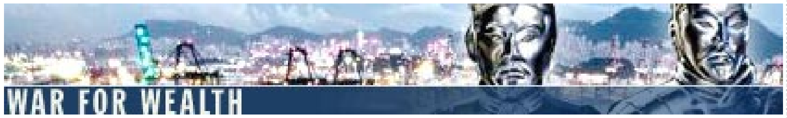

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PLAYING WITH FIRE

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America and the Dollar Illusion

By Gabor Steingart

The dollar is still the world's reserve currency, even though it hasn't deserved this status for a long time. The devaluation of the dollar can't be stopped -- it can only be deferred. The result could be a world economic crisis.

Editor's Note: The following essay has been excerpted from the German best-seller "World War for Wealth: The Global Grab for Power and Prosperity" by SPIEGEL editor Gabor Steingart. SPIEGEL ONLINE is publishing a series of excerpts (more...) from the book.

The two things investors crave most are high yields and high security. Since you can never have both at the same time, the moods of investors are like an emotional roller coaster. They shift constantly from fear to greed and back -- although major investors, like corporations and states, clearly prefer security over fancy returns. Their fear is stronger than their greed. They'll freely relinquish the really fat profits as long as the stability of their billions is guaranteed. They're afraid of political unrest, they loathe overly dramatic changes in currency value and the mere thought of creeping inflation sends them into a state of panic.

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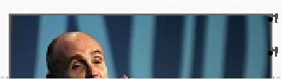

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Greenback in demand: People keep buying dollars as if possessed.

possible security in the face of these dangers. They include the United States and Switzerland. Indeed, this security is why the dollar isn't just used in trading and investment, but also functions as the world's reserve currency. Almost every country in the world distrusts its own currency to the extent that it prefers to invest the money from its treasury in the United States.

One can almost completely rule out the possibility of political unrest in the United States. Inflation is combated by the Federal Reserve Bank. Given the size of the currency's spread and the quantity of dollars circulating worldwide, speculators have no cause to get overly anxious about the dollar.

Thus, those who have money prefer to keep it in dollars. The United States disposes of a virtual monopoly on the commodity called security. For many investors, purchasing a US government bond is nothing other than a way of preserving their money. In 2005, only 20 percent of all currency reserves in the world were held in euros, whereas more than 60 percent were held in dollars. The introduction of the euro was a considerable success, and one should not downplay it. Nevertheless, the dollar has remained the world's currency anchor. As long as this anchor rests firmly on the ocean floor, stability is guaranteed for the national economies that invest in the dollar.

But if that anchor should tear itself loose and begin to drift freely in the ocean of global finance, the chaos that ensues would result in trouble for more than just exchange rates.

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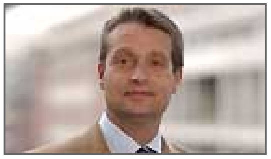
SPIEGEL Mobile: The latest headlines at your fingertips bills? Why do they rely on the good called security -- a commodity whose quantity cannot be increased at all? Doesn't every business student learn that the currency of a country is only as stable -- and hence as valuable -- as what the national economy of that country has to offer and produces? Does no one see that the tension between the dream and the reality is increasing and that this tension will snap, leading to suffering for millions?

THE AUTHOR



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Gabor Steingart, 44, heads DER SPIEGEL's Berlin office. His last book was titled "Germany: The Decline of a Superstar" and, like "World War for Prosperity," was a bestseller in Germany. Steingart was chosen as "The Economic Writer of the Year" in 2004.

Of course they see it! Investors can see what is happening. They wonder about it and shake their heads. It even scares them a little, sending chills down their spine. But they keep buying dollars as though possessed. The greater their doubts, the more greedily they order dollars. Indeed, that's exactly what is so crazy about these investors and their behavior: The client isn't just a client. He creates the security he's purchasing by the very act of purchasing it. If he were to stop buying dollars tomorrow, suspicion about the currency would spread and insecurity would grow. Then the dream would end. The dollar would start to falter and all the wealth held in dollars would lose its value. Of course, that's not something investors want to see happen.

