THE DEMISE OF THE DOLLAR . . .

AND WHY IT'S EVEN BETTER FOR YOUR INVESTMENTS

Revised and Updated

ADDISON WIGGIN

Foreword by Chuck Butler

WILEY

John Wiley & Sons, Inc.

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FOREWORD

It had been two years since I first read *The Demise of the Dollar* when Addison approached me to write a forward for the revised version. A circling back to refresh my memory was in order.

Since the original release of *The Demise of the Dollar,* 2005, the dollar has continued its long ride down the slippery slope. *Demise of the Dollar* clearly demonstrated the reasons for this dollar to remain weak, and this revised version brings you up to date.

The mantra of the current administration rings empty when they talk about "a strong dollar being in the best interests of the U.S." The dollar has lost another third of its value against the euro since the administration first uttered those words. And recently Fed chairman Bernanke suggested that the dollar's weakness was not a concern to the Fed.

So, whose concern is it? U.S. Treasury Secretary Henry Paulson tells us that he believes in the strong dollar policy, while at the same time reprimanding China for allowing a weak currency. How can Paulson say he believes in a strong dollar when he wants the Chinese renminbi to appreciate against the dollar? When cornered, Paulson has been heard to say that currency values should be set in a competitive

marketplace based on underlying economic fundamentals. So, a look at economic fundamentals is what we need to do, and in the *The Demise of the Dollar,* you will find plenty of fodder to bring you to the conclusion that the demise of the dollar is more of a reality in 2007 than ever before!

Today, the U.S. current account deficit requires $3 billion a day in foreign financing. How long can we continue to count on the kindness of strangers? In 2005, our trade deficit was $600 billion and growing. Today, we run a trade deficit of $710 billion per year, and it's still growing.

U.S. consumers continue to spend money they don't really have, or should be saving. The net savings rate in the United States has turned negative, and wages in the United States have continually fallen for years. The fundamentals for a recovery of the dollar do not look like those associated with a strong currency.

And money supply? Well, the government no longer prints M3. As a guide, we no longer know how many dollars "Helicopter Ben Bernanke" now prints on his printing press. But one thing we know for sure is that money supply is abundant, and therefore inflation remains unchecked in the United States. Now we've entered a new rate cutting cycle, as the Fed turns its back on inflation.

The credit-based economy and liberal monetary policies of the Fed allowed inflation to remain low for years, but slowly, and predictably, inflation pressures increased, and today inflation, like money supply, is abundant in our economy.

So, here we sit with the biggest fiat currency of all time, teetering on the brink of disaster, and only a few will tell you the truth about the dollar.

In *The Demise of the Dollar,* you will find economic theory that tells you why all of these awful things are happening to our economy and dollar. It will be one of the most well-written economics books you've ever read. Economic books can border on dry and boring, but this one is educational, informative, and very accessible to the average Joe who needs protection from our misguided Fed and governmental policies and misinformation campaigns.

Once again Addison Wiggin has knocked the cover off the ball with his *The Demise of the Dollar*!

—Chuck Butler

THE DEMISE OF THE DOLLAR . . .

and Why It's Even Better for Your Investments

INTRODUCTION

FALL OF THE GREAT DOLLAR STANDARD

According to the press, the world's prettiest face, Gisele Bündchen, wants to be paid in euros for U.S. modeling gigs, and in his new video, the rapper Jay-Z triumphantly holds euros—not dollars—in his upraised fist. The day after Thanksgiving 2007, anxious retailers started opening their doors before dawn to draw shoppers. Overseas visitors, meanwhile, are packing the streets of New York City, scooping up bargains. "I just saved $2,000 on this Rolex," said one shopper from Great Britain, waving her new watch at a reporter's camera. And no one's laughing now at the Canadian loonie, which reached parity with the U.S. dollar in September 2007—for the first time since 1976.

Pretty faces, angry rappers, desperate U.S. retailers, happy shopaholic tourists, and Canadians who have finally turned the tables on us . . . what on earth is happening as 2007 draws to a close and this new edition of *The Demise of the Dollar* goes to press?

Although Gisele has denied making any such claim about her payment currency of preference (and has stated that she is happy to earn salaries in a variety of currencies), the fact that this story spread

like wildfire through media outlets from Bloomberg and CNBC to E! News and *People* speaks volumes. The dollar has little cred(ibility) on the streets of New York—or pretty much on any street around the world. The twilight of the Great Dollar Standard Era is upon us. The euro is now worth almost 50 percent more than the U.S. dollar, and in Great Britain, you can get two U.S. dollars for every British pound.

