

Economic Commentary

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Don't Overlook the Underlying Cause of the Global Financial and now Economic Crisis

What may very well be the main underlying cause of the current global financial crisis is frequently overlooked. It is the fact that the entire global economy is using one single nation's currency as the world money. The US Dollar serves as the *de facto* world currency, used as the primary unit of account, means of payment and store of value of the world economy. All central banks, multinational companies, commodity and energy consumers need to hold US dollars either to store their foreign exchange reserves or for payment purposes to pay for the oil and other commodities they buy which are priced in US dollars.

This situation creates an on-going demand for US dollars that pushes the foreign exchange value of the US dollar artificially higher while that of all other currencies artificially lower. This in turn has enabled the US to purchase foreign made goods for less while it has made the sale of US-made products more expensive on world markets, especially the emerging economies. The result has been the post-war chronic US current account deficit. On the one hand it has made it possible for Americans to work less and consume more, but on the other hand it has steadily led to the deindustrialization of the country, the growth of the service sector and has put a lid on wage growth. As China and other emerging economies have sought to take advantage of their undervalued currencies to boost exports and industrialize, it has led to the well-known problem of global trade and financial imbalances.

What has made things worse is that although in 1944 the USA promised to maintain convertibility of the US dollar to gold at the official price of \$35 USD per ounce, it never lived up to this obligation. It kept on creating new money until by 1971 it was forced to cease convertibility to gold and since then has become a fiat (paper) currency, a currency whose supply depends on the discretionary decisions of the US Federal Reserve and the US Treasury and is not based on gold or some other rules based system. The result is that the US spends more than it earns, to finance its budget and trade deficits it borrows money from the rest of the world, principally the poorer countries. As the total amount of private and public US debt has exploded to almost 400% of US GDP, the financial sector has become the biggest and most powerful industry in the USA with Wall Street at its center. While it was said back in 1936 that "what is good for GM is good for America" it can be said in 2006 that "what is good for Wall Street is good for America". It can also be said that the US principal export to the world economy

has now become the sale of securities, both US treasuries and other structured financial instruments such as the now famous "sub-prime" securities.

While the gold standard placed limits on how much money any country can create and forced countries to abide by the disciplinary forces of the market, with the *de facto* dollar standard there is no such built-in disciplinary mechanism, or anchor for the global money supply. As a result, the US keeps spending more than it earns, it keeps borrowing more and more from the rest of the world, and to pay its bills, it keeps creating more and more money. This situation is clearly unsustainable. A day will come when the US reaches its borrowing limit -yes, even super powers have limits- and/or the world realizes that the "emperor has no clothes" and stops relying on the US dollar.

There is a better alternative to the present system. But it will not be arrived naturally or easily. The current system will have to convulse few more times before it becomes economically possible and politically desirable to replace it by a new system. The current global financial and economic crisis is just the prelude to the next and more serious crisis that awaits us all, and it will be the breakdown of the current international - US dollar based- monetary system itself. The next crisis could make the present one look like a "walk in the park".

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