The only way to fight a weak dollar is to strengthen it. Many people no longer care whether the US currency still justifies the faith people seem to have in it. The new game, which amounts to playing with fire, works exactly the other way around: The dollar deserves the faith it gets because otherwise it loses that faith. Dollars are bought so they don't have to be sold. The dollar is strong because that's the only thing that can prevent it from growing weak. Reality is ignored because only by ignoring it can the dream come true. Or, to put it still more clearly: Behaving irrationally has become rational behavior.

Everyone knows the danger

Of course, those playing this game know that, in the long term, currencies can't be stronger than the national economies from which they derive. Consumption without production, imports without exports, growth on credit -- these are all things that can't last in this world. Ken Rogoff, the former chief economist of the International Monetary Fund (IMF) and a man who thinks as clearly as he speaks brashly, recently criticized US economic policy even as he seemed to be praising it: Rogoff said the current boom in the United States is "the best economic recovery money can buy."

BUCHTIPP

This essay has been excerpted from **"War for Wealth: The Global Grab for Power and Prosperity"**, Germany's best-selling book by Gabor Steingart. SPIEGEL ONLINE is publishing a series of excerpts from the book in English.

Piper Verlag, Munich; 384 pages; €19.90. The German-language edition of the book is available online at SPIEGEL Shop.

But if things have become that obvious, why aren't investors recoiling in fear? Why do foreigners, US presidents of all stripes and even Federal Reserve presidents known for their seriousness allow themselves to get involved in such a risky game, when the risk is that of destroying everything? Why aren't those mechanisms of market regulation functioning that are supposed to represent the advantage of the capitalist system over planned economies?

The answer is terrifyingly simple: Everyone knows how dangerous the game is, but continuing to play it strikes them as less dangerous than quitting. After all, what's to be gained from overreacting? Investors allowed themselves to get caught in the dollar trap years ago, and there's no easy way out. If they start taking their dollar bills and government bonds to the market themselves, they would lose money -- either gradually or all at once. They would like to avoid both scenarios, at least for a time. A president who does no more than recognize the situation as an important issue may lose his position as public discontent looks for a vent. Though the governors of the Federal Reserve Bank are under the strongest obligation to tell the truth, they have let the right moment for effective intervention slip by.

Waiting for the signal

Alan Greenspan, the legendary former chairman of the US Federal Reserve, did much to feed the dollar illusion. Whenever skepticism increased, he raised the key interest rate. Any rise in the key interest rate also serves as a sort of risk premium for those who took their chances by investing in the dollar. When doubts about the sustainability of US economic growth were heard, Greenspan set out to dispel them immediately. For a man better known for his mumbling and preference to keep people in the dark about the financial world, he spoke with remarkable precision. "Overall, the household sector seems to be in good shape," he said in October of 2004. If the global financial market's managers worship Greenspan, then it's at least partly because he's given their dream a lease on life of several more years.

His successor has no other option but to do the same thing. He knows that every piece of advice issued by someone in his position will have consequences. If he issues a warning about the skewed state of the economy, the warning itself instantly becomes a self-fulfilling prophecy. Even if he chooses a subtle formulation, the financial market will perfectly understand what he's saying. Everyone is waiting for the sign that the trend has reversed. No one is hoping for that sign, but no one can afford to miss it either.

At this point, a legitimate objection could be formulated: namely, that financial markets don't normally obey politicians. So why aren't the markets correcting themselves in this instance as they normally do? Who or what is preventing investors from behaving differently towards the dollar than they behaved towards New Economy stocks?

They're going to do it. The only question is when. Financial investors aren't tax collectors or accountants: Their job isn't that of a meticulous overseer. They love excess, and they regularly cause markets to overheat. After all, speculation is the business they're in, and being in that business involves living with the risk of going too far. Their professional attitude resembles that of race car drivers whose goal is victory and not avoiding accidents at all costs. What remains unclear is just how dramatic the crash will be. Experts have often forecast the effects of a dollar meltdown. If the downward trend were to begin, interest on credit would rise step by step in an attempt to curb devaluation. That way, the dollar crisis would spread from the world of currencies to the real world of factories, businesses and household accounts within days.

