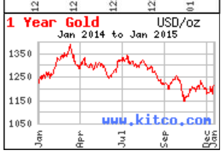

The Buck Stops Here

By Douglas E. Johnston, Jr
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The global monetary system which was laid out by the Allied nations at Bretton Woods, New Hampshire, in 1944 is nearing its end, and daily we move closer to the threshold of a financial new world order. The United States, having created the most powerful economic system yet devised by man, and having earned global 'reserve currency status' for the US Dollar through America's unequalled military and economic power as the victor of two World Wars, is now nearing the unthinkable loss of the global financial dominance of the Dollar. Following the residential real estate 'Bubble' of 2002-2006, the sub-prime Credit Crisis of 2007, and the broader global financial meltdown which has followed, the U.S. has experienced dramatically declining levels of core lending & general economic activity. With bold but ineffective stimulus and bailout plans failing to stem the dramatic fall in both business activity and tax revenues – and all in the midst of major banking and industrial restructurings - the deficit-laden U.S. has literally mortgaged its future to the breaking point, and the Dollar appears poised for a major devaluation.

So far, the US Dollar, battered and bruised and yet remarkably resilient in the face of dramatically weakened economic fundamentals, has lived a 'charmed life' of continuing support from a variety of sources - 'safe haven' buying, technical de-leveraging demand, central bank currency intervention, business inertia and a simple lack of viable alternatives for investors. But the dollar appears at last be running out of reprieves. Markets are beginning to realize that both the U.S. Economy and the U.S. Dollar are overwhelmed at home and increasingly suspect abroad. President Obama very aptly summarized the lack of options for U.S. policymakers when he addressed the unpopular financial reality of limiting healthcare promises amidst a sea of deficits and bailouts. During a Memorial Weekend interview with C-Span, the President commented, "…We are out of money now…We've got a short-term problem, which is we had to spend a lot of money to salvage our financial system…So we have a short-term problem and we also have a long-term problem. The short-term problem is dwarfed by the long-term problem.�?

The demise of the dollar has already begun despite the clever talk in the media about 'green shoots' and 'market bottoms' in the U.S. economy and stock markets. Perhaps these trumpeted 'green shoots' are more like the 'putting forth of leaves' in the Parable of the Fig Tree in Matthew 24, which foretells of the 'End Days' as summer draws nigh. If nothing else, the timing could be right. The world is simply growing weary of dollars and debt and dubious stimulus and bottomless, incomprehensible bailouts. The thing has run its course. Interest rates are now edging back up, the bond market is increasingly nervous, and major problems for the dollar lie ahead. Heaven help the U.S. when global speculators move in for the kill.

The average American has little or no comprehension of the scope of the pending global adjustment, but what is ahead will bring upon us a delayed wave of inflation and related disruption almost certain to engulf America's insular economic worldview. And from North Korea to Pakistan to Iraq to Afghanistan to Iran and especially to Israel, there are once again both drumbeats and emerging global flashpoints in many key areas. Who knows, with virtually every nation on Earth now participating on the edges of this growing financial tribulation, perhaps these really *are* the End Times.

For those less inclined to Scripture, we can readily turn to mathematics and to our instructive friend, the parabola, for clues about what lies ahead. Simply stated, parabolic growth rates herald major changes just ahead in virtually any arena of life, and the parabolic increases in the Federal Reserve's creation of dollars will prove to be no exception. The accumulated official US Public Debt of $11.3 Trillion at May 2009 has grown by over $2.1 Trillion in the past twelve months alone, with multi-trillions more ahead and no end in sight. The immediate future suggests massive additional bailouts for commercial real estate, credit card debt portfolios and insurance companies - plus the bubbling up of a Witches' Brew from *hundreds* of trillions of toxic OTC derivatives now in jeopardy - as the next major dominoes likely to fall. The www.usdebtclock.org website provides the following:

US Public Debt	$11.317 Trillion
US Government Bailouts	$11.650 Trillion
Estimated Currency and Financial Derivatives	$642.184 Trillion

Note: In March 2006 the Federal Reserve discontinued its separate publishing of the critical M3 money supply data, and so we are left to the estimate the parabolic increases in the printing of money *within* the larger 'Estimated Currency and Financial Derivatives' data.

