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Signals of the End of the Dollar Standard

October 5, 2005

Rob Lee is an economist who has been involved in investment markets for 30 years, the last few in nominal retirement.

I am an economist who worked for 25 years in large investment companies in South Africa. I "retired" to the UK a few years ago. For most of my career I lobbied for policies such as money supply targets and later inflation targets that were (implicitly) intended to substitute the role of gold as an independent anchor for the monetary system. I was never an advocate of any form of gold standard, unlike the current Fed Chairman, now ironically testing the fiat money system to destruction.

However, in recent years the scales have fallen from my eyes. As Voltaire said in 1729 "paper money eventually goes down to its intrinsic value – zero." Every fiat paper currency before or since has confirmed to this prediction. A fiat paper currency that is also the global reserve currency becomes this problem writ large. A US Treasury official of old - Sam Cross - put it this way: "if you postulate a system that depends on one country always following the right policies, you will find that sooner or later no such country exists. The system is eventually going to break down". In my view the Dollar Standard system is irretrievably breaking down, as signaled by four recent developments described below:

1. China has ended its currency peg to the dollar. The new exchange rate system for the Yuan is admittedly not yet a dramatic break from the dollar fixed peg. That is not the Chinese way. It is nevertheless hugely symbolic. It serves notice that China will be increasingly reluctant to accumulate dollars they know will depreciate in value over time. Chinese economic spokesmen have made no secret in public of their alarm at US profligacy - what is said behind closed doors?

China is clearly intent on exchanging its paper assets (predominantly dollars) for real assets, notably commodities in general and energy products in particular. On gold the strategy focuses on encouraging private citizens to own gold- deregulation of the gold market has been rapid by Chinese standards. [Ironically it may now be easier for citizens of China to invest directly in gold than it is in many western democracies].

China is likely to prefer to remove dollar support only gradually. Bear in mind though that most of the smaller economies in Asia tend to follow China - Malaysia announced a similar change to its exchange rate system very soon after the Chinese. Other countries from outside the region - notably Russia and Saudi Arabia - have indicated an intention to downgrade the dollar in their currency arrangements. Iran is attempting to create an oil trading exchange that does not transact in dollars. These are ominous straws in the wind for a currency so dependent on foreign capital.

2. Deflation in Japan is coming to an end. Japan is the biggest foreign holder of US dollars. For example, Japan held \$680bn in US Treasury Securities at the end of June - nearly 34% of total foreign holdings. This compares with \$291bn held by China (including Hong Kong). Japan will therefore play a critical part in any changes to the world's currency system.

US-Japan relations are far closer than those between the US and China. Japan also has literally more to lose from the demise of the dollar than China. Nevertheless the same logic that impels China's move away from US paper applies to Japan. As long as deflation remained the key economic concern in Japan supporting the dollar was the paramount objective of its exchange rate policy. However, there are clear signs of a self-sustaining recovery of domestic employment, investment, and consumption in Japan. The recent election victory of PM Koizumi should reinforce reform and recovery. These forces are simultaneously bringing an end to both the deflationary process and to dependence on exports for growth. The imperative to support the dollar will erode and interest rates in Japan will begin to normalize. Another straw in the wind - Japan did not increase its holdings of US Treasuries in the first half of 2005.

3. The US in effect now has to borrow abroad in order to service all its foreign debt. The remarkable down spiral in the US foreign financial position took another crucial but little noticed twist recently. In the second quarter of 2005 the US paid out more in income to foreigners on their US assets than it received in income on its foreign assets. Technically net foreign investment income went negative. No comfort should be taken from the fact the second quarter investment income deficit was a mere \$0.5bn. The income deficit will deteriorate rapidly in coming years. The US has net foreign debt (foreign liabilities minus foreign assets) of more than \$ 2.5 trillion, and this debt will grow rapidly as the US continues to rack up huge current account deficits (now roughly \$800bn annually). The income deficit on this debt has only just gone negative because the US receives a rate of return on its foreign assets roughly double that of overseas investors in the US - about 7% versus 3.4% between 2002 and 2004.

This differential return reflects the fact that Americans have invested largely in riskier assets abroad while foreigners have opted more

for Treasury securities. A world economic downturn (likely in my view) would reduce returns on US overseas assets, while rising US interest rates will raise the return to foreigners. The longer term dynamics of this process are alarming. Within a short period of years the US will be borrowing hundreds of billions merely to service existing debt. Economists call this the "debt trap" - and the US economy is heading inexorably into it Can the US dollar sustain its position as the world reserve currency in the face of these fundamentals? As the saying goes, you only have to ask the question to know the answer.

4. The gold price is breaking out in all key currencies. Not all the world's investors (or central bankers!) are blind to the scary developments sketched above. Gold in dollars has definitively been in a bull market for some time, but in recent weeks gold has decisively broken out all key currencies including the Euro, Yen, Swiss Franc and Sterling. Markets are recognizing that the failure of the Dollar Standard is one not only of US economic management but one inherent in the fiat money system itself. In the long term they may demand gold's return as an anchor to the global monetary system.

The flight from paper assets (and especially dollars) towards hard assets is now underway in earnest. There is still time - this is a multi-year trend - for investors to switch from devaluing dollars to rising gold. Those ahead of the herd are moving but the herd itself is yet to stir.

↳ **RE: Signals of the End of the Dollar Standard** [mannfm11](#) NEW 10/7/2005 1:30:54 AM [reply](#)

1929 Dow=380 at its peak. 2005 Dow=10,400 on average. Average dividend in that time=4.5% roughly.

1929 Gold=\$20 and some cents. 2005 Gold=\$480. Return in dividends for holding gold? ZERO. The dividends after tax from holding \$380 worth of stock from the 1929 peak going forward would have bought the gold that will buy the Dow and still have the Dow. Remember we are dealing with bank money, not just pieces of paper with numbers on them. The banks will try to see to it that what they get back will buy something. I wouldn't bet on the collapse of the paper currency until the men running the game own all the gold to a great extent and most of the property. It will collapse, but the point is that you and I are not privy to when it will collapse and even if our plans to take advantage of the collapse will actually pay off.

↳ **RE: Signals of the End of the Dollar Standard** [jessel](#) NEW 10/7/2005 10:54:01 AM [reply](#)

It remains that in several historical examples, including Weimar, gold proved to be the salvation of many who otherwise would have lost everything.

This is like saying that homeowners insurance is a bad deal because you have not filed a claim on it in the past 20 years.

Check out the performance of gold during the Crash of 1987. Gold is insurance against financial calamity. Its comforting to think that the powers-that-be have such perfect control over the economy that nothing will collapse until they pick the exact time.

This is the same crew that brought us Iraq and FEMA. Its more like the gang that couldn't shoot straight in my book.

Check out some of the facts on [Jesse's Charts](#)

↳ **RE: Signals of the End of the Dollar Standard** [Spike from Juneau](#) NEW 10/7/2005 12:46:15 PM [reply](#)

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