

WHAT WILL HAPPEN IF THE DOLLAR-CENTRED FINANCIAL SYSTEM COLLAPSES?



When a man like Stephen S. Roach publicly questions the role of the US dollar as the world reserve currency, and his thoughts are published in Bloomberg(!), then something momentous may well be afoot. The fact of the matter is that the dollar-centred international financial system is, for better or worse, the single most important, and perhaps most misunderstood, pillar of the world financial system. It is difficult to underestimate the far-reaching consequences that the demise of the dollar as the anchor of the international financial system would have for investors and ordinary citizens. Yet it may not be a bad idea to change a financial regime that has nurtured one bubble after another and turmoil world-wide (more on this later).

First a bit of history. Just before the end of the Second World War, the western powers gathered in Bretton Woods (Canada) with the idea of creating a new international financial system that would foster trade by minimising wild currency fluctuations and rebuild war-ravaged Europe. Moreover, since America's allies had paid the US in gold for much of the wartime aid, the US had by far the largest gold reserves in the world – enough to back the US currency and unseat the British pound as the world reserve currency. The Americans were eager to see the dollar become the world reserve currency and submitted a plan that required all commodities be priced in dollars. This meant that the Europeans needed to buy dollars to purchase commodities, while the US would accommodate the demand for dollars by simply printing more dollars. At the same time the system allowed the US to finance its trade deficits indefinitely by printing dollars which would end-up in the treasuries of the various central banks which, in turn, would recycle their dollars back into the US by investing in US treasuries.

The Europeans – and the French in particular – were aware of the consequences of this “merry-go-round”, but being in dire need of help to rebuild their economies, they reluctantly accepted, but demanded that the dollar be convertible in gold at a fixed rate of \$ 35. The idea was to discourage excessive debt accumulation by the US. The US accepted (also reluctantly) and so begun the era of the US dollar where all national currencies were pegged to the greenback (+/- 1%) and the greenback, in turn, was pegged to gold.

However, at some point the Europeans started to question whether the US had enough gold to back the huge quantity of dollars in circulation, particularly during the late sixties when then President Lyndon B. Johnson embarked on a series of expensive social programmes while escalating the equally expensive, and ultimately disastrous, war in Vietnam. Therefore, the Europeans started to demand gold in exchange for their dollars. When it became clear that the US gold stockpile risked being completely depleted, the US refused a British request to convert dollars into gold and in August 1971 President Nixon “temporarily” ended the convertibility of the dollar. This measure shook the world's confidence in the dollar, but, surprisingly, the greenback's role as the world reserve currency endured. However, the situation was not sustainable as confidence had been clearly shaken. Therefore, a permanent and sustainable solution had to be found urgently if the status of the dollar were to be preserved. Henry Kissinger, Nixon's Secretary of State, came up with the solution: Convince the House of Saud to price their oil in dollars in exchange for military protection. Under this arrangement, the Saudis would invest their excess dollars in US treasuries. Thus, the Petro-dollar was born and soon all other oil producers followed Saudi Arabia's lead and priced their oil in dollars. The dollar was now backed by oil, but someone else's oil. This was no small detail as we will see later.

It should be clear by now that this system has created a situation where the world's largest economy is literally addicted to debt. It should also be clear now how big the stakes are in perpetuating this system.

However, the aggressive weaponization of the dollar to impose sanctions to bring about regime changes is causing some countries to de-dollarize. Russia is the most advanced and pressed on the accelerator after it was hit by sanctions in the wake of the Ukrainian crisis, as the chart below clearly illustrates.



Source: US Treasury Department as relayed by Bloomberg.

Unilateral sanctions, in addition to being illegal, cause misallocation of financial resources and, because of the interconnectedness of the various national economies, inhibit world economic growth by wreaking havoc in the targeted countries' economies. Lately, the threat of sanctions has even been extended to America's allies when they seek to do business with targeted countries. These are called "secondary" sanctions. The Europeans are not thrilled.

Now for the untold truth that every "insider" knows about but is reticent to be explicit about. As we have seen, pricing oil in dollars is key to maintaining the status quo. If we turn our attention to the wars in the middle east and sanctions in general, we will see that all the countries that were invaded (Iraq and Libya) or are under stringent sanctions (Syria, Iran, Russia, Venezuela) have one thing in common: They sell, or before being invaded, were selling, their oil in Euros. These are not conspiracy theories anymore. Alan Greenspan, who was a long serving FED chairman, admitted in his memoirs that the Iraq war was all about oil.

So, let us start with the good news: The demise of the dollar should put an end to the oil related wars and the consequent humanitarian crises. The bad news is that the US will have to wean itself out of its debt addiction. This will mean true price discovery for the dollar (lower) and treasury securities (higher yields). If this is done gradually, there will be a decline in long-term economic growth and more inflation as imported goods in the US will become more expensive (good for gold). Naturally, the consequences of such a disruptive event would be felt in the rest of the world as well. But there is hope: Money can be found by drastically reducing the enormous defence and defence-related budgets in both the US and the other NATO countries. Sadly, as things stand now, and with a presidential election coming up, no one is talking about reducing the defence budget or bringing the troops home. Afterall, the dollar is still the world's reserve currency and the rest of the world is still a captive creditor of the US.

FILIPPO SCHIMENTI
CHIEF INVESTMENT OFFICER

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