Averting the U.S. Dollar Shipwreck

But aren't we at least making *some* progress in averting a dollar shipwreck? Evidently not, despite all the hopeful talk of 'green shoots.' Since the Global Meltdown began in 2007 with defaulting sub-prime U. S. residential real estate, the Fed & Treasury's massive stimulus plans, central bank/government interventions and bottomless bailouts have as yet failed to correct the course of declining liquidity and decreasing confidence. Despite trillions in bailouts, the core issue of deflationary declines in asset values continues unabated. The S&P/Case-Schiller Home Price Index for 20 American cities declined at 18.1% for the first quarter of 2009 - yet another *record* decline in residential markets, with major trouble looming in commercial real estate also.

More comparisons may be helpful as we look at the 'Disposition of the Trillions.' While the estimated Loss of US Household Wealth now stands at $11.429 Trillion, the Federal Reserve estimated at December 31, 2008 that total U.S. residential mortgage debt was a similar $11.9 Trillion. These numbers compare interestingly (and also similarly) to the sum total of $11.650 Trillion in total bailouts today. In hindsight, the math here might have been fairly instructive if we had known it more fully in 2007. Theoretically, had the US used the same $11.3 Trillion of bailout funds to pay off mortgage debt directly, then virtually every residential mortgage loan in America would already have been paid off, and the U.S. would not have lost $11.429 Trillion in household wealth, nor would it likely be facing the crushing recession ahead. The banks and other lenders would be essentially 'whole,' flush with cash to re-lend, and the American economy could begin to rebuild. In retrospect, this hindsight math suggests that a different approach might have produced very different results. But who would have dared to cancel, forgive or repay $11.9 Trillion of mortgages with taxpayer money when the initial problem seemed so temporary? Boldness on this scale would have been unthinkable at that time, or any other time.

The Real Problem Isn't the Ship, It is the Ocean of Derivatives

For various obvious reasons, this improbable $11.9 Trillion 'stitch-in-time' solution just did not happen, and we are now facing an entirely more complex set of issues, now in a fully global context. With countless other sectors of the global economy now infected, we have a still-growing contagion which has yet to be arrested. The giant pink elephant in the global financial meltdown room has slowly emerged as the underlying OTC derivatives piece, which at well over half a *quadrillion* dollars, remains both elusive and startlingly under-reported. The staggering quantity of derivatives contracts, many tied in long and complex back-to-back chains where underlying bets on mortgage portfolio performance and credit defaults are 'sliced and diced' and almost endlessly insured and re-insured, have been by definition both *unregulated* and *unsupervised*. OTC Derivatives have also lacked an adequate *clearinghouse* function to monitor settlements, and so the statistics and analysis of them have been rendered effectively unavailable.

While some notable industry participants such as Warren Buffett publicly have warned as early as 2003 that OTC derivatives constitute ‘financial weapons of mass destruction,’ the derivatives discussion was largely too complex for general comprehension. But the acceleration of underlying market events pushed the derivatives issue closer to the spotlight in late 2008. With the failure/arranged merger of Bear Stearns into JPMChase on March 16, 2008, the surprise bankruptcy of Lehman Brothers on September 15, and the US Government-sponsored bailout of AIG the very next day on September 16, the financial world permanently crossed the derivatives point of no return. These three events so jumbled the complex counter-party risks and settlement issues in the intertwined derivatives market that any real ‘unwinding’ or ‘forensic’ solution was rendered effectively impossible. Wall Street (and its foreign participants alike) has, ever since, been quietly managing a hopelessly unsolvable problem of broken counter-party risk links in complex derivatives chains *in an ocean of hundreds of trillions of dollars of derivatives contracts.*

By mid-September 2008 it was considered vastly better (especially during a U.S. Election year) to buy some time and quickly to make failing AIG (soon to be 80%-Government owned and taxpayer-funded) the collecting point/scapegoat/nominal obligor of last resort for many ‘uncontainable’ derivatives problems. So far, a succession of both Bush and Obama Treasury officials have weakly explained their ‘inability to get control’ of the scene, and that the underlying derivatives issues are truly ‘too complex to be discussed.’ Markets now face the probability that additional bankruptcies of major institutions such as GM, Chrysler, and others will reflect in the derivative credit default swaps chains, and only add to the highly complex, indecipherable and permanently flawed overall derivatives mess.

So these hopelessly broken derivatives contract chains and the uncertain asset values that have grown out of them now constitute the major elements of ‘toxicity’ in the colossal mountain of ‘opaque’ and complex derivatives which silently overhang the financial markets. That is certainly a mouthful. An easier approach would be this: When you hear ‘toxic assets,’ think ‘derivatives write-downs.’ And think BIG. RED. INK.

