

"The Sinking Dollar"

When Premier Wen Jiabao of China said in March of 2009 that he was "a little bit worried" about the state of the U.S. dollar, he echoed the feelings of states, enterprises, and individuals across the world. He called upon the United States "to maintain its good credit, to honor its promises and to guarantee the safety of China's assets."

Even five years ago, this would have seemed a very presumptuous request. Now it seems "understandable" even to Janet Yellen, the President of the San Francisco Federal Reserve Bank, although she considers China's proposals concerning the world's reserve currency "far from being a practical alternative."

There are only two ways to store wealth: in actual physical structures and in some form of money (currency, bonds, gold). They both entail risks for the holder. Physical structures deteriorate unless used and using them involves costs. To utilize such structures to obtain income and therefore profits depends on the "market" - that is, on the availability of buyers willing to purchase what the physical structures can produce.

Physical structures are at least tangible. Money (which is denominated in nominal figures) is merely a potential claim on physical structures. The value of that claim depends on its exchange relation with physical structures. And this relation can and does vary constantly. If it varies a small amount, hardly anyone notices. But if it varies considerably and frequently, its holders either gain or lose a lot of wealth, often quite rapidly.

A reserve currency in economic terms is really nothing but the most reliable form of money, the one that varies least. It is therefore the safest place to store whatever wealth one has that is not in the form of physical structures. Since at least 1945, the world's reserve currency has been the U.S. dollar. It still is the U.S. dollar.

The country that issues the reserve currency has one singular advantage over all other countries. It is the only country that can legally print the currency, whenever it thinks it is in its interest to do so.

Currencies all have exchange rates with other currencies. Since the United States ended its fixed rate of exchange with gold in 1973, the dollar has fluctuated against other currencies, up and down. When its currency went down against another currency, it made selling its exports easier because the buyer of the exports required less of its own currency. But it also made importing more expensive, since it required more dollars to pay for the imported item.

In the short run, a weakened currency may increase employment at home. But this is at best a short-run advantage. In the middle run, there are greater advantages to having a so-called strong currency. It means that the holder of such currency has a greater command on world wealth as measured in physical structures and products.

Over the middle run, reserve currencies are strong currencies and want to remain strong. The strength of a reserve currency derives not only from its command over world wealth but from the political power it offers in the world-system. This is why the world's reserve currency tends to be the currency of the world's hegemonic power, even if it is a declining hegemonic power. This is why the U.S. dollar is the world's reserve currency.

So, why is Premier Wen "a little bit worried"? It is clearly because over the past few decades, the exchange rate of the U.S. dollar has been fluctuating a great deal but on the whole slowly declining. One of the main factors has been the incredibly rising global debt of the U.S. government. There are two main ways in which the United States has been able to balance its books. It prints money and it sells U.S. treasury bonds, primarily to other governments (so-called sovereign wealth funds).

It is no secret that in recent years the largest single buyer of U.S. treasury bonds has been China. It is not the only one. Japan and South Korea, Saudi Arabia and Abu Dhabi, India and Norway have all bought U.S. treasury bonds. But China today is the biggest buyer, and given the present credit contraction, China is one of the few likely buyers in the immediate future.

The dilemma for China, as for others who have invested in U.S. treasury bonds, is that if the dollar declines further or if there is significant inflation because of the printing of money by the United States, their investment in treasury bonds may lose them money. On the other hand, what alternatives do China or the others have?

The policy conclusion that China (and other buyers) are drawing is steady low-key divestment. They want it to be not so fast as to cause a "run on the bank" but not so slow as to be the last one out the door - "before the stampede" as W. Joseph Stroupe entitled his article in the *Asia Times*.

China is reducing the amount of U.S. treasury bonds it is buying, and now prefers to buy shorter-term ones rather than longer-term ones. China is entering into "currency swaps" with other countries, such as Argentina, so that neither has to use dollars in their transactions. And China is calling for the creation of an alternate reserve currency based on the Special Drawing Rights (SDRs) created by the International Monetary Fund, which are based on a basket of currencies. Russia has endorsed this call.

The United States is not sure how to respond. When Treasury Secretary Timothy Geithner said that the U.S. government is "quite open" to China's proposal to increase the use of SDRs, the dollar immediately went down in the currency market. So Geithner then "clarified" what he had said. The dollar remained the world's "dominant reserve currency" and this is "likely to continue for a long period of time." He asserted that "we will do what's necessary to make sure we're sustaining confidence in our financial markets, and in the productive capacity of this country and in our long-term fundamentals."

Is Geithner just whistling in the dark? More important, who believes that what he says is plausible? The key to a currency's strength is not so-called fundamentals but "faith" in the reality of these fundamentals.

All the main actors are hoping there can be a soft landing, an orderly transition away from the U.S. dollar. No one wants to precipitate a free fall, because no one is sure to come out ahead if that happened. But if the U.S. stimulus turns out to be the last of the bubbles, the dollar could

very suddenly deflate in a most chaotic fashion. The way you say "stampede" in French is "*sauve-qui-peut*," which translates literally as "let him save himself who can."

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