Escape From The Dollar

Mike Whitney Interviews Paul Craig Roberts

By Dr. Paul Craig Roberts and Mike Whitney
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Paul Craig Roberts thinks the Fed has backed itself into a corner. A rise in interest rates would strengthen the dollar, give the dollar new life as world reserve currency, and halt the movement into gold, but a rise in rates would collapse the bond and stock markets and reduce the value of derivatives on the banks' balance sheets. I asked Dr. Roberts if the Fed would sacrifice the dollar in order to save the banks and what the effect would be on Washington's power viv-a-vis the rest of the world. His answers to these questions suggest that Washington's days of financial hegemony and world leadership are numbered.

Mike Whitney: Is the US dollar at risk of losing its position as reserve currency? How would this loss affect US leadership and other countries?

Paul Craig Roberts: In a way the dollar has already lost its reserve currency status, but this development has not yet been officially realized; nor has it hit the currency markets. Consider that the BRICS (Brazil, Russia, India, China, and South Africa) have announced their intention to abandon the use of the US dollar for the settlement of trade imbalances between themselves, instead settling their accounts in their own currencies. (There is now a website, the BRICSPOST, that reports on the developing relations between the five large countries.) There are also reports that Australia and China and Japan and China are going to settle their trade accounts without recourse to the dollar.

Different explanations are given. The BRICS imply that they are tired of US financial hegemony and have concerns about the dollar's stability in view of Washington's excessive issuance of new debt and new money to finance it. China, Australia, and Japan have cited the avoidance of transaction fees associated with exchanging their currencies first into US dollars and then into the other currencies. They say it is a cost-saving step to reduce transaction costs. This may be diplomatic cover for discarding the US dollar.

The October 2013 US government partial shutdown and (exaggerated) debt default threat resulted in the unprecedented currency swap agreements between the Chinese central bank and the European central bank and between the Chinese central bank and the Bank of England. The reason given for these currency swaps was necessary precaution against dollar disruption. In other words, US instability was seen as a threat to the international payments system. The dollar's role of reserve currency is not compatible with the view that precautions must be taken against the dollar's possible failure or disruption. China's call for "a de-Americanized world" is a clear sign of growing impatience with Washington's irresponsibility.

To summarize, there has been a change in attitudes toward the US dollar and acceptance of US financial hegemony. As the October deficit and debt ceiling crisis has not been resolved, merely moved to January/February, 2014, a repeat of the October impasse would further erode confidence in the dollar.

Regardless, most countries have come to the conclusion that not only has the US abused the reserve currency role, but also the power of Washington to impose its will and to act outside of law stems from its financial hegemony and that this financial power is more difficult to resist than Washington’s military power.

As the world, including US allies, made clear by standing up to Washington and blocking Washington’s military attack on Syria, Washington’s days of unchallenged hegemony are over. From China, Russia, Europe, and South America voices are rising against Washington’s lawlessness and recklessness. This changed attitude toward the US will break up the system of dollar imperialism.

Mike Whitney: How is the Federal Reserve’s Quantitative Easing impacting the dollar and financial instruments?

Paul Craig Roberts: The Federal Reserve’s policy of creating large amounts of new money in order to support the balance sheets of “banks too big to fail” and to finance continuing large budget deficits is another factor undermining the dollar’s reserve currency role. The liquidity that the Federal Reserve has pumped into the financial system has created enormous bubbles in bond and stock markets. US bond prices are so high as to be incompatible with the Federal Reserve’s balance sheet and massive creation of new dollars.

Moreover, central banks and some investors have realized that the Federal Reserve is locked into the policy of supporting bond prices. If the Federal Reserve ceases to support bond prices, interest rates will rise, the prices of debt-related derivatives on the banks’ balance sheets will fall, and the stock and bond markets would collapse. Therefore, a tapering off of quantitative easing risks a financial panic.

On the other hand, continuing the policy of supporting bond prices further erodes confidence in the US dollar. Vast amounts of dollars and dollar-denominated financial instruments are held all over the world. Holders of dollars are watching the Federal Reserve dilute their holdings by creating 1,000 billion new dollars per year. The natural result of this experience is to lighten up on dollar holdings and to look for different ways in which to hold reserves.

The Federal Reserve can print money with which to purchase bonds, but it cannot print foreign currencies with which to purchase dollars. As concerns over the dollar rise, the dollar’s exchange value will fall as more dollars are sold in currency markets. As the US is import-dependent, this will translate into higher domestic prices. Rising inflation will further spook dollar holders.

According to recent reports, China and Japan have together reduced their holdings of US Treasuries by some $40 billion. This is not a large sum compared to the size of the market, but it is a change from continuing accumulation. In the past, Washington has been able to count on China and Japan recycling their trade surpluses with the US into US Treasury debt. If foreign willingness to acquire Treasury debt declines and the federal budget deficit does not, the Federal Reserve would have to increase quantitative easing, thus putting even more pressure on the dollar.

In other words, in order to avoid an immediate crisis, the Federal Reserve has to continue a policy that will produce a crisis down the road. It is either a financial crisis now or a dollar crisis later.

Eventually, the Federal Reserve's hand will be forced. As the dollar's exchange value declines, so will the value of dollar-denominated financial instruments regardless of how many bonds the Federal Reserve purchases.

Mike Whitney: How is China likely to respond to America's changing economic position?

Paul Craig Roberts: When I met with Chinese policymakers in 2006, I advised them that there was a limit to how long they could rely on the US consumer market as jobs offshoring was destroying it. I pointed out that China's large population provided policymakers with the potential for an enormous economy. They replied that the one-child policy, which had been necessary in early years to keep population from outrunning social infrastructure, was blocking the development of a domestic consumer economy. As peasant farmers no longer could rely on multiple children for old age insurance, they hoarded their earnings in order to provide for their old age. Chinese policymakers said that they intended to develop a social security system that would give the population confidence to spend more of their earnings. I do not know to what extent China has moved in this direction.

Since 2006 the Chinese government has let the yuan appreciate 25% or 33%, depending on the choice of base. The increase in the currency's exchange value has not hurt exports or the economy. Moreover, the US no longer manufactures many of the items for which it is dependent on China, and other developing countries do not have the combination of the technology that US corporations have given to China and China's large excess supply of labor. So it is unlikely that China faces any threat to its development except for US policies designed to cut China off from resources, such as the new US military focus on the Pacific announced by the Obama regime.

China's large dollar holdings are the consequence of the technological prowess that China acquired from Western corporations offshoring jobs to China. What is important to China is the technology and business know-how, which they have now acquired. The paper wealth represented by dollar holdings is not the important factor.

China could destabilize the US dollar by converting its holdings into dollar currency and dumping the dollars into the exchange markets. The Federal Reserve would not be able to arrange currency swaps with other countries large enough to buy up the dumped dollars, and the dollar's exchange value would fall. Such an action could be a Chinese response to military encirclement by Washington.

In the absence of a confrontation, the Chinese government is more likely to gradually convert its dollars into gold, other currencies and real assets such as oil and mineral deposits and food businesses.

Quantitative easing is rapidly increasing the supply of dollars, but as other countries move to other arrangements for settling their trade imbalances, the demand for dollars is not rising with the supply. Thus, the dollar's price must fall. Whether the fall is slow over time or sudden due to an unanticipated Black Swan event remains to be seen.

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