

# *Crisis of the U.S. Dollar System*

By: F. William Engdahl  
Center for Research on Globalization  
October 14<sup>th</sup>, 2006

It's accepted wisdom that the United States, despite recent problems, is still the strongest growth locomotive for the world economy, the pillar of the global system. What if we were to discover that, instead of being the pillar, that the United States was, in fact, the heart of a dysfunctional economic system, which is spreading instability, unemployment, and depression globally?

No other nation on earth comes near to the commanding US military superiority in smart bombs, military IT, or in sheer force capabilities. The US position in the world since 1945, and especially since 1971, has rested on two pillars, however: The superiority of the US military over all, and, the role of the dollar as world reserve currency. That dollar is the Achilles heel of American hegemony today.

In my view, the world has entered a new, highly dangerous phase since the collapse of the US stock market bubble in 2001. I am speaking about the unsustainable basis of the very Dollar System itself. What is that Dollar System?

## **How the Dollar System works**

After 1945, the US emerged from war with the world's gold reserves, the largest industrial base, and a surplus of dollars backed by gold. In the 1950's into the 1960's Cold War, the US could afford to be generous to key allies such as Germany and Japan, to allow the economies of Asia and Western Europe to flourish as a counter to communism. By opening the US to imports from Japan and West Germany, a stability was reached. More importantly, from pure US self-interest, a tight trade area was built which worked also to the advantage of the US.

That held until the late 1960's, when the costly Vietnam War led to a drain of US gold reserves. By 1968 the drain had reached crisis levels, as foreign central banks holding dollars feared the US deficits would make their dollars worthless, and preferred real gold instead.

In August 1971, Nixon finally broke the Bretton Woods agreement, and refused to redeem dollars for gold. He had not enough gold to give. That turn opened a most remarkable phase of world economic history. After 1971 the dollar was fixed not to an ounce of gold, something measurable. It was fixed only to the printing press of the Treasury and Federal Reserve.

The dollar became a political currency—do you have "confidence" in the US as the defender of the Free World? At first Washington did not appreciate what a weapon it had created after it broke from gold. It acted out of necessity, as its gold reserves had got dangerously low. It used its role as the pillar of NATO and free world security to demand allies continue to accept its dollars as before.

Currencies floated up and down against the dollar. Financial markets were slowly deregulated. Controls were lifted. Offshore banking was allowed, with unregulated hedge funds and financial derivatives. All these changes originated from Washington, in coordination with New York banks.

### **The dollar debt paradox**

What soon became clear to US Treasury and Federal Reserve circles after 1971, was that they could exert more global influence via debt, US Treasury debt, than they ever did by running trade surpluses. One man's debt is the other's credit. Because all key commodities, above all, oil, were traded globally in dollars, demand for dollars would continue, even if the US created more dollars than its own economy justified.

Soon, its trade partners held so many dollars that they feared to create a dollar crisis. Instead, they systematically inflated, and actually weakened their own economies to support the Dollar System, fearing a global collapse. The first shock came with the 1973 increase in oil by 400%. Germany, Japan and the world was devastated, unemployment soared. The dollar gained.

This Dollar System is the real source of a global inflation which we have witnessed in Europe and worldwide since 1971. In the years between 1945 and 1965, total supply of dollars grew a total of only some 55%. Those were the golden years of low inflation and stable growth. After Nixon's break with gold, dollars expanded by more than 2,000% between 1970 and 2001!

The dollar is still the only global reserve currency. This means other central banks must hold dollars as reserve to guarantee against currency crises, to back their export trade, to finance oil imports and such. Today, some 67% of all central bank reserves are dollars. Gold is but a tiny share now, and Euros only about 15%. Until creation of the Euro, there was not even a theoretical rival to the dollar reserve currency role.

