The Meltdown of the Dollar: It's Systemic, Stupid!

by Lothar Komp

Does it seem paradoxical? Just a few weeks after the ostensibly glorious victory of U.S. and British troops in Iraq, the U.S. dollar and the British pound have turned into two of the weakest currencies in the world. April 2003 was already the ninth consecutive month in which the dollar declined against other leading currencies. But in May, the dollar fall sharply accelerated. On May 12, the dollar hit its latest four-year low against the euro, at $1.162, while the pound fell further, to its lowest level in six years, compared to an index of other currencies.

Since the Labour Party's Tony Blair took power in 1997, the pound has never been so low. Compared to the euro, the pound has tumbled 10% this year and has reached an all-time low. It is especially under pressure since the February surprise move by the Bank of England, which pushed down its discount rate to 3.75%, the lowest in 48 years. British newspapers are already drawing comparisons to the "sterling crisis" in September 1992, when the pound was under attack and had to be taken off the European Exchange Rate Mechanism (ERM).

As in the United States, the British current-account deficit is out of control, the industrial sector is shrinking, and private household consumption depends on a housing and mortgage credit bubble that could soon implode.

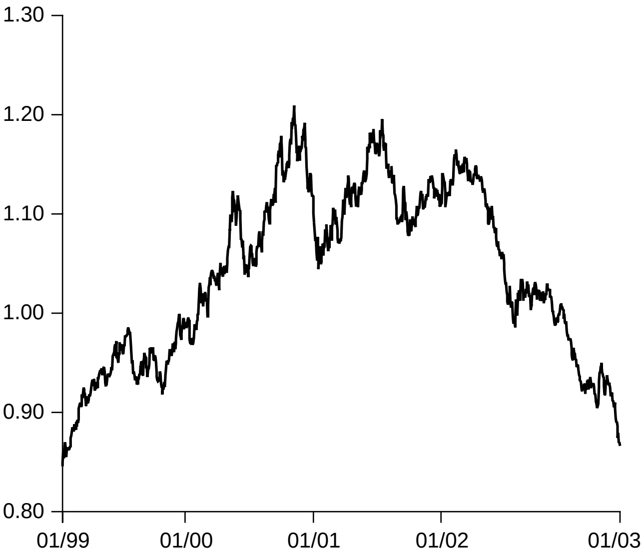
The dollar meltdown has much more dramatic international consequences. The world financial system is essentially a dollar-denominated system. Much of world trade transactions are denominated in dollars. When the World Trade Organization (WTO) in late April published its "World Trade Figures 2002," it warned that annual growth rates for world trade volume are about to fall below the 3% mark, the worst in two decades. But what does 3% annual growth of a dollar-denominated volume mean, when at the same time the dollar is crashing at a roughly 20% annual rate against the euro? (See **Figure 1.**) What if somebody calculated the recent 12 months' performance of U.S. Gross Domestic Product (GDP) in terms of euros, yen, or gold? The result would be the biggest economic contraction in the United States since the Great Depression.

The implosion in the value of the dollar is causing great concern overseas. European industrial corporations are worrying about their exports. In Japan, the central bank admitted "stealth" interventions in the foreign exchange markets amounting to 2.39 trillion yen ($20.5 billion) during the first quarter of this year; that is, buying dollars to push down the yen. Without formal acknowledgment for the time being, the Bank of Japan is widely believed to have restarted these foreign exchange interventions on a daily basis since May 8, with little effect.

International Monetary Fund (IMF) chief economist Kenneth Rogoff, who warned in July 2000 of a potential 50% crash of the U.S. dollar, noted in a *Washington Post* interview on May 9, that a sudden large drop in the dollar's value "might lay bare weaknesses in the financial system," by causing severe losses to major market players with derivatives portfolios and hedge funds, some of which rely on a stronger dollar.