In 2007, the famous refrain in the poem by Emma Lazarus describing the flood of foreigners streaming to U.S. shores needs to be updated to "Give me your tired, your rich, your huddled masses yearning to shop free." Seven out of every $10 that fuels our gross domestic product (GDP), the measure of a nation's productivity and hence security, comes—not from goods and services that we produce and sell—but from shopping. We're addicted to cheap credit.

Alan Greenspan, the longtime chairman of the Federal Reserve, set us on this runaway course, and Ben Bernanke, the new chairman since February 2006, is steadily following in his footsteps. In late October, he voted with the rest of Federal Open Market Committee (FOMC), the Fed's policy-making arm, to cut interest rates for the third month in a row this year. He is not the "un-Greenspan," as the financial press called him early in his tenure; he is the reincarnation of Mr. Irrational Exuberance himself, and he's pushing the same old monetary policy: "In debt? No problem. Spend more money—we'll print it for you."

In his autography, *The Age of Turbulence,* released by Penguin Press in September 2007—ironically, a few days before the second rate cut of the year—Greenspan says he thought it was wrong to increase scrutiny of subprime mortgages. Call me cynical, but increased scrutiny might have helped; 52 percent of these risky mortgages, made to borrowers with poor credit histories, were originated by companies and organizations with zero federal supervision. "I really didn't get it until very late in 2005 and 2006," Greenspan told Reuters in an interview, apologizing for the housing bubble he helped create, which led to the subprime mortgage mess and the credit crisis.

In the third and fourth quarters of 2007, Citigroup ($11.38 billion), Merrill Lynch ($8.48 billion), Morgan Stanley ($4.68 billion), and Barclays ($2.7 billion) led the pack in write-downs—government-approved losses on these loans. In the fourth quarter alone, we're looking at a staggering $44 billion.

And the fallout isn't over yet. In October, the U.S. Commerce Department reported that housing permits fell to a 14-year low, the lowest seasonally adjusted level since July 1993. In distressed markets such as San Francisco, home builders are shaving off as much as $150,000 from prices. And foreclosures nearly doubled (94 percent) from October 2006 to October 2007. "We have not seen a nationwide decline in housing like this since the Great Depression," said Wells Fargo chief executive John Stumpf, who thinks we're in for more rough play in 2008. "I don't think we're in the ninth inning of unwinding this. If we are, it's going to be an extra-inning game."

Well, he was right, unfortunately. By the time the year wound down, sales of new homes had plummeted 26.4 percent, according to the U.S. Department of Commerce—the worst slump since 1980. And housing starts fell almost as hard, by 24.8 percent.

BusinessWeek summed up the state of the nation with my favorite headline of 2007: "The Economy on the Edge."

Is there any good news? You bet! There are steps that smart investors can take now to escape from their vulnerability to the dollar's inevitable fall. This book lays out the problem and explains how we got here. It also explains how, with a properly positioned portfolio, the demise of the dollar could actually be beneficial to your financial outlook.

But first, let's start with a little history lesson so we can understand why we're facing a dead end with the U.S. dollar, which once set the monetary standard around the world.

It was tantamount to an international margin call—and even the most unsophisticated investor can guess that the words *margin call* don't bring good news. Your broker calls to tell you that your securities—which you bought with borrowed money—are in trouble, and you've got two choices, which really amount to no choice at all: either deposit more money (which you don't have) in your account or sell off one of your assets to stay afloat. But that's exactly what then President Richard Nixon did on August 15, 1971, when he took U.S. currency off the gold standard.

Prior to 1971, in most of the world, currency had been backed by gold for more than 100 years. In the United States, dollars issued were called *silver certificates* because currency was backed by silver (or by gold in terms of purchasing power internationally).

Our system became one of *fiat money*—a system in which the government claims a value but does not back it up with gold (or other) reserves. Today, a bill of our fiat money is identified as a *Federal Reserve note*—not a certificate worth redemption in silver or gold, but literally an IOU issued by the Fed.

As we like to point out repeatedly in *The Daily Reckoning,* the gold standard was a useful and important economic tool. The fact that gold existed only in limited supply meant that it served as an inhibitor in the rapid increase of currency in circulation. The government could not simply print all the money it wanted to.

So let's look at two questions: Why did Nixon make that decision, and how has it changed everything?

THE DECLINE OF THE DOLLAR BEGINS

The official reason for going off the gold standard was to persuade U.S. trade partners to peg their currencies to the U.S. dollar; in other words, it was an attempt at getting foreign governments to realign their currency values. Why? Nixon recognized that relying on gold as settlement for international exchange of goods and services inhibited expansion of the U.S. economy.

Removing the U.S. dollar from the gold standard was an attempt at solving the problem of falling currencies overseas. The currency exchange between U.S. dollars and European and Japanese currencies was a drain on U.S. trade. This is *opposite* to the problem we face today, that of a falling dollar.