What is little understood, is how the role of US trade deficits and the Dollar System are connected. The United States has followed a deliberate policy of trade deficits and budget deficits for most of the past two decades, so-called benign neglect, in effect, to lock the rest of the world into dependence on a US money system. So long as the world accepts US dollars as money value, the US enjoys unique advantage as the sole printer of those dollars. The trick is to get the world to accept. The history of the past 30 years is about how this was done, using WTO, IMF, World Bank and George Soros to name a few.

What has evolved is a mechanism more effective than any the British Empire had with India and its colonies under the Gold Standard. So long as the US is the sole military superpower, the world will continue to accept inflated US dollars as payment for its goods. Developing countries like Argentina or Congo or Zambia are forced to get dollars to get the IMF seal of approval. Industrial trading nations are forced to earn dollars to defend their own currencies. The total effect of US financial and political and trade policy has been to maintain the unique role of the dollar in the world economy. It is no accident that the greatest financial center in the world is New York. It's the core of the global Dollar System.

It works so: A German company, say BMW, gets dollars for its car sales in the USA. It turns the dollars over to the Bundesbank or ECB in exchange for Marks or Euros it can use.

The German central bank thus builds up its dollar currency reserves. Since the oil shocks of the 1970's, the need to have dollars to import oil became national security policy for most countries, Germany included. Boosting dollar exports was a national goal. But since the Bundesbank no longer could get gold for their dollars, the issue became what to do with the mountain of dollars their trade earned. They decided to at least earn an interest rate by buying safe, secure US Treasury bonds. So long as the US had a large Budget deficit, there were plenty of bonds to buy.

Today, most foreign central banks hold US Treasury bonds or similar US government assets as their "currency reserves." They in fact hold an estimated \$1 trillion to \$1.5 trillion of US Government debt. Here is the devil of the system. In effect, the US economy is addicted to foreign borrowing, like a drug addict. It is able to enjoy a far higher living standard than were it to have to use its own savings to finance its consumption. America lives off the borrowed money of the rest of the world in the Dollar System. In effect, the German workers at BMW build the cars and give it away to Americans for free, when the central bank uses the dollars to buy US bonds.

Today, the US trade deficit runs at an unbelievable \$500 billion, and the dollar does not collapse. Why? In May and June alone, the Bank of China and Bank of Japan bought \$100 billion of US Treasury and other government debt! Even when the value of those bonds was falling. They did it to save their exports by manipulating the Yen to dollar to prevent a rising yen.

Because the world payments system, and most importantly, the world capital markets---stocks, bonds, derivatives—are dollar markets, the dollar overwhelms all others. The European Central Bank could offer an alternative. So far it does not. It only reacts to a dollar world. German banks destroy the German economy as they rush to imitate US banks. The Dollar System is destroying the German industrial base. German national economic policy as well as Bundesbank and now ECB policy is oriented on the far smaller export sector, to maximize trade surplus dollars, or to the big banks, to attract as many dollars as possible.

### **China plays a key role today**

The biggest dollar surplus country today is China. Globalization is in fact just a code word for dollarization. The Chinese Yuan is fixed to the dollar. The US is being flooded with cheap Chinese goods, often outsourced by US multinationals. China today has the largest trade surplus with the US, more than \$100 billion a year. Japan is second with \$70 billion. Canada with \$48 bn, Mexico with \$37 bn and Germany with \$36 bn make the top 5 trade deficit countries, a total deficit of almost \$300 billion of the colossal \$480 deficit in 2002. This gives a clue to US foreign policy priorities.

What is perverse about this system is the fact that Washington has succeeded in getting foreign surplus countries to invest their own savings, to be a creditor to the US, buying Treasury bonds. Asian countries like Indonesia export capital to the US instead of the reverse!

The US Treasury and Greenspan are certain that its trade partners will be forced to always buy more US debt to prevent the global monetary system from collapsing, as nearly happened in 1998 with the Russia default and the LTCM hedge fund crisis.

