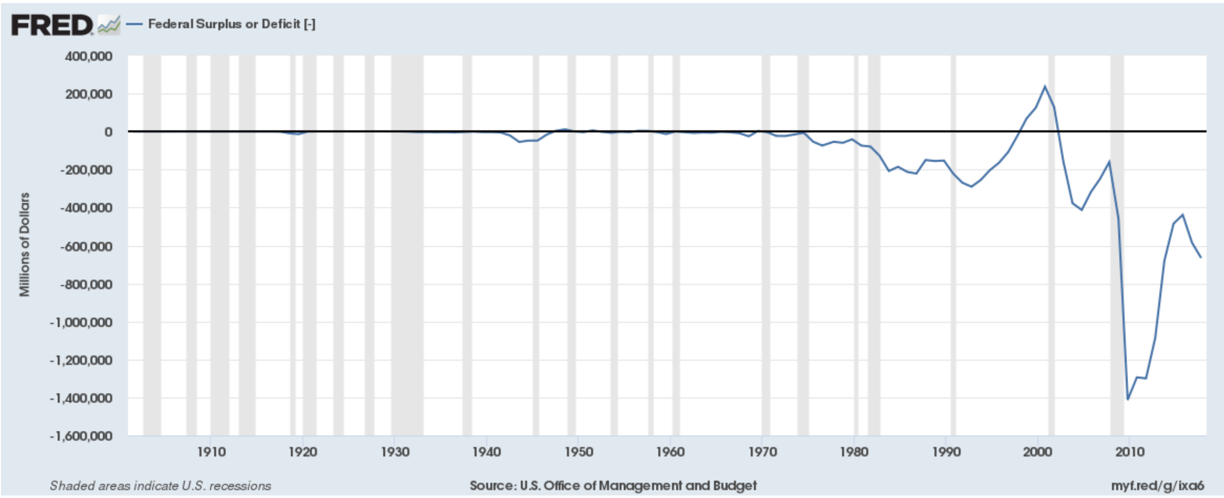
The recycling of the US dollars financing the US deficits is going to end (Part 1)

Introduction

Hugo Salinas Price wrote an excellent article called 'Bad karma brings bad consequences for those who practice it' on the unwanted consequences of the trade tariffs imposed by the US. He points out that the accumulation of US dollar reserves in the forex reserves of the central banks is a function of the foreign countries being able to sell (underselling) or export goods to the US. And the US dollars generated rom the exports allows the central banks to buy Treasuries thereby financing the budget deficits of the US that basically transpired since 1971 when the gold standard was abolished by Nixon!



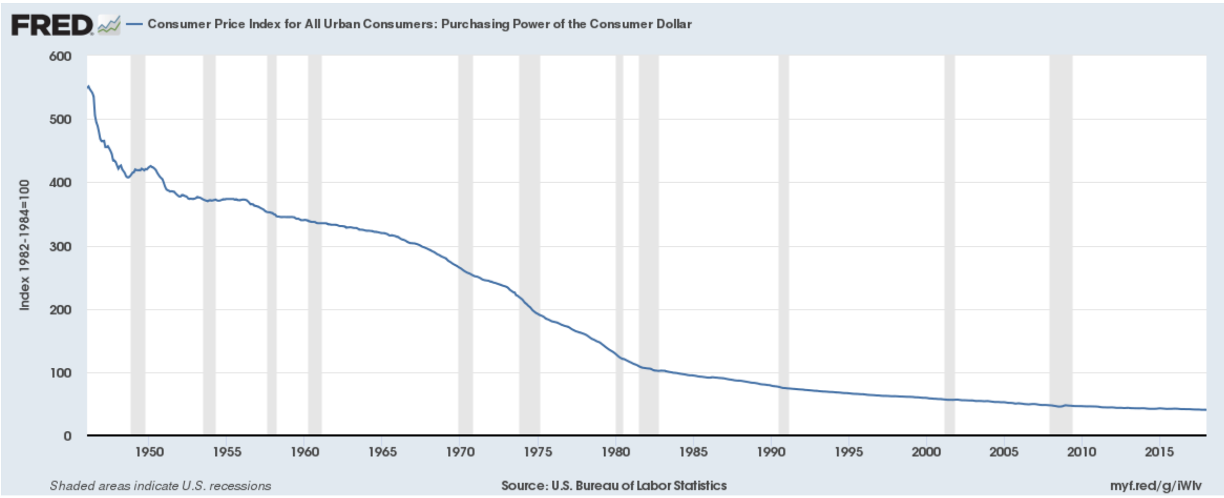
There is a lot of commentary going around the world, regarding Trump's initiation of a "Trade War" to rebuild America's industries. As Salinas says Trump thinks that tariffs will do the trick, and stop the rest of the world from taking unfair advantage of the US by selling their goods to the US in exchange for lots of US dollars. According to Trump, this nefarious behavior on the part of the rest of the world is causing a huge trade deficit, sending hundreds of billions of dollars out of the country.

