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## The Dollar Crisis

by Robert Blumen

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The current international monetary system, based on floating fiat currencies, brings about tremendous distortions which inevitably must be corrected. This much has been known to Austrians for some time. Awareness is now starting to spread to mainstream economists. To understand how we got here requires some historical background.

Under the international gold standard, the flow of gold in and out of countries responded to relative prices between countries. A country with net imports, for example, experienced gold outflows as their gold was exchanged for goods to make up the difference.



Because a country's gold reserves were finite and could be increased only by becoming a net exporter, the process of gold loss had a natural limit. But even before the gold supply was drawn down to zero, a decrease in the quantity of gold circulating within the importing country would in result in falling prices. There would at the same time be an opposite effect within the countries of the trading partners—the exporting countries would accumulate more gold over time, causing a rise in prices.

Eventually, a point would come where there was a discrepancy in prices between the two countries such that the goods of the chronic importer became more attractive as exports to the chronic exporter. The flow of gold thus worked to maintain rough purchasing power parity of an equivalent quantity of gold between nations and prevented perpetual trade imbalances from accumulating.

Where trade occurs between nations, imports must ultimately be paid for with exports. This is a special case of the general principle that consumption must be funded by production. Within a country that had accumulated gold through the sale of past exports, imports could be funded by the loss of gold for a finite period of time.

Following World War II, instead of returning to the pre-war implementation of the gold standard, a new system known as the Bretton Woods system was devised. This system designated the U.S. dollar as the international reserve asset, replacing gold in this role. A system of fixed exchange rates between national currencies was instituted. Under this system, the dollar alone was to be fully convertible to gold, and then only by foreign central banks. Other currencies would be convertible to dollars at fixed exchange rates.

Under the gold standard existing prior to Bretton Woods, exchange rates were fixed in the sense that each currency was defined as a definite quantity of gold, so exchange ratios followed directly from the definition of the currency itself.[\[1\]](#) The Bretton Woods

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agreement posited fixed exchange rates, but in practice they turned out not to be as fixed as intended.

Under Bretton Woods, countries pursued their own inflationary policy, then adjusted rates ex-post when the fixed rates became untenable. Economic journalist Henry Hazlitt forecasted the demise of this arrangement in the title of his book [From Bretton Woods to World Inflation](#). "The system not only permits and encourages but almost compels world inflation," he wrote in 1949.<sup>[2]</sup>

At the dawn of the new post-war monetary order, the rest of the world suffered from a "dollar shortage". The European countries had great difficulty in building up their supply of the reserve asset. Hazlitt argued that this situation came about because the fixed exchange rates overvalued the European currencies and undervalued the dollar. "Marshall, the President, and Congress completely misunder[stood] the real situation . . . and poured billions of the American taxpayer's dollar into the hands of European governments to finance the trade deficits that they themselves were bringing about by their socialism and exchange controls with overvalued currencies."<sup>[3]</sup>

The policy response to this imbalance was "to let loose a world scramble for competitive devaluation far beyond anything witnessed in the '30's."<sup>[4]</sup> After the avalanche of devaluations, the situation had been reversed: the dollar was overvalued in terms of purchasing power parity relative to its trading partners in Europe.

Americans could import more than they exported with the willing cooperation of Europe and Japan. In the '70s the U.S., suffering severe inflation from the deficit financing of the Vietnam war and an expanding agenda of social programs, racked up enormous budget deficits and trade deficits. The Bretton Woods system reached a crisis when it became clear that there was a run on the U.S. gold supply as foreigners sought to exchange their dollar reserves which were convertible to gold at the fixed price established by the Bretton Woods system.

As Hazlitt forecasted in 1949, an overvalued dollar would result in the loss of U.S. gold reserves. At this point, there were far too many dollars in the world for all of them to be exchanged for gold at the official price.