If Nixon had removed the restriction on gold value at $35 an ounce and allowed it to find its value in the open market, that would have done more to fix the international monetary problem. But removing the restriction on gold value was not considered a viable option, for two reasons:

First, it would have meant the United States was telling other countries (those with undervalued currencies) to raise their prices on exports to the United States. And that would never have gone over well in countries that, at the time, were being subsidized by the U.S. dollar, economically speaking. For example, the removal of an artificial

value of gold would have required Germany to raise export prices 2.4 times above levels in effect in 1971, but at the same time, U.S. goods would continue to sell in Germany for about 41 percent of previous values.[1]

Second, the change would have drastically affected world markets of natural resources, including oil—doubling the barrel price of oil. That would not have gone over well, either—although a few years later, we did in fact experience double-digit inflation and long lines at the pump as a consequence of going off the gold standard.

THE GREAT DOLLAR STANDARD ERA

Nixon's decision was viewed as the only alternative to devaluing the dollar. Currency markets already recognized that U.S. dollars had been inflated. In December 1971, leaders of the so-called Group of Ten industrialized nations met in Washington, D.C., to officially change currency values based on the per-ounce value of gold raised from $35 to $38. The dollar was lowered 7.89 percent, while the German mark was raised 13.57 percent and the Japanese yen went up 16.9 percent.

But the abandonment of the gold standard had a far deeper and longer-lasting effect than the inflationary adjustments of the 1970s. Why? Because our "money proxy" dollar circulated based on commodity reserves (gold and silver).

Nixon was concerned that the gold standard inhibited our ability to compete with devalued currencies in other nations. The U.S. government was known to issue currency above reserves by speculating, offsetting long positions in dollars with short positions in gold, and gambling that it was unlikely that demands would be made against currency reserves. But that's exactly what happened. In the days before Nixon's decision, the British ambassador presented a demand for conversion of $3 billion in currency into gold.

If we recognize that currency is simply a form of IOU against the value of goods and services we exchange, then we can see why the tables have turned. In 1971, the major foreign currencies were devalued against the dollar *and* the gold standard.

THE FREE FALL ACCELERATES

When Nixon took the United States off the gold standard, he also tried to stabilize the economy with a series of ill-fated price controls. He wanted to curb inflation, which was increasing in 1971, a time when people actually worried about what inflation might do to their net worth. So Nixon instituted a series of wage and price controls. Listening to his Fed chairman, Arthur Burns, Nixon believed what he'd been told: that the traditional view about tight money was wrong, and the key to economic recovery was government control over prices and wages.

The belief that freezing wages and prices is an effective way to stop inflation defied economic sensibility—not to mention Nixon's Republican standards that were supposed to favor a free market. The decision to do so was part of a plan to stimulate new employment in time for the 1972 presidential election. Burns warned Nixon that going off the gold standard would be viewed in Moscow and in the Russian press—at the height of the Cold War—as a bad sign for the United States. He warned, "*Pravda* would write that this was a sign of the collapse of capitalism."[2]

While it has taken more than 30 years for the evidence to present itself fully, the decisions made by Nixon in 1971 set the process in motion. Capitalism did not collapse immediately, but it is collapsing in one important respect today. The U.S. dollar's value is falling against foreign currencies. And who is replacing the United States as the new economic world leader? China, a country that in 1971 exemplified the very worst of Communism. The misguided belief that wage and price controls would fix the economy by reducing inflation and creating new jobs was simply wrong. The decision to go off the gold standard—rather than curbing the printing of currency and taking a hit on valuation—has created a far worse problem.

Of course, the wage and price controls did not work. Yes, Nixon won reelection in 1972, but unemployment did *not* fall, and inflation did *not* go away (in fact, it got worse). The administration reimposed the freeze controls that had failed before, then quietly canceled them in April 1974, only four months before Nixon resigned. By then, unfortunately, the unavoidable expansion in inflation, unemployment, and a falling dollar had begun.

We have to remember the meaning of the gold standard, and why it served such an important role in international economic policy. The gold standard was a means by which countries agreed to fix the value of their currency, based on amounts of gold reserves. The abandonment of the gold standard during World War I when most countries involved in the fighting financed their war effort with inflationary money—IOUs—eventually contributed to the massive devaluation in the 1920s and worldwide depression of the 1930s. We should learn from history. Abandoning the gold standard devastates the world economy.

From the end of World War II until 1971, most industrialized nations adhered to the standards of the Bretton Woods system, named for the U.N. Monetary and Financial Conference held at Bretton Woods, New Hampshire, on July 22, 1944.