For your information the 2017 trade deficit surged 12.1% to $566.0 billion, the highest since 2008. That shortfall represented 2.9% of GDP, up from 2.7% in 2016. The politically sensitive U.S.-China trade deficit jumped 8.1% to a record $375.2 billion last year.

Despite the gold backing the US dollar has been continuously losing its purchasing power hence the US dollar for gold swaps. No fiat reserve currency wins from gold or silver!

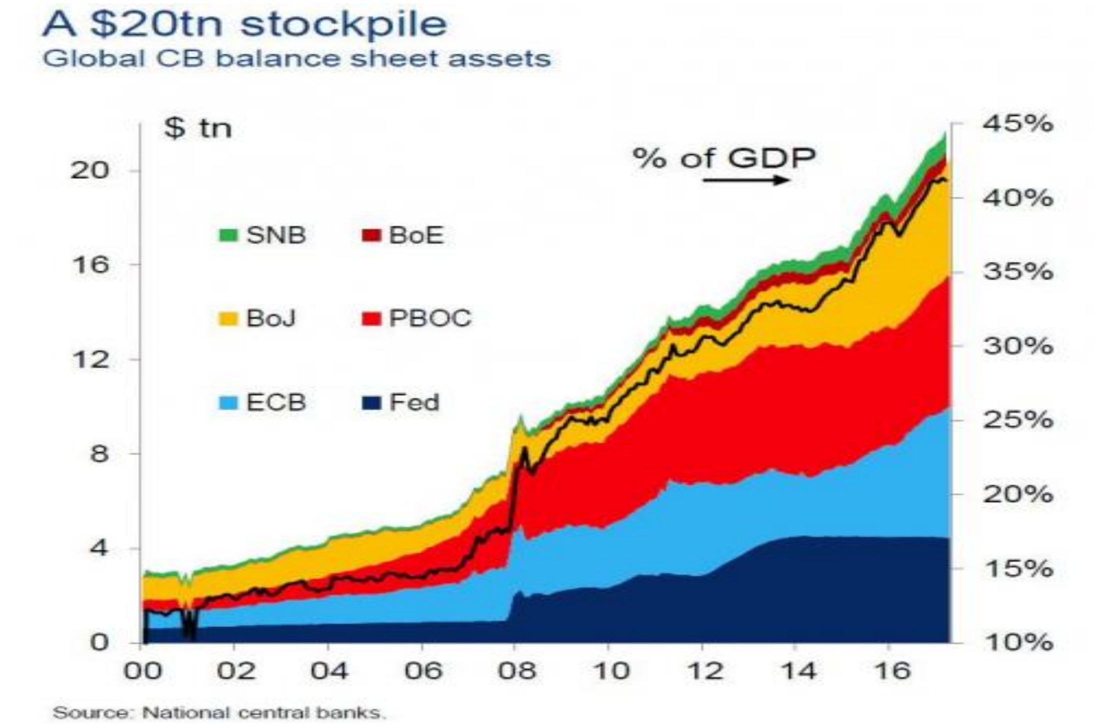
At Bretton Woods (1944) the US, the victor in WW II, forced the rest of the world to accept the US proposition whereby gold would be the world's money, supported by dollars, which were to be regarded as good as or even better than gold. At that time the US had a stock of some 22,000 tons of gold. The US is now believed to hold, that is if they haven't sold most, about 8,133 tons in total (Fort Knox and NY Fed), or about 2.4 times that of the next leading country, Germany with 3,374 tons. The Germans understand what the word inflation means hence their second largest gold reserves.

