The US Dollar's Days are Numbered

Bill Bonner - Mon 30 Mar, 2009

Gold to replace the dollar as the new world monetary system

Granada, Spain

Monday, 30 March 2009

The dollar's days are numbered. We are beginning to feel sorry for it... as we do all lost causes.

Trouble is we don't know whether it's a big number or a little number that marks the dollar's last days.

Last week, a decimal point seemed to move to the left. A UN advisory panel had suggested that maybe it was time to figure out a better way to run the world's monetary system. Better, that is, than using the US dollar as the reference currency for the whole world.

As you recall, almost every price on the planet ultimately relates to dollars. You can buy an orange here in Granada for euros. But the global market in oranges is priced in dollars. So when people figure out how much something is worth – in global terms – they typically refer to dollars. And when countries want to make sure they have enough money on hand to settle up their debts with other countries, enough money to buy Florida oranges, or enough to purchase oil to run their factories – they lay in a supply of dollars.

But while the value of everything is referenced to dollars, what's the dollar's value referenced to? At the end of the day, upon what rock does the world financial system rest? Ah... that's the weakness of it... there ain't no rock. Look at the foundation of the world's money system and all you find is mush.

And last week, the Chinese poked around with a stick to see how soft it was...

They, too, said it was time for a change... a new money system with the IMF operating as a sort of Super Central Bank... giving nations 'special drawing rights on gold.

And this week, the G20 will meet in London. They are to have a 'rendezvous with destiny,' say the papers. The world is faced with a huge challenge. People turn their weary eyes to the politicians, hoping they will meet the challenge. Historians will record the event like they did the Council of Trent or the Treaty of Westphalia.

Blah... blah... blah... as near as we can tell. Fact is, there isn't anything our leaders can do about the situation except make it worse. The markets need to clear... and adjust to the new post-bubble reality. The more effective governments are at preventing this from

happening – that is, the more successful their bailouts are – the longer and deeper the correction will be.

At least on the subject of the dollar, the G20 group could do something worthwhile. They could renounce Nixon's faith-based currency system... and return to a gold-backed system. But they're not going to do that. Not yet. Not until the dollar-based system has blown itself up.

When will that happen? We wish we knew. But, one way or another, sooner or later, a new money system is bound to emerge. Most likely, it will have gold at its base. Why? Because in thousands of years of human experience, nothing better has ever been found. Not that we completely discount the possibility of a better system; humans can be clever. But money is the sort of activity where you don't want cleverness. You want dumb, honest solidity... you want something that cleverness can't undermine or circumvent. You want money that smart people can't fiddle with.

Right now, central banks are fiddling faster than Nero. The US total cost alone for all this fiddling is something on the order of $14 trillion. Under these circumstances, you'd think inflation was a sure thing... and that the dollar was a goner.

Not so fast. Inflation is not that easy to create or control. It could be months... or years... before consumer prices rise. As we explained last week, people who expect consumer prices to rise immediately could be deeply disappointed.

For one thing, the depression is sucking money out of the system even faster than the feds are putting it back in. It's that old 'paradox of savings' issue. When an economy goes into a downswing, people save money. This causes prices to fall... making saving more valuable. Then, people save even more. Instead of circulating, money goes into pockets, vaults, and mattresses; saved for a rainier day... and lower prices.

For another thing, "the money multiplier... has collapsed," as one economist put it in the Financial Times. Normally, when banks get more money they 'multiply' it by lending out even more. That's how fractional reserve banking is supposed to work. But now, the banks aren't lending. They're rebuilding their own coffers... just like ordinary citizens. Besides, they're afraid to lend – who knows what the collateral will be worth when this depression gets finished with it! The multiplier has forgotten how to do arithmetic.

And for still another thing, there's what Keynesian economists call an "out put gap." What this means is that the economy is functioning at less than full capacity. In fact, Goldman Sachs estimates this "out put gap" at 8% of global GDP. As long as industry can provide more things – using its surplus capacity – without the need for major additional inputs, it has no pricing power.

People can buy... but it won't cause prices to rise.

We also have the Japanese experience. True, the US is not Japan. Things are different.

And we have a strong hunch that they will turn out differently too. But the Japanese experience is worth keeping in mind. The Bank of Japan tried to get prices rising for more than 10 years – putting huge amounts of cash into the system. But instead of causing consumer prices to rise in Japan, the money was borrowed and re-invested in the US and emerging markets. It did nothing to increase consumer prices in Japan.

So, what's the bottom line, you're probably wondering...

