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Crossing the River 'Rublecon'

by Jason Hundhausen

"The present is the past rolled up for action and the past is the present unrolled for understanding."
– Ariel Durant, *The Lessons of History*

"The first lesson of economics is scarcity: There is never enough of anything to satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics."
– Thomas Sowell

"There are decades where nothing happens; and there are weeks where decades happen."
– Vladimir Ilyich Lenin

"They basically said your FX reserves, Russia, are no longer 'money good.' And that to me…I think we will look back in a few years' time and realize that was every bit as big as Nixon closing the gold window in August of '71."
– Luke Gromen, *The Grant Williams Podcast, Feb. 2022*

Over the first three weeks of July in 1944, nearly five years into WWII and still nine months before V-E Day and V-J Day, 730 delegates from forty-four nations including the U.S., Canada, Australia, and much of Western Europe met in Bretton Woods, New Hampshire. Their objective: to establish and agree upon the rules of a new monetary system that could provide the credit and capital to rebuild a world ravished by war.

Two plans for this new system had been proposed; the first by Lord John Maynard Keynes, the famous English economist and an unpaid advisor to the UK Treasury, and the second by Harry Dexter White, the not-so-famous Chief International Economist of the U.S. Treasury Department.

Representing the descending power of Great Britain, Keynes's plan called for the creation of a global central bank, which he referred to as the "International Clearing Union." The Clearing Union would issue a new, supranational currency called "bancor," which would be backed by a basket of neutral commodities, including gold. This system had rules that would tend to make it self-regulating, discouraging nations from building up excessive surpluses or deficits, but it would also allow for those temporary imbalances in trade to occur—such as might be needed when a country is trying to rebuild after a war.

Representing the ascending power of the United States, White's plan took a slightly different approach. Instead of creating a new currency, each nation would contribute currency and gold to a new monetary agency called the "International Stabilization Fund." In White's plan, the Fund would lend in U.S. dollars—and potentially other currencies or gold—to provide a limited line of credit to countries to finance the rebuild.

The two sides duked it out, for the most part maintaining diplomacy and collegiality, but at times devolving into tense and explosive debates. In the end, the plan adopted was a hybrid of the two, but White had the upper hand. At the time, the United States held most of the world's gold and was a powerful creditor nation, so the fact that we ended up with a dollar-based system might not come as too much of a surprise.

On July 22, 1944, delegates signed the Articles of Agreement at Bretton Woods, thus creating the International Monetary Fund (IMF). Instead of bancor residing at the center of the monetary universe, the U.S. dollar was given the honor. The dollar was to be backed by a neutral asset—gold—and the value of the dollar was set and convertible to physical gold at a rate of 35 dollars per ounce. Every member nation would peg the value of its currency to the dollar—give or take some wiggle room when needed—thereby pseudo-backing themselves to gold. (Interesting sidebar that delegates from Russia, an ally during the war, signed the Bretton Woods Agreement, however near the end of 1945, when it came time to join the IMF, Stalin declined because he feared (and rightfully so) that the IMF would largely be controlled by the United States. Perhaps coincidentally, the relationship between our two nations has been rocky ever since.)

While the Bretton Woods Agreement may have been signed in 1944, it would take another 14 years before it was fully implemented. In the intervening time, this new monetary system, coupled with the post-war production capabilities of America not only led to a boomtime in American history, but was also successful in providing the capital and goods to rebuild Europe; however, upon taking effect in 1958, a shift occurred. Countries that had been left in ruins, who initially relied heavily upon exports from the U.S. to rebuild, roared back to life and began exporting goods of their own. The balance of trade shifted, and as other nations began exporting more goods to the U.S., the U.S. gold reserves began to fall. Under a true gold-backed system, less gold would mean less dollars in circulation, but that's not what happened. It was becoming apparent that the dollar wasn't quite as good for gold, after all—at least not if everybody wanted to redeem their dollars.

You can't pick up one end of the stick without picking up the other.

Other nations took notice of this, notably France in the mid-60s. French president Charles deGaulle more than ruffled a few feathers in the U.S. when he vocalized his concerns that the system, as structured, while necessary and useful during the post-war rebuilding, was now creating an unfair advantage and a moral hazard. He felt the system incentivized Americans to consume more than they produced because they could pay for it with money they could print at will. It was his conclusion that the only fair system would be one where the currency bore no mark of any nation. That currency? Gold.