The system collapsed when Nixon suspended convertibility by "closing the gold window." The current monetary order, which stems from the demise of the Bretton Woods system, consists of market-determined exchange rates between floating fiat currencies, entirely lacking any commodity backing.

The current international monetary system, like a bad horror movie, is a sort of return of the living dead Bretton Woods. A vestige of the agreement placing the dollar at the center of international finance, securities denominated in fiat U.S. dollars are the most widely held reserve asset. Dollars that were accumulated under the promise of convertibility are now held in such large quantities by most major central banks that they cannot be sold without destroying the value of the remaining asset.

Under the current system, the United States year after year imports goods from the rest of the world for consumption and pays for them with dollars. The dollars are then used by foreign central banks to purchase debt instruments from either the Fed or the private sector, in addition to U.S. stocks and real estate. Where these are treasury securities, they are created out of nothing, requiring no savings by any American consumer.

Under this arrangement, Americans are now freed from the ponderous burden of saving and the onerous requirement of first producing in order to later consume. Their consumption is offset by a growing indebtedness of the private sector and the Fed to foreigners. This

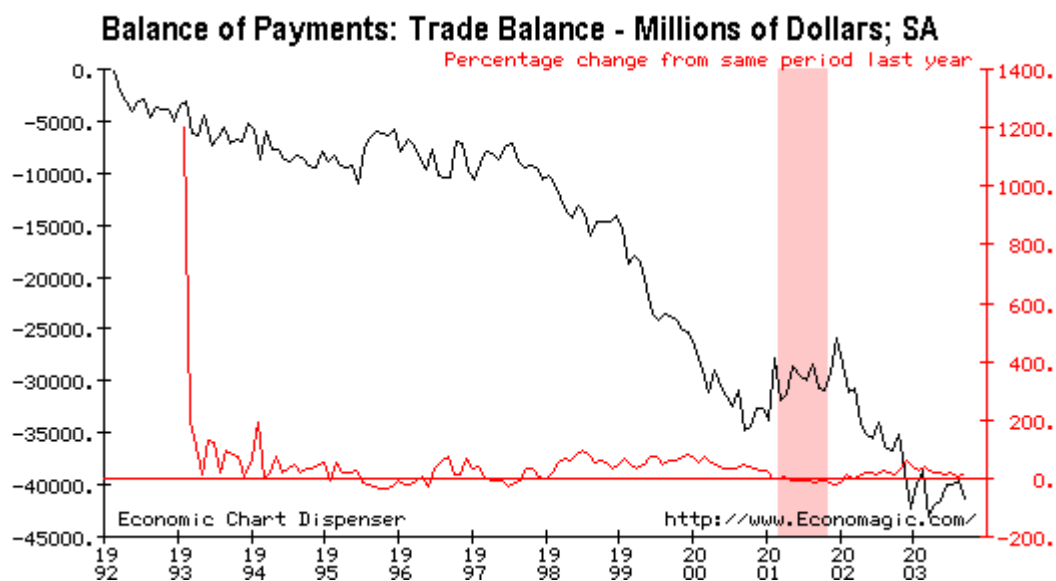


state of affairs is unsustainable, and will come to an end with a deep fall in the exchange value of the dollar relative to other currencies. That is the argument of a provocative new book, [The Dollar Crisis: Causes, Consequences, Cure](#) by Richard Duncan.

A theme of the work is that the automatic adjustment mechanism of the gold standard has ceased to function in the modern world. As a direct result, we have suffered an "explosion of credit creation that has destabilized the global economy." Central bank holdings of "reserve assets," which now consist mostly of debt securities such as other central bank securities (backed up only by the taxing power of the sponsoring government), have soared to staggering heights from the relatively modest levels of the 60s.

The system of floating exchange rates between fiat currencies has put the U.S. in the historically unique position of having the largest trade deficits in history, and of being able "to finance its growing level of indebtedness to the rest of the world by issuing debt instruments denominated in its own currency." By 2001, Duncan notes, the U.S. trade deficit was larger than the entire GDP of all but 13 countries.

