

Dollar Crisis In The Making

Before the stampede

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Increasingly ominous clouds are gathering in what could soon be the perfect storm against the United States dollar and against the present dollar-centric global financial order.

This is not shaping up to be a storm that anyone is trying to initiate, not even those who are actively driving for a new global financial order that is no longer centered on the dollar. Instead, it will result from a correlation of forces arising out of the deepening global financial and economic crises, coupled with recurring and conspicuous miscalculation on the part of some of the world's political, financial and economic leaders.

The storm has the potential to cause upheaval on a grand scale, opening the door to swift, and largely uncontrolled, fundamental transformation.

As is widely recognized, the present financial order that is inordinately reliant on the US dollar must some day give way to a new order that is more balanced, stable, resilient and reliable, one that is based on multiple currencies and that therefore won't be plagued by the extremely dangerous structural drawback of an increasingly worrisome elemental single point of failure (the dollar).

But if the current dollar-centric financial order should become more seriously shaken than it already has been, perhaps even suffering a collapse, as a casualty of the present deepening global crisis, then the transition to any new global financial order is most likely to be disorderly, disruptive and unmanageable rather than gradual and orderly.

We can hope – but cannot be at all confident – that world leaders and global investors will act coherently, cohesively and intelligently enough in this crisis so as to ensure that the policies and actions being undertaken will not put at further serious risk the fundamental structure of the current dollar-centric financial order, and that they will instead be effective in bolstering deteriorating global confidence in the present order and in the safety of the dollar, at least until we get through this crisis.

Unfortunately, we cannot be confident that world leaders know what they are doing in seeking to resolve the crisis. Are their measures attacking the heart of the problem, or only its periphery? Are they exacerbating the crisis, either by enacting certain misdirected measures, or by failing to enact certain required measures? Are they setting up conditions that make a dollar crisis and radically increased financial upheaval virtually inevitable, by blindly pushing ahead with a simplistic agenda of trying to spend their way out of the present crisis?

If the dollar is being put at significant short- and medium-term risk by such measures, then

we're seriously risking plunging the global financial order into a depth and breadth of transition that we cannot adequately control.

Investment, finance and economics are a complex mix of at times downright illogical human psychology with the pure logic of mathematical science, introducing possibilities for potent wild-card factors that must be taken into consideration in any calculation.

History provides many unfortunate examples of how the psychological components of uncertainty, fear and panic can, at crucial times, trump the components of logic, reason, knowledge and discipline to give impetus to shortsighted and risky policies and actions that create a full-blown crisis. Humans simply don't always act in a rational and logical way that is in their best strategic interests. And institutions, regulatory agencies and governments, being composed of humans, don't always act rationally either.

All are subject to the potent influence of human psychology, which can at times be quite defensive, knee-jerk, irrational and somewhat unpredictable. In a crisis situation such as we presently find ourselves, the darker side of psychology's influence is often and unfortunately magnified.

Added to this is the fact that global investment, financial and economic systems have become increasingly complex and interrelated much faster than the ability of experts and leaders to adequately comprehend them. This makes it much easier to make mistakes of real consequence. This complexity also at times prevents governments and other institutions from taking requisite bold, comprehensive actions in the midst of crisis for fear that these may backfire by producing some unforeseen and intolerable effects and repercussions.

Further complicating matters, investment, finance and economics are nearly always deeply intertwined with politics, adding to potential uncertainty – especially so in a time of deepening global crisis, when individual governments invariably lean toward self-interest, nationalism, protectionism and self-preservation.

To illustrate the disturbing truthfulness of the foregoing, remember when experts and leaders confidently concluded that the free markets could mostly regulate themselves with success; when they concluded that no housing bubble existed in the US, but only some "regional froth"; when they insisted that complex new mortgage-backed securities, including high-risk mortgage paper, dispersed throughout the financial and investment system, would decrease default risk.

Empty reassurances

Remember when the present crisis broke in 2007, the reassurances that it would not spread beyond the confines of subprime; when it did spread, the forecasts that Wall Street banks' losses would amount only to a total of about US\$200 billion. Remember when "experts" insisted no widespread credit crunch would result. Remember when they insisted that the crisis was unlikely to spread from Wall Street to the real economy on Main Street?