This triggered a wave of countries—"speculators," as Nixon referred to them—pulling their gold out of the U.S., accelerating the drawdown that had been going on since implementation of Bretton Woods in 1958. At its peak in the mid-50s, U.S. gold reserves stood at around 21,000 tons. By 1965 when deGaulle opened his big mouth and got France put on America's "bad actor" list, U.S. gold reserves had already fallen by a third to around 14,000 tons. The run continued for another six years, by which time America's gold reserves stood at just 8,000 tons. Then, on Sunday, August 15, 1971, President Nixon shocked the world when he announced on TV that he had directed the Treasury Secretary to suspend the convertibility of the dollar into gold. The order was to be a "temporary closure" to protect the currency. Milton Friedman used to say that "Nothing is so permanent as a temporary government program." The gold window is still "temporarily" closed today.

One might ask, "Without the dollar being backed by anything, how has the United States been able to maintain its status as the global reserve currency?" The answer: oil.

A 1945 agreement between the U.S. and Saudi Arabia may have created the petrodollar, but the term didn't find its way into widespread use until the early 1970s. The petrodollar refers to the (voluntary) agreement by other nations to price and trade oil using U.S. dollars. By the early '70s, with the cooperation of Saudi Arabia and the rest of OPEC, the global oil market had grown so large that it became the de facto reserve asset instead of gold. In other words, instead of being pegged to gold, the dollar had become pseudo-pegged to oil.

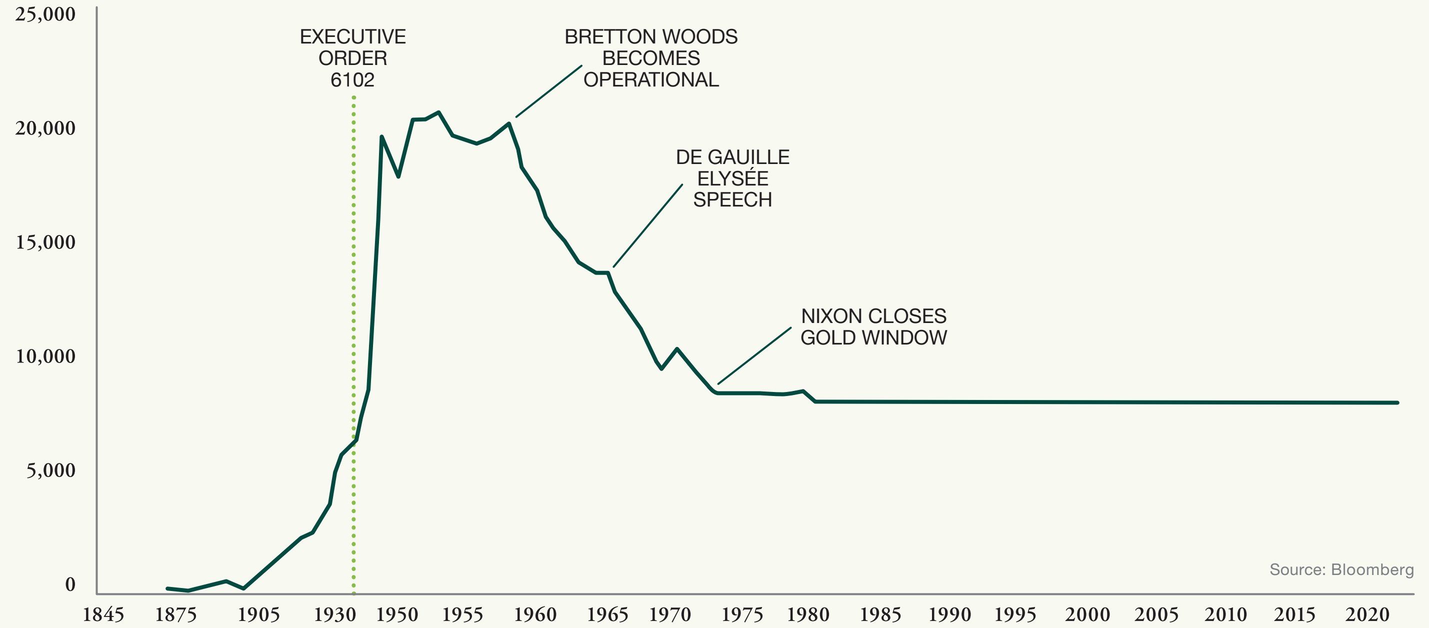
As the economy grew, so did the demand for energy, and as such, so did the demand for dollars. Americans could import (spend) far more than they export (produce) because they had an ever-growing pool of dollars (oil) to draw from. Other countries played along because they could use those dollars to buy assets, among them U.S. Treasury bonds. Countries that needed to import a lot of oil (*cough China cough*) could use their surplus trade reserves to purchase Treasury bonds and the interest paid on those bonds could be used to buy oil. And because the central bank effected monetary policy to maintain a relatively steady price of oil, the interest payments on our bonds provided these countries a relatively steady supply of oil for over 30 years.