Though as time went on, US trading partners began to ask for gold instead of dollars, a thing of which the US disapproved – General Charles de Gaulle increasingly asked for France´s gold (to which France had a rightful claim). What jumps to mind is JP Morgan's famous quote 'Gold is money, everything else is credit'. The increasing exchange of US dollars for gold was clearly motivated by the ongoing devaluation of the US dollar. Since 1945 when the index was 550 the purchasing power has fallen by an astounding 93% to 40 today as clearly shown by the following chart of the Fred (St Louis Fed).

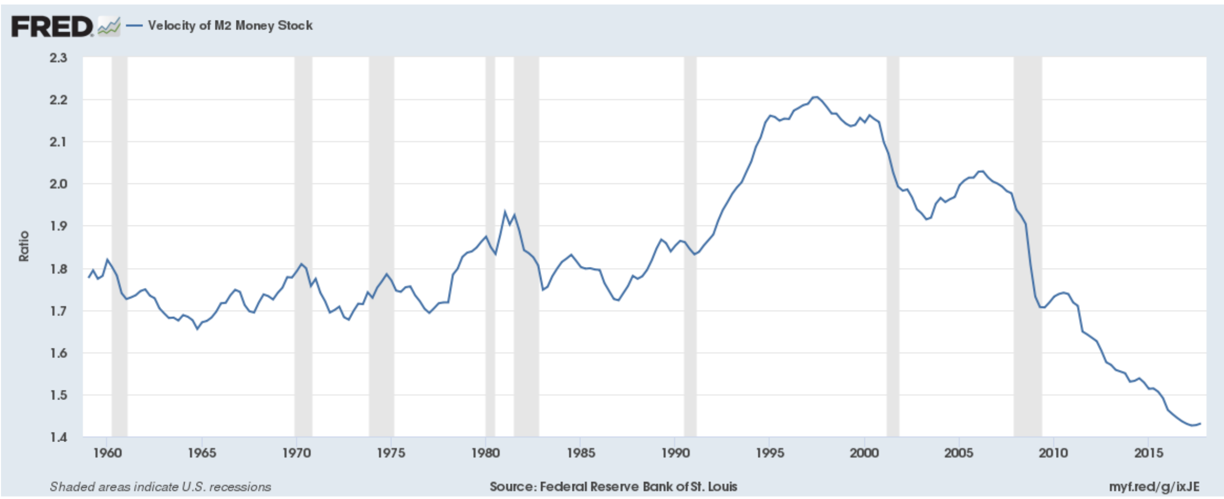


Being Dutch myself I would also like to refer to the actions of Jelle Zijlstra who was a renowned Dutch economist and one of Holland's finer statesmen and who acted in a similar fashion as the De Gaulle. Zijlstra had all the qualifications for making the right decision. Early in his career in 1948, shortly after World War II, Zijlstra became a professor, specializing in the velocity of money (he would be amazed by todays velocity of money chart of the Fred).

The equation for velocity of money is MV= PT. **M**oney in circulation or M3 times **V**elocity is equal to **P**rice (a combination of real growth + inflation) times the number of **T**ransactions, which is basically equal to **GDP**.



And as we know **M**oney in circulation has risen strongly as a result of the QE programs (see the balance sheet assets of the 6 most important central banks here-above) hence why, assuming relatively stable growth in GDP, the velocity of money has gone down as illustrated by the chart below. $V = \frac{GDP \text{ or } PT}{M3}$. And now the M3 is being reduced we see the velocity of money turning upwards slightly (see chart below).



By 1952 Zijlstra was appointed minister of economic affairs, followed by becoming Dutch treasurer from 1958 to 1963 and again from 1966 to 1967.

During his last term as treasurer he led the Dutch Cabinet as prime minister as well until 1967, after which he became president of De Nederlandsche Bank (DNB). Whilst president of the Dutch central bank he was appointed as the president of the Bank for International Settlements (BIS) as well, positions he held until his resignation in 1981. I think one should especially zoom in on the fact he was also president of the BIS, now one of the main “managers” of the gold price.