Major and minor private investments yield lower returns when interest rates climb. People would start to save, the economy would falter and eventually shrink. The first mass layoffs would arrive soon afterwards. US citizens would have to once more drastically reduce their level of consumption, as unemployment and waves of bankruptcy would shake up the country. Millions of households would become unable to pay back their bank loans. Then real estate prices and share values would begin to drop, having been overpriced for years and used as mortgages for consumer credit. When the real estate bubble bursts, consumption inevitably dwindles even further. The hunger for imports would fade, causing problems for exporting countries as well. It would only be a matter of days before newspapers would once more feature a term that seemed to have disappeared decades ago: world economic crisis.

Steroids for the giant

Last century, the United States already suffered from one deep economic crisis that gradually spread to the rest of the world. The Great Depression lasted 10 years and brought mass unemployment and starvation to the United States. The country's economic power sank by one-third. The crisis virus wrought havoc all over the West. Six million people were unemployed in Germany when the economic fever was at its peak.

Today's investors face a difficult choice, one they're not to be envied for. They can see the relative weakness of the US economy and they're registering the tectonic shifts in the world economy. They know that a great statistical effort is being made to prolong the American dream. For some time now, government statistics have announced sensational productivity leaps for the US economy -- productivity leaps that, strange as it may seem, haven't led to any rise in wages for years. This is in fact genuinely bizarre: Either capitalists are reaping the fruits of increased productivity all by themselves -- which would be a political scandal even in capitalism's heartland -- or the productivity leaps exist only on paper. There is much to suggest that the second hypothesis is correct.

Half the world is impressed by the low levels of unemployment in the United States. The other half knows that these statistics aren't official, but the result of a voluntary telephone survey. Many of those who declare themselves employed are assistants and day workers. Working just one hour a week is enough for one to be classified as "employed." Given that it's considered antisocial to declare yourself unemployed, the US statistics may well say more about American society's dominant norms than about its actual condition.

The US economy's high growth rates aren't to be completely trusted either. They are the result of high public and private debt. In no way do they express an increased output of domestically produced goods and services that the United States has achieved by its own strength. They say more about the successful sales ventures of Asians and Europeans. New loans taken by the US government were responsible for fully one-third of US economic growth in 2001. In 2003 they were responsible for a quarter. The United States is an economic giant on steroids -- doped so its decline in performance doesn't become too apparent.

Trust in God, market style

For capital market investors, reality isn't reality until the majority of investors are convinced it is reality and have begun reacting accordingly. Right now, everyone is watching everyone else closely. Everyone knows the dream of the stable economic superpower has ended, but everyone is keeping his eyes shut just a little longer.

Government bonds and shares don't have any objective value -- nothing you can see, weigh, taste or even eat. Their value is measured by investors' faith that the purchasing power of $1 million will still be $1 million 10 years from now, rather than having been reduced by half. This faith is measured on the markets almost every second -- and the measure used is nothing but the faith of other investors. As long as the faithful outnumber the skeptics, everything works out fine for the dollar (and the world economy). The trouble starts the day the scale begins to tip.

The process is complicated by the fact that investors aren't driven by blind faith alone. In part, it seems, hard facts also push them to extend their credit of trust a little longer. US economic growth -- an impressive figure on paper -- is an important benchmark. When it is high, investors feel reassured in their faith in the power of the US domestic economy to perform well. True, the trade balance deficit has skyrocketed since it first appeared in the mid-1970s. But the economy is growing steadily anyway, as the dreamers note with growing self-confidence. It may not be growing as rapidly as the Chinese economy, but it is growing twice as fast as the European economy.

And yet this benchmark is not as reliable as it seems. The faith investors have in the figure has actually helped create it. After all, the purchasing price of a government bond feeds almost directly into state consumption, just as the purchasing price of a share makes companies more inclined to consume. It also extends the credit basis of millions of private households -- which in turn boosts consumption. In this way, the expectations of investors -- including the expectation that the United States will continue to grow -- transform into certainties almost all by themselves.