All of that started to come to an end in the early 2000s when the geological realities of a limited supply of oil combined with rising global demand caused prices to start rising. From the perspective of, for example, China, who needs to import twice as much oil as they produce, this loss in purchasing power poses a serious threat to national security. Without energy, 1.3 billion people start to get cold and run out of food.

Historically, when faced with rising oil prices, the U.S. would raise interest rates (tighten monetary policy) to bring the price down, but this time it was not to be. Thanks to the onset of the Global Financial Crisis (GFC) in 2008 and subsequent collapse of the U.S. housing market, stock market, and bond market, the Central Bank faced a difficult decision: raise rates to protect the dollar at the expense of the economy, or cut rates to save the economy, but sacrifice the dollar in the process. They chose the latter.

"You can't pick up one end of the stick without picking up the other," is an old adage meaning you can't have an action without some kind of consequence. This can be positive or negative. In the case of our response to the GFC, we saved

United States Gold Reserves (Metric Tons) 1875–2022



the financial/banking system, but we sent a message to the world that when push comes to shove, we'll print all the money we need, and with over $100 Trillion in unfunded future obligations in the queue, other nations know that the printing has only just begun and there's nothing anybody can do about it, right? Wrong.

We should never underestimate the tenacity of somebody who's hungry, and we should never forget that the second law of thermodynamics—the one that says order within a system is, at most, temporary—can never be broken. The rise of nations comes from a hunger and desire to prosper, and the monetary system we've been using for the last 80 years is now impeding that progress for some of the most powerful nations on the planet. This is not new, this is not "because of the pandemic" or "because of the war in Ukraine" (although both have greatly accelerated and exacerbated the situation). Our competitors have been building their gold reserves and fortifying their currency for many years and they're challenging the petrodollar system by trading oil priced in their own currencies, even going so far as to create oil contracts that are convertible to physical gold. In short, they're reducing their reliance on the U.S. dollar.

Which leads me to the reason I chose this topic for the newsletter in the first place. I'm of the opinion that on February 26, 2022, the United States and Europe crossed the river Rubicon—or should I say, "Rublecon"—when they blocked the Russian Central Bank from accessing their FX reserves, which is sovereign property held on deposit at the Federal Reserve Bank of New York with the promise that we will keep it safe and never seize or prevent them from accessing it. But we broke that promise and, while we may be right and justified in doing so given their invasion of Ukraine, it doesn't mean there won't be a consequence. That consequence is that we have sent a message to every nation on the planet that, despite our words, your reserves are not safe if the relationship sours. The trend of nations reducing their reliance on the dollar just accelerated.

"Yeah, but that's only for bad actors," some may argue, but ask yourself who *hasn't* been on America's "bad actor" list over the last 80 years? Germany, Russia, China, Cuba, half of Central and South America, practically every country in the Middle East, even France in the '60s! The point is that if you're any other country besides the U.S.A., you can't afford to risk having your FX reserves seized should your actions not align with the goals of the United States. And as for the other countries, such as Iraq, Libya, and Venezuela, whose bank reserves we've seized in the past? They're not Russia. And don't think China, by far the largest exporter in the world, with its own eyes on Taiwan, hasn't taken notice.

Errol Flynn once quipped, "My problem lies in reconciling my gross habits with my net income." I think Russia, China, and other nations are nearing their limits of tolerance for the gross habits of U.S. currency debasement and the net new levels of public indebtedness resulting thereof. And so that is where I think we find ourselves: a turning point in global monetary policy history, one where the U.S. dollar takes another step to the side as assets like gold (or even Bitcoin?) once again take a step closer to center stage in their role as sound currencies. ■