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## *Introduction*

**O**ne dark November day, people in the Netherlands turned on their TVs to watch something few thought they'd ever see: The mighty dollar was collapsing before their eyes.

The currency's sudden demise begins at 1:00 A.M. Greenwich mean time (GMT), when a trader at a large Singapore bank receives a big order to sell dollars. Rumors spread quickly that the request came from a giant hedge fund that needs to unload its dollar-denominated assets at any cost. Central banks in Japan, South Korea, and China—all big-dollar holders—start buying more dollars to steady the greenback's decline. But by now panic has set in, and the central banks' dollar purchases are overwhelmed by private investors, traders, and speculators who are scrambling to sell dollars as fast as they can.

The dollar is sinking rapidly when trading opens in Europe. The region's bond markets have frozen up and its stock markets all plunge more than 10 percent in a few scary minutes. Even before the European Central Bank (ECB) announces that it will provide emergency loans to commercial banks, the ECB's phone lines are jammed with desperate calls. Traders report that the

dollar's unforeseen collapse has put countless hedge funds out of business. A Dutch news anchor reports winding lines at ATMs in Amsterdam, where crowds turn hostile after finding the machines empty. The city's foreign exchange kiosks shut their doors. At 1:00 P.M. GMT, a mere twelve hours after the crisis started with that big trade in Singapore, Banca di Torino becomes the first European bank to go under.

Then trading begins in the United States. The dollar keeps falling. A dispute breaks out between America's Federal Reserve and the European Central Bank over how best to respond. The ECB wants to enforce a new fixed exchange rate between the euro and the dollar, but the Fed balks. It decides instead to freeze all trans-Atlantic financial transactions. The United Kingdom sides with Washington, threatening to quit the European Union unless the ECB backs down. But the oil producing nations of OPEC ally with Europe, announcing that crude oil prices will now be priced in euros instead of dollars. Back in Amsterdam, at the end of this dizzying day, a man calls for a taxi to take him to a train station. With both the dollar and the euro in flux, he pays the driver with three packs of Marlboro cigarettes.

This scenario, of course, did not happen in the real world. But it did play out on a Dutch television network in 2005. Reminiscent of Orson Welles's famous *War of the Worlds* radio hoax, many viewers who tuned in mid-program and saw real-life news anchors reporting the dollar's meltdown believed the fictional account to be terrifyingly real. Some even raced to withdraw cash from their ATMs before it was too late. "We wanted to show that the world is a more dangerous place financially

than most people realize,” Maarten Schinkel, a Dutch economics newspaper reporter who wrote the script for this film, told me. “What people don’t understand is how much the world is still dependent on the dollar.”

Financial Armageddon, if it ever comes, probably won’t unfold as quickly or dramatically as Schinkel depicts. But he’s right that the dollar’s presence has become so ubiquitous in our world that it is like water to a fish. It’s around us every day, and we take for granted that it always will be. Few of us ever pause to consider how powerful a force the dollar is in the world today and the degree to which it drives both America’s and the globe’s prosperity. Likewise, few reflect on the possibility that the dollar’s privileged status might one day end. And what that would mean for us all.

This book aims to shed a bit of light on these issues with a scenic tour of the dollar through the global economy. It examines the greenback’s allure, its history, its many functions, and its role as a catalyst for globalization. These pages also assert that the dollar’s emergence as the world’s main currency is driving two of the defining trends in the world economy today.

The first development is unambiguously positive: The dollar’s universal acceptance has been an essential force behind the world’s powerful economic expansion. This has swollen the ranks of the middle class and lifted many others from poverty. But the flipside has been cause for concern: Enduring demand for the dollar has also encouraged the United States to run up enormous—some would say unsustainable—foreign debts and record trade deficits. The United States now pays out hundreds of millions of dollars each day just in interest payments

on that foreign debt. Washington's ability to assuage international borrowers, who are becoming increasingly fearful these debts and deficits are running out of control, may well determine how long the dollar can continue to enjoy its special status. And as we will see, loss of that status would have serious consequences for Americans and the rest of the world alike.

To understand why any change in the dollar's global role would have such a far-reaching effect, it helps to appreciate how almighty the buck really is. Even by the standards of a military and economic superpower, the dollar's supremacy has been remarkable. While the U.S. economy accounts for about 30 percent of global gross domestic product and American companies compose nearly 50 percent of the world stock market capitalization, the dollar's dominance is greater still. It figures in nearly 90 percent of all trades in the more than \$3.2-trillion-a-day foreign exchange market. Nearly two-thirds of the world's central bank reserves are held in dollars.