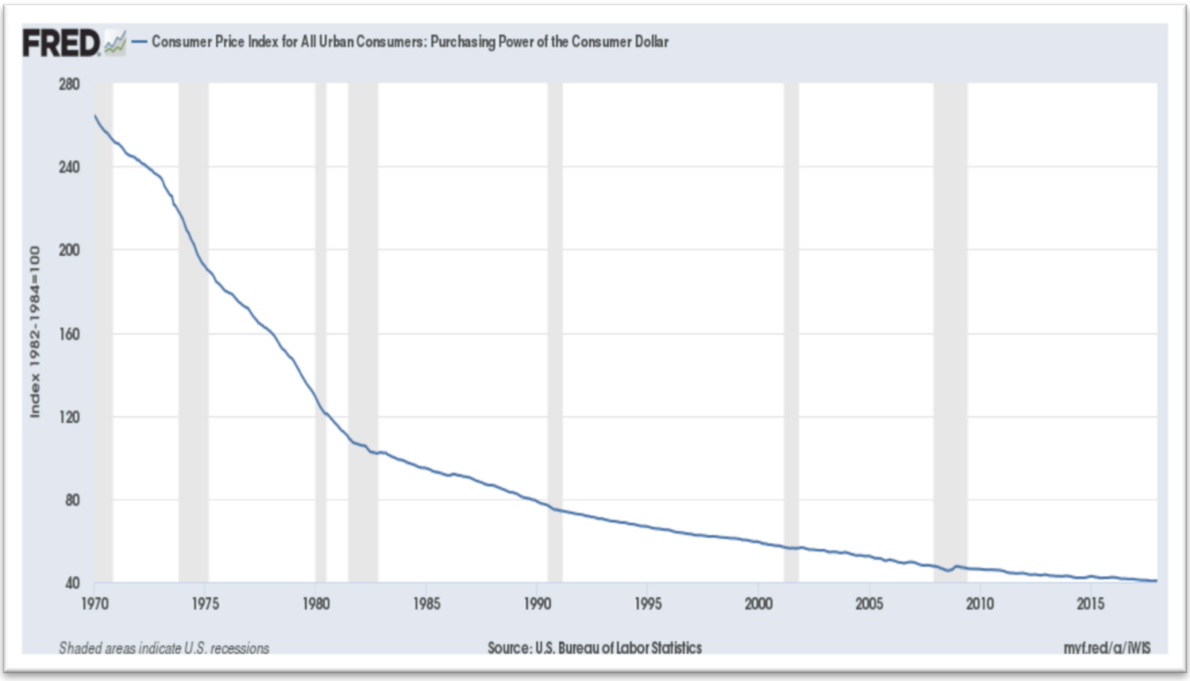
It gets especially interesting when Zijlstra writes about then-U.S. Treasury Undersecretary Paul Volcker and Federal Reserve Board member Dewey Daane of the Richmond Federal Reserve Bank. On the July 7, 1971, Volcker and Daane arrived in Amsterdam to urge the Dutch government not to convert any more of its dollar reserves into gold.

Zijlstra writes in his biography (p. 191): “From the beginning of 1971 we had already converted almost $600 million in return for gold or an asset on an equal footing. ”When Volcker visited Zijlstra as Treasury undersecretary, Volcker said, “You are rocking the boat.” Zijlstra replied: “If the boat is rocking because we present $250 million for conversion into gold or something that can be considered an equal asset (referring to the US Dollar), then the boat *has* already perished.” (P. 191.). Zijlstra refused to heed the U.S. request and converted DNB’s dollar holdings for gold.

And thus finally 1971 came around, the US stock of gold was severely diminished, because of the dollar for gold exchanges to whom only the central banks were entitled, and Nixon had to revoke Bretton Woods by declaring that the US would no longer redeem dollars held by foreign governments, for gold.

The gold window was closed because the US dollar couldn’t keep equal footing with gold as indicated by the reduction in purchasing power. The Dollar Standard was set and the dollar became the essential currency (by lack of the better alternative: gold) required for Central Bank reserves, a situation which prevails till the present time.

See in the chart below what happened to the purchasing power of the US dollar since that moment! From 250 to 40 today an 84% decline! It should be noted here that the average life expectancy for the fiat currency is 27 years and every 30 to 40 years the reigning monetary system fails and has to be retooled.