Washington Treasury officials have learned to be masters at the psychology of "monetary chicken." Treasury Secretary Snow used an implied threat of letting the dollar collapse, after the Iraq war, to warn Germany about the risk of trying to be too close to France with the Euro. Some weeks after the dollar had fallen sharply, and German export industry was screaming pain, Snow reversed his stand and the dollar stabilized. Now the dollar again rises as foreign money flows back in.

But debt must be repaid you say? Does it ever? The central banks just keep buying new debt, rolling the old debts over. The debts of the USA are the assets of the rest of the world, the basis of their credit systems!

The second key to the Dollar System deals with poorer debtor countries. Here the US influence is strategic in the key multilateral institutions of finance—World Bank and IMF, WTO. Entire countries like Argentina or Brazil or Indonesia are forced to devalue currencies relative to the dollar, privatize key state industries, cut subsidies, all to repay dollar debt, most often to private US banks. When they resist selling off their best assets, they are charged with being corrupt. The growth of offshore money centers in the Caribbean, a key part of the drug money cycle, is also a direct consequence of the decisions in Washington in the 1970's and after, to deregulate financial markets and banks. As long as the dollar is the global currency, the US gains, or at least its big banks.

This is a kind of Dollar Imperialism more slick than anything the British Empire even dreamed of. It is a part of the current America "Empire" debate no one mentions. Instead of the US investing in colonies like England to earn profits on the trade, the money comes from the client states into the US economy. The problem is that Washington has allowed this perverse system to get out of all control to the point today it threatens to bring the entire world to the point of collapse. Had the US instead promoted long-term policy of investing in the economic growth and self-sufficiency of countries like Argentina or Congo, rather than bleeding them in repayment of unpayable dollar debts, the world would look far less unstable today.

### **The internal debt bomb in the USA**

The question is if the Dollar System is reaching its real limits? The Dollar System for the past 30 years has been built on growing dollar debt. What if the rest of the world decides it no longer wants to give its savings to the US Treasury to finance its deficits or its wars? What if China decides that it should diversify its risk by buying Euro debt? Or Japan or Russia? That day may come sooner than we think.

In addition to colossal debts to the rest of the world, the US internal debt burdens have reached alarming levels in the past three decades, especially the past decade.

The total US debt—public and private—has more than doubled since 1995. It is now officially over \$34 trillion. It was just over \$16 trillion in 1995, and "only" \$7 trillion in 1985. Most alarming it has grown faster than income to service it, or GDP.

Since the Asia crisis in 1998, the US debt situation has exploded. The heart of the debt explosion is in US private consumer debt. And the heart of consumer debt is the home mortgage debt growth, helped by two semi-government agencies—Fannie Mae and Freddie

Mac. Since 2001 and the collapse of the stock market wealth, the Federal Reserve has cut interest rates 13 times to a 45 year low.

US Households took on new home mortgage debt in the first six months this year at an annual rate of \$700 billion, double the debt growth in 2000. Total mortgage debt in the US totals just under \$5 trillion, double the debt in 1996. It has grown far faster than personal income per capita. That is larger than the GDP of most nations.

The aim has been to inflate a housing speculation market in order to keep the economy rolling. The cost has been staggering new debt levels. Because it was created with record low interest rates, when rates again rise, millions of Americans will suddenly find the burden impossible, especially as unemployment rises. Fannie Mae and Freddie Mac combined guarantee \$3 trillion in US home mortgages. The US banking system holds much of their bonds. When the housing bubble collapses, a new banking crisis is pre-programmed as well, with JP Morgan/Chase, Wells Fargo and BankAmerica the worst.

The US economy has only managed to avoid a severe recession since the collapse of the stock market three years ago, by a record amount of consumer borrowing. "Shop until you drop" is a popular American expression. The Federal Reserve has pushed interest rates down to 1%, the lowest in 45 years. The aim is to keep the cost of the debt low such that families continue to borrow, in order to spend! Some 76% of the US economy GDP today is consumer spending. And most of that is tied to a record boom in home buying.