In the post World War II era, the dollar has become the primary unit of international trade and finance. Emerging market nations borrow in it. China pegs its currency to it to ensure stability. All major commodities, from oil to soybeans, are priced in dollars. The dollar is truly the world's currency in that of the \$760 billion in circulation, about two-thirds are held abroad. Foreigners collect and spend these dollars even though, since the United States abandoned the gold standard in 1971, they are now backed by nothing more than faith in America.

"The dollar is the greatest monetary achievement in the history of the world," says James Grant, a financial

historian and publisher of *Grant's Interest Rate Observer*. "It is a paper claim of no inherent value that is accepted on its face in every corner of the earth. There is nothing behind it but the idea of America."

So inescapable is the dollar's reach that even the nation's historic adversaries have embraced it. Julia Kiraly, an economic consultant I met at Café Gerbeaud in Budapest, recalls that during the Cold War, Hungarians were allowed a trip abroad every three years. Her priority during each visit to western Europe in the 1970s and 1980s was to bring back as many dollars as she could hide in her apartment. Even when the Cold War ended and she was living in Belgium in the mid-1990s, Kiraly would continue to convert her Belgian franc paychecks into dollars. "I knew it didn't make any sense," she said, explaining that all her expenses were in the Belgian currency. "But I am from the generation where we weren't comfortable unless we had a big deposit in U.S. dollars."

In the other capitals of the Eastern bloc, a sort of "dollar apartheid" flourished in the early 1990s, as demand for the currency pushed it out from the shadows of the black markets. A visitor to Moscow in the middle of that decade would find that rubles were fine for buying toilet paper at the corner store or purchasing a ticket for the metro. But the prices at the city's nouvelle French restaurants and the cover charge at trendy nightspots were settled in dollars. And while Saddam Hussein, in an act of rebellion against the United States, used to insist on being paid in euros for Iraqi oil, his captors found in his possession \$750,000, all in neat stacks of one hundred dollar bills. There was not a euro among them.

Anti-American protesters might torch the Stars and

Stripes or throw a brick through the window of a local McDonald's, but when was the last time you saw footage of anyone burning that cotton-and-linen rectangle bearing the visage of Benjamin Franklin? Forget Coca-Cola, Microsoft, Toyota, Manchester United, the Christian cross, or the Islamic scimitar—the most powerful, most well-recognized, and most widely used and distributed symbol on earth is arguably \$.

Yet, at the start of the new millennium, it is hard to mistake signs that the dollar's unrivaled supremacy is in the early stages of inevitable decline. The first sign is the birth of the euro in 1999, now the currency of sixteen European nations—more than 325 million people—and soon perhaps several more. “For the first time there is the prospect of another currency to rival the dollar,” says Barry Eichengreen, an international economist at the University of California, Berkeley, who has written extensively on currencies. “The euro has permanently changed the international financial landscape. The question is how quickly the transition will go.”

By most accounts, any transition will be gradual. Global markets and central banks don't readily switch reserve currencies. The pound sterling remained the world standard for some forty years after the United States had eclipsed Britain as the world's economic superpower. Moreover, few see the dollar being completely knocked off the mountaintop—at least by the euro, and not for a while. Rather, economists see the euro, and eventually the Chinese yuan, playing increasingly important roles in the global economy, chipping away at the dollar's dominance.

Some of this is already under way. Central banks from Moscow to Riyadh have diversified their reserves

to include more euros. While this shift in part may reflect concern over a dollar bear market that started around 2002 and has wiped away more than half of the dollar's value against the euro, the rise of a viable alternative currency suggests central banks will store a portion of their reserves in euros on a permanent basis. Washington can slow this transition by cutting deficits and enacting measures to encourage private savings, steps that would likely help the dollar rally and raise its value. But U.S. policymakers cannot change the broader dynamics that lead central banks to diversify their holdings.

The financial crisis of 1997 and 1998 also marked a shift. Following a depletion of their dollar reserves, most Asian and Latin American countries stopped pegging their currencies to the dollar, allowing their currencies instead to float more freely. As governments also whipped their economies into shape, paying down their debt and building up their reserves, they found that they could borrow money through the international markets in their own currencies. Global investors no longer insist that these bond transactions be sold in dollars.

The growing sophistication of financial systems could diminish the dollar's central role in foreign exchange trading, too. One reason the dollar figures in 90 percent of all activity is because it serves as a go-between when transactions are made between more thinly traded currencies, say the Colombian peso for the Thai baht. But superior technology is expected one day to allow these currencies to swap directly, rather than into dollars first, thus further eroding at the margins the dollar's central role in global finance.