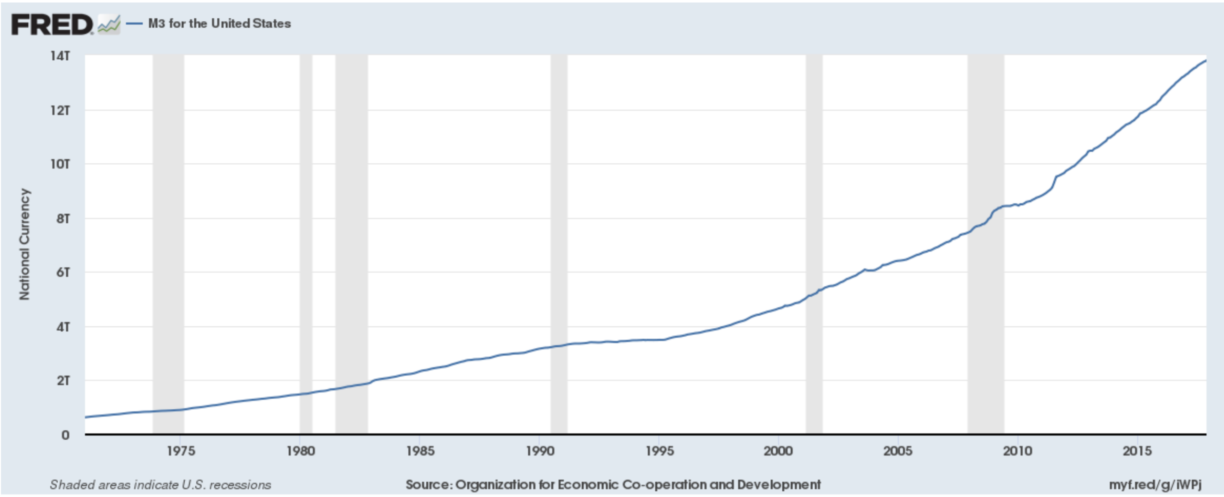


Calculating today's gold price on the basis of the loss of purchasing power in the US dollar and the increase in fiat money or debt for that matter

With the Bretton Woods agreement in 1944, all major industrialized countries adopted the United States dollar as the world's reserve currency backed by gold. All international settlements were in dollars, other currencies were fixed to the dollar and the dollar was pegged to gold at a price of $35/oz., and as mentioned only foreign governments could convert dollar reserves into gold at that price till 1971. And taking into account the de-pegging of the US Dollar vis a vis the US dollar we should calculate how much gold should have revalued since 1971 taking into account the loss of purchasing power in the US dollar and the increase in the amount of money in circulation.

So if we would calculate the gold price on the basis of the devaluation of the US dollar in terms of purchasing power, after all gold is the mirror image of the reserve currency, what the dollar loses gold wins, the gold price now should be 250:40 x $35 = $219/oz. I realize the method I have used is a simple mathematical straight calculation. Though this price of $219/oz. should be corrected for the increase in the money in circulation.

The money in circulation is measured according to the inclusion of the different forms of money. M0 and M1, also called narrow money, normally include coins and notes in circulation and other money equivalents that are easily convertible into cash. M2 includes M1 plus short-term time deposits in banks and 24-hour money market funds. M3 includes M2 plus longer-term time deposits and money market funds with more than 24-hour maturity. The exact definition of these instruments depends in general on the country. In the US the M2 is considered a key economic indicator used to forecast inflation whilst the M3 is M2 plus large and long-term deposits. Though since 2006, the M3 is no longer published by the US central bank. However, there are still estimates produced by various private institutions. I use the M3 calculated by the Fred (Federal Reserve bank of St Louis) for my calculation of the theoretical gold price because in the end it is the conversion of all fiat money for real money i.e. gold that determines the theoretical price of gold. I am aware that I should use the increase of the increase in global M3 though that figure is difficult to find.



Since 1971 the M3 in the US has risen from \$633bn to approx. \$13,800bn in January 2018 equal to a 21.8 multiple. If we would apply that multiple to the \$219 calculated gold price we would arrive at a gold price of \$219 x 21.8 = \$4,774/oz. using only the US money in circulation figures. This is of course as mentioned a simple theoretical calculation or approximation indicating the blatant manipulation that the monetary authorities, especially the Fed and BIS, apply in order to keep the US Dollar Ponzi scheme going.