In other words, the capital of trust creates the very growth rates it needs in order to justify itself. US economic growth, in fact, is fueled by ever-increasing consumer spending -- puzzling given that American wages are dropping as is industrial output. Still, everyone knows the answer to this riddle. The rise in consumption isn't based on an expansion of production, a rise in wages or even an increase in exports. To a large extent, it's based on the growing debt. But why do banks keep issuing credit? Because they accept the ever-increasing prices of stocks and real estate as a kind of collateral. A closed circuit of miraculous money minting has been created.

Self-delusion

The extent of this self-delusion can be read in the balance sheets of the banks: Almost no one is saving money in the United States today. The US foreign debt grows by about $1.5 billion every weekday and has now reached about $3 trillion. Private household debt, both at home and abroad, has reached $9 trillion -- and 40 percent of these debts has been incurred since 2001. The Americans are enjoying the present at the cost of selling off ever larger chunks of their future. Arguably, the imminent economic crisis is the most thoroughly predicted one in recent history. Rather than refuting the crisis, the current US economic boom merely heralds it.

Biologists have observed similar phenomena in plants contaminated by toxins. Before they wither, they produce one last batch of healthy shoots -- to the point that they can hardly be distinguished from healthy plants. Some speak of a panic bloom.

So who will be the first to destroy the dollar illusion? Aren't all investors bound together by an invisible link, since every attack on the key currency would lead to a loss of value for them, perhaps even destroying a large part of their financial assets? Why should the central banks of Japan or Beijing throw their dollars onto the market? What could make US pension funds wilfully destroy their wealth, held in dollars? What sense would it make to send the United States into a deep crisis when that crisis could drag all the other states along?

The underlying motive is the same as the one that once prompted investors to buy dollars -- fear. This time it is fear that someone else may be faster, fear that the dollar's strength won't last, fear that every day spent waiting may be one day too long. It's fear that the herd instinct of global financial markets will set in and overtake those who can't keep up.

Weaker than they say

These days, the dollar is making a lot of people uncomfortable. One morning many dollar-owners will wake up and look at the facts about the US economy without their rose-colored glasses -- just as private investors woke up one day and took an unflinching look at the New Economy, only to see companies whose market value couldn't be justified by even the most dramatic of profit increases. Some of the revenue forecasts that had been issued far exceeded the total value of the market. The Nasdaq presented the spectacle of a stock market whose added value increased by 1,000 percent in just a few years, when the nominal growth of the US economy during the same period was only 25 percent.

Greed triumphed over fear for a few years -- but then fear came back. The value of high-tech shares plummeted by more than 70 percent in just a few months, and they're still less than half as high as they were then. Even the Dow Jones, a stock market index based on the value of the largest US companies, was devalued by some 40 percent.

Much the same fate is in store for the dollar and for dollar loans. The United States has sold more security than it has to offer. The expectations traded will turn out to be valueless because they can't be met. Just as the New Economy was unable to provide investors with either the growth or the profits that had been predicted for investors, currency traders will one day have to admit that the economy backing the currency they sold is weaker than they claimed.

The crash can be deferred, but not stopped

The dependence of foreign central banks on the dollar will defer its crash, but it won't prevent it. Today's snowdrift will become tomorrow's avalanche. The masses of snow are already accumulating at breathtaking speed. The avalanche could happen tomorrow, in a few months or years from now. Much of what people today think is immortal will be buried by the global currency crisis -- perhaps even the leadership role of the United States.

Incidentally, the commission that former US President Bill Clinton created to investigate the negative balance of trade concluded in clear terms that the government has to do whatever it can to put an end to the growing disparity between imports and exports. It demanded that the public give up its optimism and return to realism, that people start saving again and that the state reduce its imports in order to prevent too hard a crash landing.

None of that has been done. In fact, what is being done is the opposite of everything the experts recommended. Debt is growing, imports are increasing and an optimism now lacking every basis in reality has become official state policy. Lester Thurow, a member of Clinton's commission, draws the sober conclusion that no one will believe the US balance of trade could produce a crisis "until it happens."

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