A few resourceful souls on Wall Street and elsewhere with friends in the right places appear to have learned how to exit these ‘toxic asset’ problems at par, but the rest of the financial establishment has been faced with mere cents-on-the-dollar valuations. Faced with a huge daisy-chain of re-surfacing write-downs, clear systemic risks and mounting Congressional pressures, the Financial Accounting Standards Board timely chose April 3rd (just days before U.S. first quarter banking & corporate earnings results were to be announced) to shift course. The FASB abandoned its push for consistency and backed down from its celebrated ‘mark-to-market’ rules for distressed assets, offering instead that companies may use more *discretion* in valuing assets ‘over the long term’ instead of meeting strict standards for providing current values on a *consistent comparison* basis for investors. In essence, the hallmark transparency of the U.S. financial world as we have known for it decades was thrown under the bus. The American Institute of Certified Public Accountants likewise bowed out of the debate of policing valuations, offering that companies are now obliged merely to do their best. Said AICPA CEO Barry Melancon: “All participants in the financial reporting system have an obligation to *move forward* (emphasis added) and provide the most transparent and reliable information on hard-to-value assets so that our capital markets can use that information to allocate capital efficiently.�? Just a day earlier it was the CPA profession's job to monitor these values for the benefit of third parties, while after April 3rd the issue was evidently being left more up to the companies themselves to decide. By indications, Wall Street was very pleased, at least in the short run. Winks all around.

Clearly, what we *don't* know about derivatives vastly exceeds what we *do* know, but at least two things are certain: 1) the few people who *do* understand them very clearly are not talking, and 2) through the hastily-arranged bailout of AIG, the wonderfully quiescent American taxpayer has now been maneuvered into place to absorb the gathering avalanche rolling toward the bottom of the Great Smoky Mountain of *$642 Trillion* in derivatives. Look out below, dear patriots. And please note, up there on the Hill, another warm tip of the hat from a grateful Uncle Sam and his friends on Wall Street.

The Beginning of the End

With the ever-mounting problems in the U.S. Economy, the ineffectiveness of bailouts and the increasing ‘opaqueness’ on Wall Street, the end of the USDollar’s role as the lynchpin of global commerce has been telegraphed for many months (if not years) by an increasing chorus of uneasy foreign holders of our current $11.3 Trillion of official public debt. China, Russia, the Arab States and other uneasy holders of suspect and weakening dollar-denominated assets have already aggressively called for the replacement of the USD with other currencies and/or a convertible gold-backed currency (or currencies).

China, which has carefully developed a national savings of $2 Trillion in foreign reserves through *decades* of thrift, hard work and trade surpluses, clearly watched very unhappily as its friends at the Fed and US Treasury created another $2 Trillion in less than *one week* last Fall – out of thin air – to accommodate a wide arrange of bailouts, currency swaps and political expedience. No surprise, then, that China would work quietly but diligently to try to diversify out of its huge reserves of dollars, and to arrange non-USD and swap/barter deals with Argentina, Brazil, South Korea, Australia and other raw material-rich or willing nations. China has also taken bold moves to try to install its own currency, the yuan, as either a global or regional ‘reserve currency’ to replace the dollar.

In the Arab world, the 6-nation Gulf Cooperative Council (GCC) convened in December 2008 to announce plans to launch its own gold-backed currency, the *khaleeji*, by the end of 2009/early 2010. In April, Dubai completed construction of its state-of-the-art gold vault (Dubai Multi Commodity Center) and has apparently recalled the gold that it has previously stored in London. The proposed new Arab currency may perhaps include a Russian tie (the Saudi Arabians want Riyadh as the new central bank site instead) as these issues and new currency alliances are still unfolding. The key issue is this: Arab oil producers whose crude is priced in dollars currently face a lose-lose scene, as their USD savings face rapid debasement through the US Government’s stunning fiat money-printing & core inflationary activities, yet the abandonment of the USD as the medium of exchange for oil pricing would do incalculable damage to the exchange value of their own *existing* vast dollar holdings as well.

For China, Arab world and all significant dollar holders alike, it is a question of biting the bullet. If not now, *when*? With the virtually endless prospect of deficits and dollar printing ahead by the US Government, the current scene will likely only worsen. And so long as the unbacked US Dollar remains the global reserve currency, the US can simply keep printing money to pay its debts, and it can keep debasing the other nations’ savings to save its own political skin.

Thus far, the Europeans and other more senior G-8 economies have remained more low-profile on the reserve currency topic as befits their stature, their measured national interests and simple common sense. Why announce the advance sale or conversion of your US Dollar savings assets, and equally, why even discuss a change until you are absolutely prepared for something else?

