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Dumping US dollars could trigger 'economic September 11': the East Asian connection

By Bruce Stannard

[*Warren Buffett, the so-called Sage of Omaha (and the world's wealthiest investor), reputedly lost $310 million in the first quarter of this year betting that the US dollar would fall. On the other hand, he is said to have made masses of money on the same bet last year. When asked about the dollar, Buffett admits he can't say whether its value will be up or down a year from now, but is confident it will be down over five years. As long-time Japan watcher Clyde Prestowitz points out in this article, Buffett is not at all alone. George Soros, Bill Gates and many others with plenty of cash to absorb even immense losses, are patiently waiting for America's overheating structural problems - especially the huge and expanding budget and trade deficits - to melt more wax from the still high-flying dollar's wings.*

With the world's savviest private investors and so many structural problems betting against the dollar, one has to wonder why it's still up there. Ironically, the key is the public sector, that isthe public sector in other countries. As US Treasury statistics show, it's particularly the demand from East Asian central banks that keeps the dollar strong and staves off the day of reckoning on US consumption profligacy. Japan, China and the rest buy US public sector debt in order to keep the dollar from depreciating relative to their own currencies and to maintain the level of U.S. imports that sustains their export-driven economies. Their buying has been so frenzied over the past few years, especially in the wake of the 1997 Asian currency crisis, that the World Bank estimates that fully 70 percent of global foreign reserves are now held in US dollars.

Insisting that their perspective on investment is in the centuries, the Bank of Japan claims to be unruffled by the prospect of a collapse in the value of the dollar that would result in huge losses on the nearly $US 700 billion Japan holds in Treasuries. Maybe they're just putting on a brave face or really don't worry because it's not their own money and they won't be held accountable for losing it. But excessive consumption in the US supported by East Asian finance is perhaps the most serious structural imbalance on our era. If this blithe Icarus does indeed come crashing down in a hard landing, as Prestowitz and many others warn, the shock will almost certainly set off recessions as well as sorely test the asset and other bubbles that already seem ripe to implode on their own.

Such is the role of the public sector these days: while Buffett and Soros issue sober warnings of the disaster ahead, in all likelihood they will ride the crest all the way to the bank, while the rest of us will experience a rain of "creative destruction." Japan Focus]

There is a potentially fatal flaw at the heart of the global economy: the strong possibility of financial meltdown following a collapse of confidence in the greenback. The nightmare scenario that haunts global strategist Clyde Prestowitz is an economic September 11 -- a worldwide financial panic triggered by a sudden massive sell-off of US dollars that would lead inexorably to the collapse of economies around the world.

Prestowitz is not a doomsayer, neither is he alone in his views. As president of the Economic Strategy Institute, a Washington think tank, he is in regular contact with the most influential US business leaders, several of whom -- Warren Buffet and George Soros included -- have taken steps to hedge their currency positions against the possibility of a cataclysmic plunge in the greenback.

"Right now," he says, "we have a situation in which the US is running huge trade deficits -- about $US650 billion ($766 billion) in 2004 -- which are financed by borrowings from the central banks of Asia -- mainly the Chinese and the Japanese. All the world's central banks are chock-full of US dollars -- they're holding many more dollars than they really want. They're holding those dollars because at the moment there's no great alternative and also because the global economy depends on US consumption. If they dump the dollar and the dollar collapses, then the whole global economy is in trouble.

"However, some countries have a bigger stake than others in maintaining the status quo. China and Japan have a big stake in maintaining the flow of their exports to the US and keeping the US economy humming. Russia, on the other hand, does not export much to the US. India doesn't export much to the US. Yet Russia and India are also big dollar-holders. They hold many more dollars than they really want or need.

"It doesn't take any great stretch of the imagination to see what could happen if one of these central bank managers decides to dump dollars. We had a situation recently when a mid-level official at the Central Bank of Korea used the word 'diversification'. It was a throwaway remark at some obscure lunch, but there was instantaneous overreaction. The US stock market fell by 100 points in 15 minutes because the implication was that South Korea might be shifting out of US dollars.

