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The U.S. Moves From A Gold Standard To The Petrol Dollar – What's Next?

Saudi Arabia severs diplomatic ties with the United States – False U.K. Daily Mail headline October 22, 2013

Saudi Arabia made the news earlier this week when Prince Bandar bin Sultan, the Saudi intelligence chief threatened to change the cozy relationship that his country has had with the United States for the past few decades. Saudi Arabia, however, did not sever diplomatic ties as the Daily Mail reported. Prince Bandar apparently is upset with the United States' inaction over Syria and its offer to hold talks with Iran.* On the surface, it may appear that this is an insignificant diplomatic dispute. It's not.

The United States' relationship with Saudi Arabia enables the United State to maintain a high standard of living. Saudi Arabia sells plenty of oil to the United States, but that isn't what makes it one of its most important allies. After all, Saudi Arabia sells oil to a lot of nations. It's the agreements that the United States has with Saudi Arabia and the other countries in the Organization of the Petroleum Exporting Countries (OPEC) that create the international demand for the U.S. dollar and give it the support it needs to retain its status as the world's reserve currency.

Those agreements provide broadly that Saudi Arabia and the other OPEC nations will price their oil in dollars and accept only dollars in payment in exchange for their oil and the U.S. would provide the Saudis military protection and hardware. These agreements, established in the early 1970's, created the "petro dollar" and have engendered consistent global demand for the U.S. dollar and its dollar denominated securities like U.S. Treasuries for the past forty years.

The demand for petro dollars enables the United States to maintain and expand a massive welfare/warfare state as the deficit spending the United States does is financed through the issuing of debt securities, much of it purchased by foreigners. Thus, the dollar is a very important strategic asset to the United States that must be protected by maintaining demand for it and its dollar denominated debt securities.

Now that Saudi Arabia has made public the nature of its dispute with the United States, it perhaps makes sense why the President of the United States and Congress were pushing for immediate military action against Syria last month even though there was overwhelming public opposition to military action against Syria and there didn't appear that any vital United States interest was threatened -unless one considers what is in Saudi Arabia's interest is also in the United States' interest; i.e. keeping Saudi Arabia happy in order to maintain the petro dollar agreement.

Why is the Dollar the World's Reserve Currency?

In 1944, as World War II drew to a close, delegates from forty-four countries met at the Mount Washington Hotel in Bretton Woods, New Hampshire to hash out a new international monetary system. The United States was the dominant military and economic power at the time and held most of the world's gold, so the U.S. dollar was selected to be the world's reserve currency. According to the Bretton Woods agreement the dollar could be redeemed by other countries' central banks for gold from the United States Treasury upon request. This "gold standard" coupled with the United States' preeminent military and economic position, gave the world confidence that the dollar was as good as gold. Click here for a short monetary history from Bretton Woods to the present day.

The Mount Washington Hotel, Bretton Woods New Hampshire

The Bretton Woods agreement worked for awhile but began to show weakness in the 1960's as it became apparent to many countries that the United States was spending far in excess of its gold reserves. Many countries, notable France and Switzerland became increasingly concerned and upped their gold redemption requests. These increased requests were rapidly depleting the United States' gold reserves.

The Nixon Shock – Nixon Ends the Bretton Woods Agreement and Closes the Gold Window

On August 15, 1971, President Richard Nixon in a nationally televised speech unilaterally and without warning ripped up the Bretton Woods agreement. In his address, Mr. Nixon announced that he was "temporarily" suspending the convertibility of the dollar into gold. That temporary suspension is still in effect. Nixon justified his action as necessary to protect the dollar against nameless "international speculators" who held the dollar "hostage" and to help the United States worker.

Mr. Nixon also attempted to dispell the "bugaboo" that taking the U.S. dollar off the gold standard would result in a devalued dollar by assuring the nation that "your dollar will buy just as much tomorrow as it does today." That may have been technically correct, but it was not true that a dollar on August 15,1971 would buy as much as it did on that day as it would on August 15, 1973 or August 8, 1974, the day Nixon resigned, or on August 15, 1979, as inflation raged throughout the 1970's.

Richard Nixon, having just unilaterally breached the Bretton woods agreement, also attempted to assure the international banking community that the United States could be trusted. In a pre cursor variation of his Watergate scandal era "I am not a crook" statement, Richard Nixon said "I give this assurance…The United States will always be a trustworthy trading partner." U.S. Treasury Secretary, under Nixon, John Connally told his G-10 counterparts later in 1971: "It's our currency and your problem". Trustworthy indeed!

Why The United States Needs to Maintain the Dollar as The World's Reserve Currency

Having the world's reserve currency allows the United States to continue to spend far in excess of its tax revenues without experiencing hyperinflation as it can export its inflation by spreading the dollars across the globe while maintaining their demand.

In the past few years some countries notably Iran, Russia, China and Brazil have made efforts to reduce their need to hold dollars for settling their international trade accounts.

Among these countries, China has made the largest moves. Prompted in part by the recent U.S. debt ceiling debate and what it perceives as dysfunctional monetary and fiscal policies China's state run media called to de americanize the international financial system and has made recently large non dollar deals with the European Central Bank and Singapore and has massively increased its gold reserves. China is taking these steps to diversify its assets away from the U.S. dollar while buttressing support for its own currency to be used in international trade instead of the dollar.

The United States is so deep in debt it can't fund its annual deficit spending or its unfunded social security and medicare expenses via taxation so it has relied on foreign borrowing and the Federal Reserve's quantitative easing (QE) bond buying program to help fund them. Foreign holdings of U.S. Treasuries remain at near record levels but new purchases are slowing.

Indeed, without continued and increased borrowing, the United States is in no better position to meet its unfunded liabilities than is Detroit- except for one difference – its ability, in the words of the Maestro Alan Greenspan, to print money to pay any debt.

"The United States can pay any debt it has because it can always print money to do that." said former Federal Reserve Chairman Alan Greenspan responding to a question as to whether United States Treasuries were safe to invest in.

If, however, the United States dollar loses its status as the world's reserve currency, the ability to print money to pay any debt won't matter so much. Holders of dollars would dump them in exchange for other currencies like the Chinese Renminbi or other assets like gold and silver and the demand for U.S. Treasury securities and U.S. dollars would fall dramatically. The slack in demand would almost certainly be filled increasingly from the Fed's QE purchases made by printing dollars out of thin air.

In this scenario, hyperinflation and a drop in the standard of living of Americans would almost certainly occur and the value of hard assets and commodities would skyrocket.