The Dollar as Reserve Currency

Before considering the other growing weaknesses in the US Dollar, let’s pause a moment to consider just exactly does central bank ‘reserve currency’ status imply, and why does it really matter? *Implicit in the terms of being the global reserve currency is the right for the U.S. to simply print money to pay its debts, not only domestically as other central banks do, but also abroad.* (Americans do not generally conceive that our continuing internal deficits are essentially paid for by the rest of the world when foreigners are induced buy our bonds.) From the standpoint of the Federal Reserve, the ‘reserve currency’ game is even better - not only does the Fed have the right to create money ‘out of thin air’ via the printing press, but in connection with the U.S. Treasury, it may also charge interest on it. So from the Fed’s perspective, this is clearly an interesting game worth preserving at all costs. As Will Rogers noted in his usual wry style: “There have been three great inventions since the beginning of time: Fire, the Wheel and Central Banking.�? Especially, it must be noted, if you are the U.S. Central Banker, the Federal Reserve.

What, also, is the importance of gold in the backing of a reserve currency? Gold has represented ‘sound money’ as both a store of value and a medium of exchange for centuries – and in virtually every advanced culture and civilization in world history. It has especially been employed many times in British, American and European history to anchor currencies from excess political spending. Gold is, in essence, ‘honest money,’ since under a gold standard nations pay a high price – the automatic adjustment loss of some of their gold reserves – if they spend more than they receive. Given these constraints, gold has been periodically ignored, rejected, and/or shunted aside by ambitious politicians who want to be freed of rigid spending constraints. We have lived in just such times since August 1971, when President Nixon removed gold backing from the dollar.

In many ways, gold is the antithesis of central bank paper money systems, which rely on public confidence and careful central bank management to survive. Central banks and their tenured friends in academia will therefore likely dismiss gold convertibility as vehemently as possible until, perhaps, they have cornered gold themselves and choose at last to reintroduce it. A new such cycle may lie ahead.

So it can be readily concluded that the Fed can and will do almost anything to keep its 'reserve currency' advantage for its paper dollars, and for as long as possible. But decades of inflationary spending on wars, social programs, trade & budget deficits, and staggering bailouts have so weakened the dollar as a store of value that the sharks (read 'other central banks') are circling. The 10-year-old Euro has long been considered as a replacement currency for the dollar, although the lack of structural controls over the various European sub-national economies may still prove to be a barrier for the Euro. More recently, the Russians, Arabs and China have each proposed getting into the 'reserve currency' arena to replace the dollar, and, interestingly, each of their proposals has included implicit or explicit backing by gold. China, in particular, has been aggressively promoting the yuan as a new global reserve currency alternate. Ultimately, the acceptance or rejection of a currency has to do with *confidence* and that currency's acceptance by the market.

Underpinnings for the Dollar

We have entered a final phase in the drama where confidence in the US Dollar is being undermined at many levels. Let's look again at the status of the *overall* characteristics that normally make for a sound reserve currency, and see how they look for the U.S. Dollar in 2009:

Political Stability**.** North America has been a war-free continent for over 150 years and the U.S. has supportive neighbors. The well-known political stability and 'safe haven' status of the U.S. remain as significant continuing attractions for global investors, as do the ready availability and convertibility of dollars around the world.

Gold Convertibility**.** When the dollar was agreed as the global reserve currency in 1944, it carried a fixed convertibility rate into gold at $35/ounce at the option of the other nations. This vital lynchpin of dollar-gold convertibility was severed unilaterally by President Nixon in August 1971. Thereafter, the era of 'floating exchange rates' was ushered in, whereby each currency's attractiveness was determined more by that nation's relative interest rate differentials.

Interest Rates. Since late 2008, short-term U.S. interest rates have been reduced virtually to zero, thus eliminating this important comparative foreign exchange attraction for the dollar. Equally troublesome is that with the U.S. economy now in deep recession, and any *increase* in rates from here will *also* spell further trouble for the dollar.

Trade & Budget Surpluses/Deficits. The U.S. continues to spend vastly more than it receives. The current data indicate another $600 Billion Trade Deficit for 2009, and the overall U.S. Budget Deficit is now estimated at nearly $2 Trillion for 2009-2010. The General Accounting Office (GAO), Office of Management and Budget (OMB) and Treasury Department have all stated that the Government's fiscal path is 'unsustainable.'

GDP Growth and Earnings Capacity to Service the Public Debt**.** With America entering a deep and powerful recession, business levels and tax receipts are down dramatically, and the U.S. Government's 'AAA' credit rating is in jeopardy as U.S. Public Debt as a percentage of Gross Domestic Product (GDP) is estimated to reach 100% by 2010 (vs. only 65.5% as recently as 2007). These precarious levels have not been reached in nearly 60 years since the close of the WWII Era.