Remember when they said the hundreds of billions of dollars of liquidity thrown into the system would free up the credit seizure. Remember when they said the October 3, 2008, \$700 billion stimulus package and the many more hundreds of billions of dollars in bank and corporate bailouts would move the system out of crisis. Where are all these pseudo-intellectual ideas, beliefs, ideologies, assessments and assurances now? On the trash heap,

precisely where they belonged in the first place.

The record inspires little confidence in the ongoing efforts of governments to resolve the crisis, or even that they know how to resolve it. The damage and outright destruction inflicted on vital components of the present global investment, finance and economic orders just keeps piling up while governments keep trying their various “solutions”.

As for the newly passed \$787 billion stimulus package, and its accompanying sketchy bank rescue plan, economists and the markets widely doubt whether the two measures are potent enough and targeted accurately enough to come anywhere near accomplishing their stated aims.

The same is true of the perpetually disjointed and half-hearted efforts of the Group of Seven (G-7) leading industrialized nations, whose most recent confab in Rome ended with the customary whimper. In addition to its historic impotency, the G-7 is now being almost totally emasculated by the broader Group of 20 nations, to which has fallen the task of designing and constructing a new global order to replace the present broken one. If you concluded based on the hard facts that this crisis is spinning increasingly out of control in spite of, and in some important ways due to, the efforts of governments to resolve it, you would not be far wrong.

Investors, both private and official, around the globe have generally given in to a crisis reflex psychology of extreme risk aversion and have been clutching the US dollar ever more tightly, massively running into Treasuries as a refuge in the mounting storm. This fact would seem to imply that global confidence in the dollar is still fundamentally sound, despite the well-documented bruises it has received over the past few years.

The truth is that the potential for a global dollar panic is becoming greatly heightened, in spite of (and in part, actually because of) the dollar's recent significant gains as a refuge for investors, the bulk of whom continue to be distinctly risk-averse. Ironically, this massive piling onto the dollar opens yawning new vulnerabilities and risks that either did not exist before, or were at most very minimal.

For example, a number of experts warn that US Treasuries are increasingly taking on the characteristics of a bubble, and they remind us that bubbles inevitably deflate, and they rarely, if ever, do so in an orderly fashion. When this one deflates there could be uncontrolled, perhaps even chaotic, repercussions for the dollar.

Much discussion and debate is currently underway as to whether the US will find sufficient global demand for the more than \$2 trillion in new Treasuries coming online this fiscal year alone. But the fundamental risks for the dollar aren't only arising out of that fear over whether demand for Treasuries will be sustained.

Serious risks for the dollar also arise if global demand for Treasuries is sustained. Why? Because that would only thrust the present Treasuries bubble to even more gigantic proportions, further warping the structure of the already severely deformed present global financial order, magnifying the dangerous distortions that already exist and increasing the likelihood of a massive second wave of damage and destruction in this present crisis, and an eventual burst in the Treasuries bubble.

The emerging markets and their banks and governments are suffering under increasingly

tighter credit strangulation and mounting financial and economic losses, with skyrocketing risks of default, due to the tightening global credit seizure. And US and European commercial credit not explicitly backed by governments is also suffering likewise. As if that dangerous situation were not bad enough, the massive spending and debt issuance policies being embarked on by the US government only greatly exacerbate the increasingly unstable situation for all these players.

By facilitating and encouraging the massive global flight into Treasuries, and by issuing a huge new supply of US sovereign debt, emerging markets, their governments and banks, and US businesses are deeply suffering. As the US government sucks all the air out of the global credit markets via the unstemmed growth of its latest in a series of dangerous asset bubbles, namely the Treasuries bubble, these other entities find it extremely difficult to issue debt (obtain credit) at feasible costs, if at all. Investors are demanding very high yields to exit the relative “safety” of Treasuries to invest in corporate and government bonds in the emerging markets and in large swaths of the US and Western Europe as well.

