with the end result of being included in a **basket of currencies**, referred to as the Special Drawing Rate (SDR). He added that there is a move to make the SDR the new global reserve currency.

“Everybody knows that the U.S. dollar’s days are numbered but there is no really currency to take its place except for the SDR,” he said.

“What the world is trying to do is move to the SDR and China is fine with that.”
Rickards added that **China’s goal of being in an SDR basket is the best of both worlds; the country can still have total control over its monetary policy and capital accounts but still influence global economics by being part of a basket of currencies**.

“What the Chinese want is to have the Yuan in the SDR basket but not open up their capital account,” he said. “That is a backdoor way for the Yuan to be a de facto reserve currency without having to give up control.”

What’s Missing?

It is silly to exclude the Yuan from the basket of currencies.