Sound Fiscal & Monetary Policies/Relative Absence of Inflation.With the M3 money supply data no longer published, and with foreigners increasingly reluctant to buy Treasuries to finance ever-increasing U.S. deficits, the Fed and Treasury have now adopted what appear to be extreme emergency measures to fill the funding gaps. In March 2009, the Fed announced its new advanced money-printing policy of 'Quantitative Easing,' as well as the reinforcement of its direct 'yield management' efforts to contain rising interest rates on medium- and long-term U.S. bonds. Still further, the Fed announced its direct plans, for the first time ever, to buy up any U.S. Treasury bonds which are not bought by foreign creditors. This so-called 'monetization' of debt, or 'printing money to buy up your own debts when nobody else will do so,' is regarded by economists as the precursor to *hyperinflation*, as was experienced in both the German Weimar Republic in the 1920's and Zimbabwe over the past few years.

Depth and Breadth of Financial Markets. The once-dominant and aggressive U.S. investment banks have now been merged into more restricted commercial banks. Those major commercial banks which still remain now operate under deep earnings pressures and more strict regulatory restrictions including extensive 'stress testing' and 'capital impairment' lending restrictions, and the much-discussed 'capital crunch' has now pervaded virtually all sectors of U.S. business activity. Merger & acquisition activity, major debt syndications, securitizations, commercial paper activities and normal corporate lending functions have all been drastically reduced. Normal U.S. capital formation and IPO activity have all but ceased since late 2008.

Transparency & Consistency of Accounting & Regulation**.** The U.S. has now clearly abandoned the necessary system-wide focus on transparency and consistency which is needed for foreign and domestic market participants properly to assess risk.

1. The $700 Billion in TARP bailout recipients remain completely shrouded in hushed secrecy, while the Treasury and Fed also move directly and without accountability in numerous debt and equity markets via the Plunge Protection Team ('PPT').

2. The ever-burgeoning government-sponsored take-over of AIG, along with the hundreds of trillions of overhanging derivatives now in selective jeopardy, continues unchecked and evidently beyond either examination or discussion.

3. The FASB's 'mark-to-market' accounting rules are now compromised, with consistency and third-party verifications of accounting standards abandoned in many cases.

4. The 'watchdog' SEC is now widely known for its under-enforcement and delays and/or missed prosecutions of key fraud and securities violations, notably including the well-publicized Bernard L. Madoff case.

5. The Treasury and Federal Reserve have intervened directly in the restructure, merger and/or bankruptcy preparations of Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Bank of America, Merrill Lynch, GM and Chrysler, among others. In the process, the Obama Administration has undertaken to undermine core business practices, the sanctity of contracts, and the bankruptcy processes which are so necessary to attracting investment capital to re-start the U.S. economy.

6. The expanding political initiatives of intimidation, governmental coercion and/or regulatory favoritism are clearly evident toward selected banks and Wall Street firms.

A New Era

Can we rule out the truly unthinkable – an actual market loss of confidence in Uncle Sam and his sinking ship, the U.S. Dollar? Save for the continuing political stability of the U.S., the Dollar's key supports have been lost, abandoned or compromised, one by one. The U.S. financial system is in very deep trouble, the Fed and Treasury's remedies are still missing the mark, and the U.S. has veered dramatically away from its ethical mandate of providing a transparent & level playing field for all market participants. At some point, the U.S.' deficits, debts and dilemmas become so unmanageable that not even America's large size and cherished safe haven status can protect its reputation or the dollar's value in world markets. It is probably no longer out of the question that Uncle Sam's creditors and investors may soon reach a crisis point of repudiation, triggering a major dollar devaluation and/or the replacement of the dollar as the global reserve currency. This will bring about profound changes in the American lifestyle.

In remarks on April 21st, former Fed Chairman Paul A. Volcker noted, "The dollar is the most overextended currency internationally…For better or worse, we are at the point where the Federal Reserve Act…with all that has happened…is going to be reviewed…as to the appropriate role for the Fed in the future.�? To most, this implies a major revamping of the very structure of the U.S. financial & regulatory systems (as Volcker himself confirmed directly), while to others these comments also imply a possible actual monetary default ahead by the U.S. Government.

We may view this scene again in collective realization, just as Hans Christian Andersen once described in fable. At some point soon, the market may finally acknowledge that the vaunted US Dollar, the Emperor, is no longer wearing any clothes. And for both Wall Street and the average American alike, the Buck may stop here, at last.

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