Several important agreements came out of that conference. The International Monetary Fund (IMF)[3] was established by the international conference to ensure regulation and order over world currencies and trade policies. This organization was a sort of worldwide version of the U.S. Federal Reserve, with power to regulate currency policies. Second, given the need for postwar reconstruction, the conference also established the International Bank for Reconstruction and Development (also known as the World Bank)[4] to provide financing to countries most devastated by World War II. Activities of these two organizations included agreement on currency controls, investment, lending activities, and foreign international activities.[5]

The Bretton Woods agreements were significant because, for the first time, there was international agreement on monetary matters—or at least the seeds of such agreements were planted. Those adhering to the gold standard recognized the value of price stability on an international basis, and it was quite visionary. While the pending end of World War II motivated much of the discussion, those in attendance also knew that future economic policy would determine the economic stability for the entire world. They knew that there were bound to be periods of inflation, unemployment, and currency instability, as part of the natural economic cycle, but the decision to go off the gold standard destroyed the orderly economic policies made possible through Bretton Woods. The period of the early 1970s was the start of a very unsettled time, based on both economic and political strife. In hindsight, it seems

obvious that the decision to go off the gold standard was devastating. It didn't lead to the immediate fall of capitalism, but now—more than 30 years later—it has brought us to the precipice, and perhaps the decline, in the long-running U.S. dominance of the world economy.

THE TWILIGHT OF THE GREAT DOLLAR STANDARD ERA

American consumers face the specter of losing value in their retirement savings, finding out they cannot live on a fixed income, and suffering from chronic hyperinflation. These changes are unavoidable. Today, the problem is compounded because the U.S. dollar's value is falling. It all involves productivity changes in the United States. We have not competed with the manufacturing economies in other countries, and that is why our credit (i.e., our dollar) is suffering.

Any number of things could create a sudden, wrenching drop in the dollar's value. Consider the following three possibilities:

1. *Foreign countries drop their U.S. dollar reserves.* We depend on foreign investment in our currency to bolster its value or, at least, to slow down its fall. When that thinly held balance changes, our dollar loses its spending power. In February 2005, South Korea announced that it will stop holding U.S. dollars and bonds in its reserves—but that was only the beginning. In an odd twist of financial fate, on the same day that the Canadian loonie achieved parity with the U.S. dollar, Saudi Arabia refused to adjust rates in lockstep with the Federal Reserve. Keeping its interest rate unchanged may signal Saudi Arabia's desire to break its dollar peg. Iran, Iraq, and Kuwait have already dumped the dollar; will the Saudis be next? At a November 2007 meeting of the Organization of Petroleum Exporting Countries (OPEC)'s 13-member cartel, Iranian President Mahmoud Ahmadinejad, whose country already receives payment for 85 percent of its oil exports in nondollar currencies, urged other countries to follow suit and "designate a single hard currency aside from the U.S. dollar . . . to form the basis of our oil trade." "The empire of the dollar

has to end," chimed in Venezuela's Hugo Chavez; his state oil company changed its dollar investments to euros at his order—er, request.

Rumors are circulating that the Bank of Korea, after selling off $100 million worth of U.S. bonds in August 2007, is getting ready to sell $1 billion more, and if Washington forces trade sanctions, China, which threatened recently to cash in $900 billion of U.S. bonds, will probably follow suit. In Russia, Vladimir Putin's dream of a stock market to trade the country's natural resources in rubles is not so far-fetched; in 2005, Russia, the world's second-largest exporter of oil, followed South Korea's lead and ended the dollar peg. And once again, Sudan is hinting that it will impose trade or financial sanctions against companies that do business with the United States—only this time, the words just might have teeth.

As other countries follow suit, the dollar—and your spending power—drops. What does this mean? You will need more dollars to buy things than it takes today.

2. *Oil prices increase catastrophically.* We—and our real inflation rate—are at the mercy of Middle East oil. In 2005, we couldn't imagine what would happen if the price of oil were to double—or triple; but that's exactly what has happened in 2007 as oil kept flirting with $100-a-barrel prices. Our vulnerability is not imaginary. For example, if terrorists were to contaminate large reserves with nuclear radiation, the supply of oil would drop and prices would rise. We are all aware of our vulnerability and dependence on oil, but we don't like to think about it. Rising oil prices affect not only what you pay at the pump, but many other prices as well: nonautomotive modes of travel, the cost of utilities, and local tax rates, for example. It all adds up to unquestioned "pain at the pump" for American consumers. By September 2007, gasoline averaged $2.78 a gallon—double 2002's price. "Pain at the pump" leads to "pain in the pocketbook," as consumers know. You're not seeing double in the checkout line at the grocery store—costs really *are* double. There was a 5.6 percent increase in 2007, compared with 2.1 percent for all of 2006.