In this context I would like to refer again to Zijlstra, who as president of the DNB (The Dutch Central Bank) and of the BIS, already in 1971 alluded to the fact that “the boat *has* already perished.” In that context one has to admit that it has been pretty amazing how the cabal has managed to still keep “the boat” sailing despite the 47 years that have expired since then. I will explain later in this article how that game is being played and why I think that March 26 of this year is going to be a very interesting moment for the price of gold. It could actually break the US dollar.

Another way of calculating an estimated value of the current gold price would be to look at the total debt in the world because all money is a debt from the central banks/treasuries. According to the GFMS the total amount of gold is approximately 193,000 tons, or 6.2bn ounces. Global debt is estimated to be approx. $230trn an increase of $80trn (+53%) since 2008. The global debt is about 3 times global GDP of approximately $80 trillion. If we take the global debt number $230trn and divide that by the total number of gold ounces in the world we would arrive at a gold price of $230,000bn: 6.2bn = $37,000/oz. This might look very unlikely now though that was also said about Bit coin, which got to an all-time high of $19,783. Who is going to give his wife Bit coin earrings? Getting the gist? Though I agree though that the block chain technology, which verifies and secures the transactions without the intervention and outrageous fees of the banks, has enormous potential for the future. So far an important issue that needs to be dealt with is the security of the wallets that seem to be hacked regularly. I would like to make one last remark with respect to the crypto currencies. If and when the financial markets won't be upheld any longer and underlying values of real estate and other assets decline steeply a bail in of the banking system cannot be excluded even not in the US. This would make a strong case for people wanting to secure their wealth through crypto currencies and enabling them to access their wealth anywhere in the world. That won't be the case with money deposited in banks! Although I strongly believe that gold and silver will be the preferred asset class to preserve your capital they don't have the transferability, movability, accessibility that the crypto currencies have.

How does the recycling of US dollars work?

Anyway till the moment of truth arrives, which as I mentioned here above I believe is getting very close, the world still revolves around the US dollar, and thus is it essential for the central banks of countries to hold dollar reserves as Salinas Price writes.

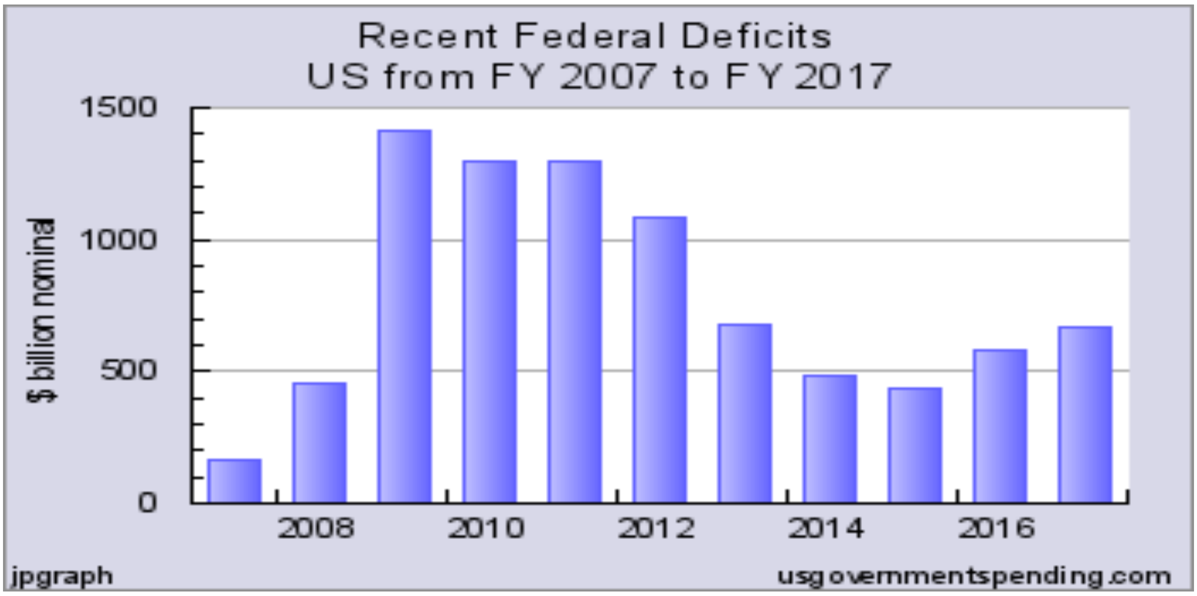
It should be stated that the Petro-Dollar contract was created by Nixon and Kissinger whereby they promised the Saudi to protect them in exchange for pricing oil in US dollars and the Saudi pledge that they would invest their dollar back into US treasuries securing the reserve status of the US dollar. This situation is coming to the end of its life.