"So picture this: you have a quiet day in the market and maybe some smart MBA at the Central Bank of Chile or someplace looks at his portfolio and says, 'I got too many dollars here. I'm gonna dump $10 billion'. So he dumps his dollars and suddenly the market thinks, 'My god, this is it!' Of course, the first guy out is OK, but you sure as hell can't afford to be the last guy out.

"You would then see an immediate cascade effect -- a world financial panic on a scale that would dwarf the Great Depression of the 1930s."

Prestowitz says the panic could be started by something as simple as a hedge-fund miscalculation.

"We had exactly that scenario in the US recently," he points out, "when a big hedge fund called Long Term Capital Management went belly-up. These guys were pros. They had two Nobel prize-winning economists writing their trading algorithms, and their traders were the creme de la creme among New York bond traders.

"They made a big bet -- a trillion dollars leveraged 20 to one, and they blew it. They went belly-up. That threatened to bring down the whole system so US Federal Reserve chairman Alan Greenspan had to organise a bail-out through the Federal Reserve Bank of New York.

"Now consider this: there are currently 8000 hedge funds in the US alone. Every day $6 trillion of derivative instruments trade on international markets. If there are four people in the world who understand those trades, I'd be surprised. So the potential for another disaster is not insignificant. This is why Warren Buffet, chairman of investment giant Berkshire Hathaway, is betting $US21 billion against the dollar. This is why currency speculator and hedge fund manager George Soros has also made a big bet against the dollar.

"Soros is one of the greatest currency speculators of all time. He was the guy who broke the British pound in the early 1990s by betting $US10 billion it would fall. He made a quick billion when it did. In 2002, he warned that the greenback was in danger of losing a third of its value. Of course, it could be argued that Soros is a professional hedge fund manager whose job is to play the ups and downs of currencies and his remarks could be seen more as manipulation than prophecy. And yet, in conversations with me, Soros has expressed concern about the market fundamentalist view that prevails in Washington and parts of Wall Street.

"This is the belief that markets are self-correcting and best left alone. Soros calls this a dangerous siren song. Far from being self-correcting, he emphasises, markets tend to excess. They over-shoot. Anyone with any experience of markets knows this.

"When markets are going down, all the weaknesses get concentrated, and you need intervention at the right time to stop things from getting out of control. If the dollar started to melt down, the results could be really nasty. A 1930s-style global depression is not out of the question."

To underscore the point that he is not alone in this, Prestowitz cites Paul Volcker, head of the Federal Reserve before Greenspan, who has said publicly there is a 75 per cent chance of a dollar crash in the next five years.
"No wonder people look at this and say, 'Holy cow!'," he says. "No one knows for sure what will happen, but clearly the global markets could implode very quickly. The lack of an alternative to the dollar is the only reason it hasn't taken a big fall already."

Prestowitz, formerly a trade adviser and negotiator for former US president Ronald Reagan, believes the US will continue to be the world's most powerful economy for the foreseeable future. But he foreshadows an inexorable decline, a trend that is likely to continue "depending on the way we play our cards".

"Right now, we're playing them just about as badly as it's possible to play them, and that has geo-political implications." he says. "We've outsourced trying to deal with North Korea to China, we really can't deal with Iran, so we've outsourced that to the EU, which is struggling, and Iran is cozying up to China. Other bad actors like Zimbabwe's Robert Mugabe and Sudan are cozying up to China.

"America's global hegemony is already under challenge, and that challenge is going to become more and more evident as the extent of the relative US economic decline becomes evident. Right now, the US dollar is probably 40 per cent overvalued versus the Japanese yen or the Chinese renminbi. How's the US going to look as a global power when the dollar is at 50 per cent of its current value?"

Three Billion New Capitalists: the great shift of wealth and power to the east by Clyde Prestowitz is published by Basic Books.

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