We're wondering too. What we take from this soliloquy is that inflation is tougher to conjure up than is generally recognized. Putting an extra dollar of cash into the system doesn't necessarily make prices rise.

On the other hand, this mush under the world financial system makes the structure inherently unstable. And as more and more brine is pumped in, it becomes even more unstable.

It's not that the additional liquidity raises the consumer price level directly... dollar for dollar. Instead, it is like floodwaters backing up behind an earthen dam. The risk of a sudden flood increases... one that will swamp the dollar and send investors and savers running for the high ground.

Yes, dear reader....there's the surprise we were looking for. The Fed's "quantitative easing" won't cause inflation. At least, not serious consumer price inflation directly linked to the money supply increases. The Fed will inflate the money supply. But consumer price inflation will remain relatively low – as it did in Japan. This will lead investors to believe that they can sit tight... believing that they will be able to move to a higher elevation when consumer prices finally begin to rise. They will think about buying gold, but they will put it off – waiting for the CPI to rise.

Then, very suddenly, investors will see the threat. Maybe the Chinese will be the first to rush. Maybe private investors will make the first move. Maybe it will be a sudden spike in the CPI that sets them off. Maybe it will be an unexpected spike in the price of gold... or oil. Or maybe even a bold move from the Fed that leaves no doubt as to its intentions. Then, all of a sudden people will realize that what they are holding is just paper... nothing more... and they will try to get out of it as fast as possible.

But it will be too late. Once the dike breaks, in a matter of hours, the dollar will sink like Lehman shares.

That's why we will keep our Dollar Crash Alert flag flying... while recognizing that it may not happen soon.

More news:

"The macroeconomic environment is gradually moving from appalling to merely bad but that does not mean we have started a return to a sustainable rise in stocks," writes Theo

Casey. "I'm not among the gaggle of commentators predicting the death of the equity markets. I firmly believe that the FTSE 100 will again be a leading index in a bull market. But a bull market requires lots of buyers and buyers are only coaxed by true optimism. "Perhaps world leaders meeting in London next week will be able to provide some. Or perhaps they will make things worse. Irrespective of this, the skepticism of "the crowd" does not put me off buying stocks right now. Indeed, if investors are to buy stocks at all it makes sense to do so when they are cheap. In recent months, we have selected a number of good stocks that we believe offer remarkable value – shares with low P/E ratios and high dividend yields that will be great long-term holdings..."

Editor's note: Theo Casey is investment director of The Fleet Street Letter. Theo's just made some shocking predictions that affect all UK investors. These are the dangers you need to protect yourself from – and opportunities that could help you profit.
And more thoughts:

*** We can't get away from it. Wherever we do... there we are – in the middle of a worldwide financial meltdown. Here in Granada, life seemed to go on as usual this weekend. The restaurants were nearly full... the bars were overflowing... people were out late laughing and singing until 5am.

But come this morning, and we find that the Bank of Spain has had to put up $9 billion to guarantee the depositors and creditors of the Caja Castilla-La Mancha that they won't lose money.

Here in Spain, as elsewhere, the banks have a lot of credits in their vaults that are beginning to stink. They've lent billions to builders, for example. And now prices have collapsed on Spanish property... and their mortgages loans along with it.

*** Granada is a great place for people who like lost causes.

It was the last hold-out of the Moors in Europe. For 700 years, they controlled much of present-day Spain. Finally, in 1492, Ferdinand and Isabella, after many years of war, brought Granada into the Christian kingdom. Then, in the Spanish civil war, the Alhambra fortress held out against the rebels... until it was finally forced to surrender to Franco's forces.

The Alhambra still dominates the Granada skyline. It was as a massive fort and official residence for the Moorish emirs who ruled the place. Later, Charles V built a huge palace in the complex.

Washington Irving was so taken with the place, he spent the best part of a year here – living in the Alhambra while he wrote the "Tales from the Alhambra." We felt sorry for him. It was windy and cold on the day we visited. Maybe we came too early in the year. The wisteria was in bloom, but most of the trees and bushes are just budding out. It must be a wonderland when they are in full flower.

We felt sorry for the Moors too. After 700 years, they must have felt they had a right to the place. Adverse possession only requires 25 years, after all. And then, after they had gone to all the trouble of building elaborate and magnificent monuments... constructing sophisticated systems of irrigation... planting orchards and vineyards... and showing the locals how to do math... and how to design gardens and fountains... fine thanks they get; along come the Christians and take it all away from them.

But Ferdinand and Isabella felt they had a manifest destiny to control the Iberian peninsula. And since they had more money, bigger armies and bigger cannon than the Emirate, the matter was decided.