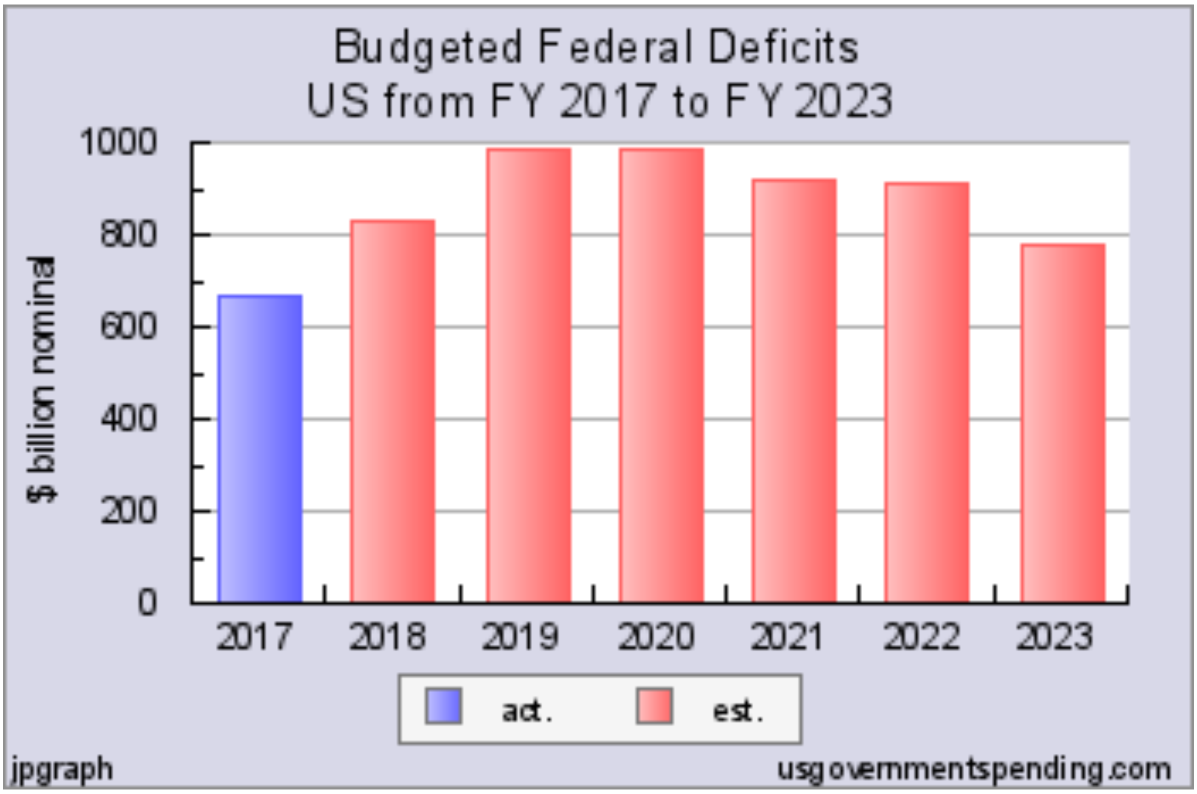
Salinas Price asks, "How can the rest of the world obtain those dollars"? Central banks could buy US dollars with their own currencies though why would they devalue their own currency by selling their currency for dollars? The most common way for the Central Banks of foreign countries to own dollars is by having their companies sell goods and services to the US. And as Salinas writes the only way to sell things to the US, is by underselling US producers i.e. by being so competitive that Americans want the cheaper or better version of the products/services they produce or because they don't produce the goods/services themselves at all.