Unlike gold, which can only be extracted from the earth with great difficulty, these assets can be created with relative ease or in the case of treasury debt with no effort at all.<sup>[5]</sup> Under the fiat dollar standard, there is no adjustment mechanism short of a crisis such as a hyperinflation or a debt default implosion that can rebalance world trade.



Duncan writes, "How much longer will the rest of the world be willing to accept debt instruments from the United States in exchange for real goods and services? It is only a matter of time before the United States will no longer be considered creditworthy. It is only a matter of time before the United States will not be creditworthy." The dollar must collapse, forecasts Duncan, because it will become impossible for the U.S. to continue to sell one-half trillion dollars worth of debt securities each year (the amount required to offset the trade deficit) for very much longer.

Some analysts who take a bullish stance on the U.S. dollar, and some U.S. government officials have ludicrously blamed foreign countries for this problem. They cite the supposed eagerness of overseas investors to invest in U.S. assets, due to the alleged superiority of American financial markets and the larger number of investment opportunities here as the cause of the trade deficit.

Typical, for example, is St. Louis Fed [President William Poole](#):

The general public is also concerned about the large and increasing U.S. trade deficit. Some of the concern reflects a view that U.S. exports should equal U.S. imports. This view fails to appreciate that a country's trade balance and its capital account are very closely related. . . . Via basic accounting, a country's capital account surplus is equal to its current account deficit. For simplicity, let's view the current account deficit as the trade deficit. A common mistake is to treat international capital flows as though they are passively responding to what is happening in the trade account. In fact, investors abroad buy U.S. assets not for the purpose of financing the U.S. trade deficit but because they believe these assets are sound investments, promising a good combination of safety and return. On a personal level, every one here has the option of moving funds abroad, for example through mutual funds that invest in foreign stocks and bonds. Why is the net capital flow into rather than out of the United States? The reason is that for most investors the United States is the capital market of choice. There is no better place in the world to invest.

In sum, the United States has created for itself a comparative advantage in capital markets, and we should not be surprised that investors all over the world come to buy the product. As investors exploit the opportunities provided by U.S. financial markets, trade deficits can arise. Thus, my view is that our current trade deficits are not a cause for alarm because on the whole they reflect extremely positive forces driving the U.S. capital account.

Duncan is quite harsh on this view: "It is hard to understand how such a ridiculous idea could be taken seriously" he says. French economist Jacques Reuff called the fiat dollar system [6] "a childish game in which, after each round, the winners return their marbles to the losers". Reuff was referring to the activities of the French central bank (for example) when it acquires dollars from French exporters in exchange for French Francs who have sold their goods to Americans for dollars but require Francs to pay their costs, then turns around and invests those dollars back in the U.S.

Without the ability to settle foreign exchange transactions in gold, the rest of the world had no choice but to continue to fund U.S. indebtedness with the proceeds earned from U.S. consumption. As the dollars return home, they enter the U.S. banking system, where they can serve as the base of the money creation pyramid resulting in U.S. credit expansion, which can fund more U.S. imports, thereby continuing the cycle.

Duncan has done a tremendous job illustrating the story. For one example, he notes that since 1980, U.S. total debt has grown at twice the rate of GDP. Increasing U.S. budget deficits will require even more debt in search of willing lenders.

The more familiar effect of inflation, consumer price inflation, is the bidding up of the money prices of consumption goods as the money supply expands. However, inflation does not always take this route: asset price inflation occurs when credit money creation flows into financial assets. Duncan cites statistics showing a strong correlation between credit growth and asset prices in bubble economies. Financial manias otherwise known as bull markets are the result. The ever-expanding supply of dollars in the absence of market exchange rate adjustments has created credit bubbles both abroad and at home.