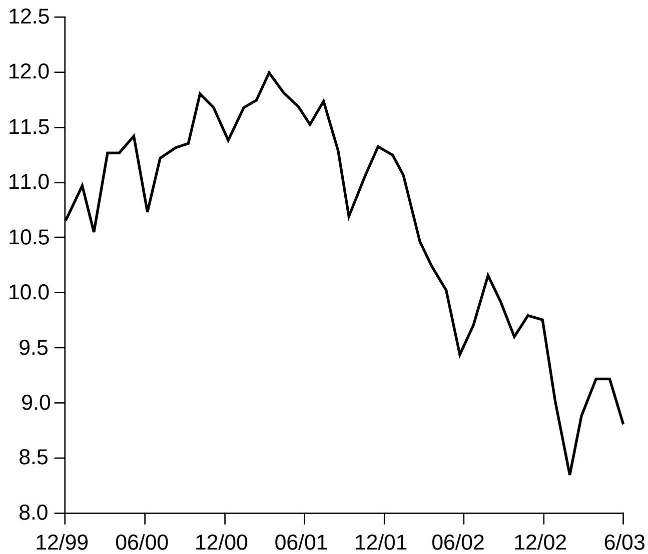
Rather than comparing the value of the dollar to that of other currencies, the dollar decline can be measured in terms of its power to buy gold (**Figure 2**). After going up $10 in the week ending May 2, the gold price increased another $8 per ounce in the following week, before reaching $351 per ounce on May 12. In March 2001, for every $100 you could buy 12.0 grams of gold. Today, the same amount of dollars just purchases 8.8 grams of gold.

FIGURE 1
The Dollar Plunges Against the Euro
(Value of the Dollar in Euros)



Source: Wall Street Journal.

FIGURE 2
Gold Value of the Dollar
(Grams of Gold per $100)



Sources: London Bullion Market Association; EIRNS.

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The Actors on the Scene

The question naturally arises: Who or what is responsible for the rapid dollar decline? At first glance, the most important issue here seems to be what the various actors on the scene—from central bank governors and treasury secretaries, to currency traders and private investors—have on their mind. And indeed, most of them have good reasons to sell dollars:

• The Asian central banks are now holding about 80% of all foreign exchange reserves worldwide, and most of this is still invested in U.S. government bonds and other U.S. assets. Nobody can be surprised that these central banks are rapidly losing confidence in the U.S. power to sustain a giant $500 billion current-account deficit, now being joined by a $300-400 billion U.S. government deficit. They are looking for alternatives, whether it will be euros, regional currencies, or gold.

• Most outspoken are the central banks of Malaysia and Indonesia. Following the announcement by the Indonesian state-run oil producer Pertamina to consider selling oil for euros instead of dollars, Indonesian Finance Ministry advisor Mahenda Siregar, in late April, confirmed that Indonesia is considering introducing the euro as a currency for foreign trade. According to Singapore's *Business Times*, the central bank of Indonesia has already quietly replaced 15% of its dollar-denominated foreign exchange reserves—in total, $33 billion—for euros. Citing the dramatic fall in the value of the dollar since early 2002, and expecting the fall to continue, Malaysian Prime Minister Mahathir bin Mohamad said on May 8 that the state-owned oil company Petronas should consider a plan similar to Pertamina's. Mahathir, asked wouldn't the United States be unhappy with such a move, responded, "It is not a question of the United States being unhappy, but whether we get value for our goods."

• As a consequence of the U.S. geopolitical rampage, Arab investors are raising the question, whether re-investing oil revenues in U.S. assets is still such a good idea. Any country could suddenly be added to the "axis of evil" list and wake up one morning to find its assets in the United States frozen. In recent months, there have been several reports about the withdrawal of up to $200 billion of Saudi money from U.S. markets. Regardless of whether this is true or not, the reluctance to buy additional U.S. assets is rising by the day.

• In Europe, there may be some political/financial circles who think that by introducing the euro as a competitor to the U.S. dollar in foreign trade transactions and for currency reserves, they could somehow have a useful tool to counter U.S. hegemony in international affairs. But after all, the European economies are in a precarious situation as well, and the relative strength of the euro is nothing more than a reflection of the dollar's weakness.

• Finally, there is the Bush Administration, which is getting ever more desperate about the ailing state of the economy.

For the third year in a row, we are now hearing promises about a robust recovery "sometime in the second half of the year." Even according to official figures, more than 2.5 million jobs have been lost in the U.S. economy since George W. Bush took power. As 12 interest rate cuts by the Federal Reserve have completely failed to boost corporate investments, and the tax cut package is running into resistance by the U.S. Senate—whether it would help at all is another question—some people in the Administration might welcome a smoothly declining dollar. Even if it doesn't foster U.S. exports, it might increase the price of imported goods, thereby reducing the trade deficit and helping domestic producers.

Such theories are pretending there is a control over foreign exchange movements, which the Administration no longer has. The whole dollar-denominated financial system is disintegrating. Since Spring-Summer 1995, Group of Seven central banks have again and again opened up their monetary floodgates to rescue a system, plagued by one catastrophe after the other: the near-default of Mexico and the Japanese banking crisis in 1995; a series of derivatives disasters including Barings bank in the same year; the Asian economic and financial dramas in 1997-98, the Russian bond default in August 1998; the LTCM meltdown a month later; the Brazil crisis in 1999; the Argentina default in 2001. The net effect of the liquidity-pumping was the build-up of new financial bubbles, which later burst, culminating in the biggest stock market slide in 70 years.