So the unique privilege of the US, being the issuer of the reserve currency, allows them to print the world's fundamental currency - which allows it to purchase anything in any amount, in any place, at any price – and as Salinas says "produces automatically the fundamental need of foreign countries to undersell US producers to obtain the dollars they need to prop up their economies". By imposing tariffs Trump makes it much more difficult for foreign companies to sell their products into the US. And thus foreign companies will receive less US dollars for their sold goods and services to the US hence why the central banks of those countries will get less US dollars into their forex reserves when the companies sell their US dollars for their local currencies in which currency they have their cost base, to the central bank. Though the consequence of the central banks having fewer US dollars in their forex reserves means that fewer US dollars will be recycled into US Treasuries helping to finance the US budget deficit. After all the US citizens barely safe with a savings rate of only 2.7%. See below the US budget deficits since 2007 and their forecast till 2023.

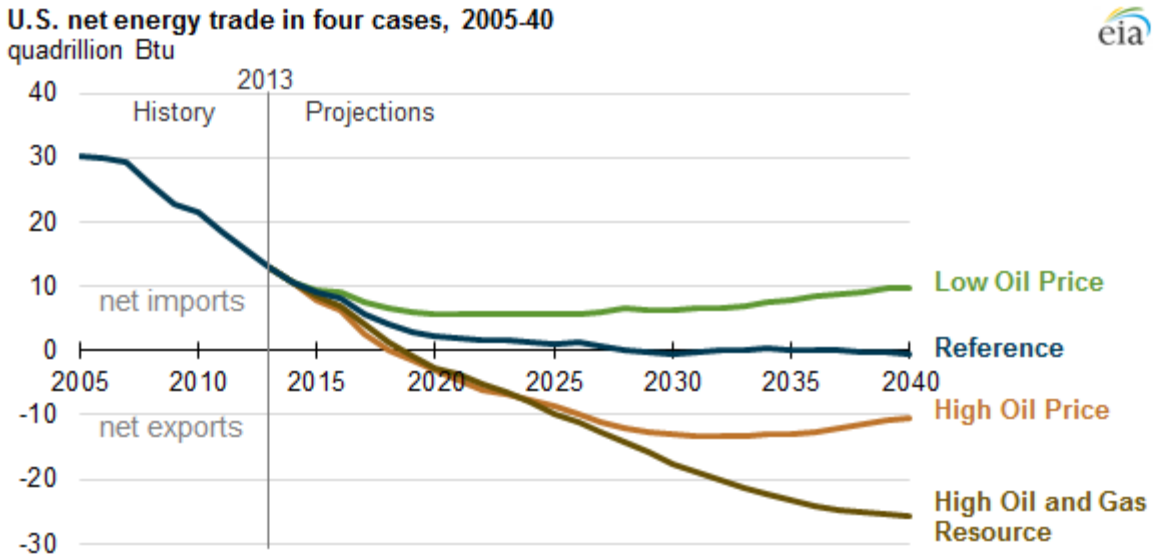
Deficits in billions

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
$161	$458	$1,413	$1,294	$1,295	$1,087	$679	$485	$438	$585	$665





Adding to this reduced flow of export born US dollars in a major way will be the acceptance of the Petro-Yuan-Gold contract by the Saudis. China imported 281.1 million tons of crude in the first eight months of 2017, equivalent to 8.44 million barrels per day (bpd), according to customs data, of which The Kingdom accounted for some 1.03 million bpd in the first eight months or 12% of China's imports. Of the top five sources of U.S. crude oil imports for December 2017 Canada was number one with 3.7 million b/d, Mexico nr 2 with 726,000 b/d, Saudi Arabia nr 3 with 690,000 b/d, Iraq was nr 4 (605,000 b/d), and Venezuela nr 5 (437,000 b/d). And with the US becoming an exporter of oil between 2019 and 2030 depending on the oil and gas prices one could argue that the Saudis want to please their customers and allow payment in Yuan rather then US dollars. Next to that the Saudi have indicated that they would like 5% of Aramco when it has its IPO which listing is now delayed till 2019.



Source: U.S. Energy Information Administration, *Annual Energy Outlook 2015*

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