These increasingly high yields demanded by investors translate into high costs and mounting losses by banks across the financial system. The situation is moving rapidly to a potential massive wave of bank, corporate and government defaults. Eastern Europe is on the very precipice as a result. If such already severely weakened emerging market governments, banks, businesses and US corporations do default, they will place enormous new pressures on European and US banks which are either heavily exposed, or not sufficiently immunized, to the risks.

The global credit markets and financial systems are deeply interconnected, meaning that contagion spreading from an Eastern Europe default to the rest of Europe and the US is virtually assured. So those pressures will be felt by the entire global financial order, and such new and profound stresses upon an already extremely shaky order won't likely be endured without a genuine meltdown of the entire system.

These huge and dangerous distortions in the global financial order are due largely to US government policies regarding Treasuries and the shortsighted willingness of global investors to participate in pumping up that profoundly harmful bubble. If the US succeeds in selling its greatly increased supply of Treasuries, then such distortions in the global order will only become more profound, their negative repercussions (credit strangulation) will only become much more potent, and the feared second wave will be virtually assured. And so far, demand for Treasuries has remained high, thereby ensuring the dangerous persistence of the credit strangulation referred to here.

That second wave, if it comes, will also carry profoundly negative repercussions for the Treasuries bubble itself, because the US and Europe will be plunged into undeniable, full-blown depression via a financial meltdown by the heavy burden of the cascading effects of default in Eastern Europe. That eventuality will force global investors to finally begin to evaluate the safety and appeal of Treasuries and the dollar based much more on the swiftly disintegrating fundamentals of the US economy and much less on a psychological reflex, driven by extreme risk aversion, that at present corrals investors into Treasuries for their supposed safe-haven benefits.

The stampede in the making Investors will begin to stampede out of financial assets such as Treasuries and into hard assets like precious metals and certain commodities whose price has been severely beaten down. These will offer comparatively much safer stores of wealth,

ones with a real profit potential. China, via its resource buys, is already blazing the trail, going energetically into hard assets, rather than sustaining its 2008 rate of purchases of Treasuries and other financial assets.

Replay the recent histories of the chaotic housing and the commodities bubble bursts. Global investors, at the behest of enthusiastic governments, largely ignored the inevitable risks and piled into these assets on a grand scale, with the hottest interest coming just before the burst occurred. The environment of very low global interest rates and a massive global credit excess set the stage for enormous investor profits on these gigantic and mushrooming asset bubbles.

But when mounting inflation obliged the Fed to begin to steadily hike interest rates, the housing bubble began to burst in late 2006. As the dollar weakened under mounting inflation and loss of its appeal as a safe store of wealth, global investors piled ever faster into commodities for safety and for profit, inflating that bubble to gigantic proportions by the summer of 2008, when oil nearly reached \$150 per barrel.

Then, when the global recession emerged later that summer, investors realized global demand and prices for commodities would plunge, so they stampeded out of commodities and into Treasuries, and the commodities bubble burst. Both bubble bursts left a great deal of wreckage in their wakes, with asset values collapsing, pulling businesses, banks and even governments into the abyss.

Though the present Treasuries bubble is more about safety than it is about profit, the fundamental risks associated with bubbles still apply to it. The bigger it gets, and the more reliant upon it as a safe store global investors become, the more unstable it turns out to be because it becomes more sensitive to various factors, both internal and external, both real and psychological.

The bigger and hotter any bubble gets, the more prepared its devotees become to speedily abandon it in favor of the next one. That explains why investors have mostly piled into very short term Treasuries – they know they may well have to sell out even faster than they bought in.

So, no one should assume that the present crisis will moderate or move toward resolution just because global demand for Treasuries might remain high in coming months. That would only signal that the Treasuries bubble is growing more massive, and that the distortions in the global financial order are only becoming more profound and dangerous, threatening to bring in a second wave of destruction, and that the bubble is therefore much nearer to bursting. This constitutes a potential perfect storm against the dollar and against the present global financial order that no one wants, but no one is seeking to prevent either.

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