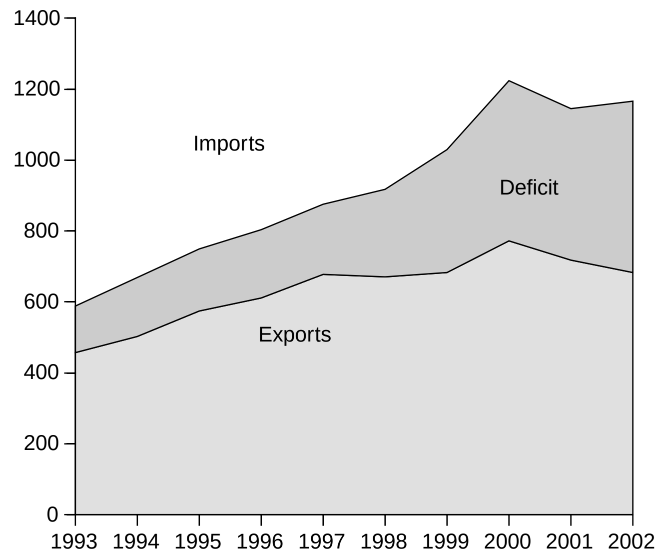
Starting from the periphery, the global financial disintegration has now made its way right into the very center of the system: the U.S. financial markets and the dollar. While the American industrial sector is shrinking, corporations, households, and governments are still piling up almost $2 trillion in additional debt every year, both in respect to domestic and foreign creditors. This debt pyramid is coming down soon, no matter how much more liquidity the Federal Reserve might pump into the system. And the rapidly deteriorating power to finance the U.S. current-account deficit is just one aspect of this overall financial disintegration process.

Tectonic Disruptions of Foreign Capital Flows

In the year 2002, the U.S. current-account deficit exploded to yet another record-high of $503.4 billion, up from $393.4 billion in the year before. The main contributing factor was, of course, the giant deficit in foreign trade, which worsened again last year (**Figure 3**): While exports of goods decreased from $718.8 billion to $682.6 billion, imports further increased from $1,145.9 billion in 2001 to $1,166.9 billion in 2002, pushing up the trade deficit alone to $484.4 billion (compared to 2001's $427.2 billion).

The extremely high and still rising U.S. trade deficit would require further net capital flows into the United States to finance it. However, there actually has been a dramatic decline in the overall net purchases of U.S. assets by foreigners: from $1,024.2 billion in 2000, to $752.8 billion in 2001, and only $630.4 billion in 2002.

FIGURE 3
U.S. Foreign Trade in Goods
($ Billions)



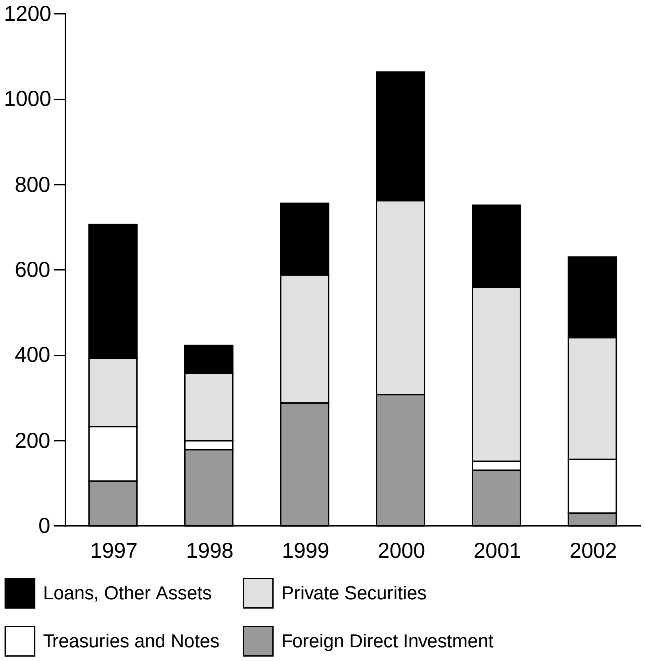
Sources: U.S. Treasury; EIRNS.