*The Dollar Crisis* traces the flow of dollars into Japan and Asia, which suffered their own asset price bubbles in the '80s and '90s respectively. As dollars enter foreign banking systems in exchange for exports to the U.S., they increase the monetary base, which leads to more a domestic credit expansion. Bubbles are followed by busts, which usually result in banking crises, and then fiscal crises generated by the ensuing costly bailout of the banking system by the government.

The recycling of these dollars back into America drives a series of asset price booms here. Duncan writes, "Consequently, [America's trading partners] acquisitions of U.S.

dollar-denominated stocks, corporate bonds, and U.S. agency debt have helped fuel the stock-market bubble, facilitated the extraordinary misallocation of capital, and helped drive U.S. property prices higher."

Duncan forecasts a "New Paradigm Recession" following the collapse of the dollar, which he compares to the Great Depression of the 1930s. The New Paradigm Recession will emerge out of the continuing U.S. downturn (which Duncan views as only a warm-up for the real thing) as the U.S. economy can no longer service the massive debt load that exists in the consumer, corporate, and government sectors. The recession, when it comes, will be global in scope. It must come, Duncan argues, because of the unsustainability of current trading patterns and exchange rates.

America's foreign creditors are stuck with their vast piles of U.S. dollar-denominated securities, partly because they have pursued mercantilist policies of favoring exports over imports, which would be imperiled if their currencies rose against the dollar. These export-subsidizing economies created a productive structure in their economy that is overly invested in creating goods for export to the U.S. and underinvested in satisfying the demand of domestic consumers.

This pattern, which Duncan calls "over-investment" will be recognized by Austrian readers as malinvestment. A recession in the U.S., resulting in a decline in consumption of imported goods, will spread to the exporting economies of Asia when Americans can no longer afford to import the goods that they produce.

The current housing bubble and the contemporaneous "refinancing extravaganza" as a creation of the housing GSEs (Government-Sponsored Enterprises), notably Fannie Mae and Freddie Mac, come under heavy criticism in *The Dollar Crisis*. Homeowners borrow against their home in order to consume beyond their means while those same foreigners who produce the goods that they consume lend them the money through their purchase of GSE debt.

To bring this unsustainable experiment in world wide fiat money to an unpleasant conclusion, the dollar must fall against the countries having trade surpluses with the U.S. by enough to reverse the U.S. trade deficit, especially China and the Asian exporting countries. This will bring an end to "the era of export-lead growth".

Duncan attacks the view that "any economic difficulty can be overcome simply by adjusting the money supply up or down, depending on the circumstances", In a passage that could almost have been written by von Mises, Duncan writes: "the recession is the period during which equilibrium is restored to the economy after a long period of over-stimulation due to excessive monetary stimulation through credit expansion."

Booms involving periods of extraordinary asset price inflation are episodes of economic drunkenness, where credit is the drink. All those who believe that increasing the money supply in Japan would cure the long ongoing recession there, or that monetary expansion during the 1930s would have prevented the Great Depression, fail to understand, or at least refuse to admit, that the extraordinary booms that preceded those slumps were unnatural and unsustainable economic events originating in too much credit and that it was those booms themselves that were responsible for the ensuing crises.

Duncan's analysis of the problem is masterful, and his forecasts are more than likely to be accurate in their broad strokes. Austrians may hope that out of the ashes that will be left by the demise of the international fiat money standard, a return to gold as the basis for the monetary system will be seen in a better light.

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[1] As [Rothbard has argued](#), this is not a form of price control. It is more analogous to the definition of a foot as twelve inches.

[2] Henry Hazlitt, *From Bretton Woods to World Inflation*, p. 159.

[3] Hazlitt, p. 161.

[4] Hazlitt, p. 162.

[5] Recently, Fed Governor Bernanke gave a speech in which he ominously reminded his audience that the central bank has a printing press, and will use it to any extent necessary to ensure the continued generation of inflation.

[6] Quoted by Duncan.

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