But the rate of new debt growth among families is rapidly reaching alarm levels, while the overall manufacturing economy continues to stagnate or decline. Today US factories only operate at 74% of capacity, near historic lows. With so much unused capacity, there is little chance companies will soon invest in new factories or jobs. They are going to China.

So Greenspan continues to rely on foreign money to prop up his consumer debt bubble, at low interest rates. Were foreign money to stop propping the US economy, now at some \$2.5 billion daily, the Federal Reserve would be forced to raise its interest rates to make dollar investments more attractive. Higher rates would trigger a crisis in consumer debt, mortgage defaults, credit card and car loan failures. Higher rates would plunge the US economy into a depression. This may be about to happen, despite poor George Bush's desires to get reelected.

There is a limit how much debt US families can pay to keep the economy afloat.

There is no US recovery, merely a debt spending boom based on this home buying explosion.

Total US household debt reached a high in June of \$8.7 trillion, double that of 1994. Families are agreeing to longer debt payments for basics like homes or cars. The length of new car loans now averages 60.7 months, and the amount of car debt financed increased to \$27,920, and the average new home costs \$243,000.

With rapidly rising unemployment and a real economy that is not growing, at some point there will come a violent reality clash, as the market for home lending reaches its limit. At that point the danger is the consumer will stop buying, and the manufacturing economy will not be able to create new jobs and a real recovery. The jobs have gone to China!

We might already be at or very close to that point. In the past six weeks, US interest rates have risen sharply, as owners of US bonds have started to sell in panic levels, fearing the bonanza in real estate may be over, and trying to get out with some profit before bond prices collapse. The European Central Bank is advising member banks to not buy any more US Freddie Mac or government agency debts.

The problem is this process of creating debt, domestic and foreign, to keep the US economy going, has gathered so much momentum it risks destroying what remains of the US manufacturing and technology base. Henry Kissinger warned in a conference of Computer Associates in June, that the US risked destroying its own middle class, and its key strategic industries via outsourcing to China, India and other cheap areas. Today only 11% of the total workforce is in manufacturing. In 1970, it was 30%. Post-industrial America is a bubble economy about to pop.

Fed chief Greenspan even warned China about the rate of its trade increase with the US, pressuring China to up value the Renminbi to make its goods less competitive in dollar markets, and slow the job loss. But this is dangerous. China holds \$340 billion in US Treasury bonds and other reserve assets. The US needs the Chinese dollar savings to finance its soaring deficits.

It is caught in its own web: American jobs, hi-tech jobs as well as factory jobs, are vanishing permanently as US factories source to China, India or other cheap areas. If Washington pressures China and others to cut back exports they risk to kill the goose that lays golden dollar eggs. Who will buy that growing Government dollar debt? Private bond traders are desperately trying to sell their US bonds. Germany can only buy so much dollar debt, also Japan.

The US waged war in Iraq not out of fundamental strength but fundamental weakness. It is economic weakness however, not military.

### **Oil and food, and money as strategic weapon**

The fundamental reason for the Iraq war, beyond agendas of Richard Perle or other hawks, is hence, strategic in my view. US economic hegemony in this distorted Dollar System increasingly depends on a rising rate of support from the rest of the world to sustain US debt levels. Like the old Sorcerers' Apprentice. But the point is past where this can be gotten easily. That is the real significance of the US shift to unilateralism and military threats as foreign policy. Europe can no longer be given a piece of the Third World debt pie as in the 1980's. Japan has to cough up even more, as does China now.

Even ordinary Americans have to give up their pension promises. If the Dollar System is to remain hegemonic, it must find major new sources of support. That spells likely destabilization and wars for the rest of the world.

Could it be that in this context, some long-term thinkers in Washington and elsewhere have devised a strategy of establishing US military control of all strategic sources of oil for the one potential power rival, Eurasia, from Brussels to Berlin to Moscow and Beijing? The dollar vulnerability and debt problems are well known in leading policy circles.

As Henry Kissinger once noted, "Who controls the food supply controls the people; who controls the energy can control whole continents; who controls money can control the world."