One category of U.S. assets after the other is facing a collapse in foreign demand (**Figure 4**). At a time when the Potemkin village of the American "New Economy" was fooling investors worldwide, foreign net buying of U.S. stocks doubled each year, reaching an all-time high of $192.4 billion in the year 2000. Since then, stock markets all around the globe have crashed and foreign net buying of U.S. stocks has plunged, to $119.5 billion in 2001 and to a tiny $55.8 billion in 2002.

Again related to the "New Economy" hype was the global takeover bonanza in the late 1990s and 2000, preferably the buying up of U.S. entities. Net financial inflows for foreign direct investments in the United States peaked in the year 2000 at $307.7 billion, before melting down to $130.8 billion in 2001 and $30.1 billion in 2002, just one-tenth of what it was two years before.

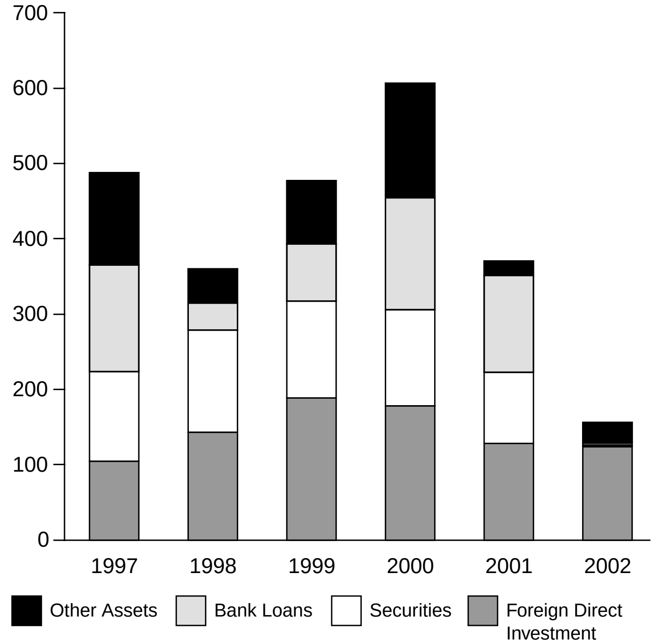
What somehow kept foreign capital flowing into the United States in the recent two years, was the bond market. Bonds promise a defined return and, following the stock market crash, were perceived as a safe investment. Foreign net buying of U.S. corporate bonds, therefore, was still able to reach a record high in 2001, at $288.2 billion. But since then, there has been an unprecedented series of mega-defaults in the U.S. corporate sector—seven of the ten biggest corporate defaults in U.S. history happened in the years 2001 and 2002—and bonds of the respective firms lost of all their value. Those firms still offering corporate bonds have to promise

FIGURE 4
Foreign Net Purchases of U.S. Assets
($ Billions)



Sources: U.S. Treasury; EIRNS.

FIGURE 5
Net American Purchases of Foreign Assets
($ Billions)



Sources: U.S. Treasury; EIRNS.

much higher yields. As a consequence, foreign net buying of U.S. corporate bonds fell more than 20% last year, to $228.8 billion in 2002.

The only asset category showing rising foreign demand in 2002 was government bonds. While in the years 1999 and 2000 there had been net selling of U.S. Treasuries and other U.S. government securities by foreign investors, 2002 saw a remarkable net capital inflow in this category, amounting to $127.3 billion. But following Federal Reserve Chairman Alan Greenspan's 12 interest-rate cuts since early 2001, the yields on government bonds have also fallen to a 40-year low. The only way for the U.S. Treasury to boost foreign buying of its debt would be a sharp rise in interest rates, which would further depress public finances, could trigger the bursting of the housing bubble, and would certainly cause the default of numerous corporations and private households.

'Can Nothing Stop' Dollar Fall?

Overall, as the "new economy" myth has collapsed, total net purchases of U.S. assets have dramatically declined in the recent two years. But, the U.S. current-account deficit is still rising; therefore, the United States now needs even higher capital inflows than two years ago. How can this be done? In 2002, it was only possible to create an apparent increase in net capital inflows, by cutting American net purchases of foreign assets, much faster than foreign investors cut down their purchases of American assets (**Figure 5**). From $581 billion in 2000, American net purchases of foreign assets fell to $371.0 billion in 2001, and to $156.6 billion in 2002. In the category of stocks and corporate bonds, there was a *net liquidation* by U.S. investors in 2002. In particular, the German stock market was affected by massive American liquidations.

Since there is no longer any attractive investment which the United States can offer foreign investors, and as the liquidation of foreign assets doesn't present a long-term alternative, the U.S. current-account deficit is now about to hit the wall. As a European bank economist with special insights into U.S. economic developments noted recently: The fall of the dollar "is out of control, nothing can stop it."