For now, however, the dollar remains the name of

the game in currency trading. So we'll start the dollar tour in America's financial capital, New York City, at the midtown Manhattan office of hedge fund managers FX Concepts. The firm is among the most active currency speculators in the world, turning over as much as \$3 billion a day in currency trades. In Chapter 1, you'll meet John Taylor, the sixty-four-year-old cofounder of FX Concepts and a pioneer in the field of foreign exchange trading. Taylor offers a ringside seat at the frenetic world of currency trading, where the dollar's value is determined each day and individual fortunes can be made or lost. You'll witness the ways big hedge fund traders decide whether to bet on the dollar's rise or its fall and how a small number of people have come to have such a disproportionate effect on your currency's value.

In Chapter 2, we'll travel to the Bureau of Engraving and Printing (BEP) in Washington, D.C., where this arm of the U.S. Treasury Department cranks out 9 billion currency notes annually. The BEP is also in the advanced stages of its most important project: the newly designed \$100 bill. Planned for a 2008 release, the new hundred is said to use the most sophisticated anti-counterfeit technology ever seen. It had better. The new bills must not only frustrate the growing army of at-home counterfeiters, with their powerful PCs and high-resolution color printers, they must foil the shadowy counterfeiters behind the extraordinary Supernotes—fakes so realistic they fool even most experts and have already undermined the dollar's acceptance in certain corners of the globe. Larry Felix, the new head of the BEP, takes you behind locked doors to show you how ink and paper merge to become dollars and to offer you a glimpse at

what the government has planned to derail the funny money makers.

Chapter 3 takes us back in time to trace the rise of the dollar from its humble beginnings during the Civil War to its role as nexus of the global economy and as one of America's most potent symbols of power and influence. Along the way, you'll be introduced to Paul Warburg, the German-born banker most responsible for overcoming America's historic prejudice against central banks. He devised the Federal Reserve system, which proved to be the final piece in the puzzle for making the dollar an international currency. You'll also meet Paul Volcker, a towering figure of six foot seven who as Treasury undersecretary helped prod the United States to end the gold standard, releasing the dollar from a leash that had kept both U.S. and world economic growth from reaching their full potential. Years later, as Fed chairman, Volcker's series of interest rate increases would send the United States into recession to save the dollar's privileged status. That rescue would help set the stage for even greater economic growth in the final years of the twentieth century.

Next up, in Chapter 4, we visit South America, arriving at the poor, divided nation of Ecuador. Improbable as it may seem, it is here that one of the grand financial experiments of our time is unfolding. In 2000, after suffering years of massive devaluations and spiraling inflation, Ecuador scrapped its own currency, the sucre, for the U.S. dollar. Unlike other countries that peg their currencies directly to the dollar, or even countries that use the dollar alongside their own currency, Ecuador took a more drastic step. It eliminated the sucre

entirely, throwing its lot in with the dollar in a desperate Hail Mary attempt to solve Ecuador's recurring economic problems. In this brave new world of dollarization, even the U.S. government was powerless to stop it. You'll hear from the country's winners, losers, and those who still aren't sure to which camp they belong: the central banker, the energy minister, middle-class yuppies, a Kia car dealer, a floral exporter, gardeners, a retired pensioner, housewives, and a college dean, among others. Together, they paint a complex portrait of the unique opportunities and unforeseen traps that await a nation that has sacrificed its currency to that of the world's lone superpower.

From Latin America, we'll travel to Asia in Chapter 5 for a stop at the corridors of financial power in Seoul, South Korea. The country's massive build-up of dollar reserves in recent years has had an unexpected side-effect: Investor fears that the Koreans might one day sell down their dollar holdings has changed the nature of the relationship between South Korea and the United States. In today's interconnected global economy, the value of America's currency sits, to some degree, with people like Heung-Sik Choo, a mild-mannered official at South Korea's central bank. His decisions, along with those of his counterpart Keehong Rhee at a special government fund set up to manage the country's reserves more aggressively, have the potential to rock the dollar. You'll learn a bit more about their current thinking and the investment process embraced by Asian central banks with big-dollar holdings that increasingly hold the fate of the dollar in their hands.

The dollar tour ends back in the American heartland,

St. Louis, Missouri, for Chapter 6. That's where Chuck Butler, president of EverBank, is sowing a radical idea among millions of his countrymen: The dollar is not the only game in town anymore. He spends his days warning people to protect themselves from its inevitable decline. His solution is a foreign-currency savings account or certificate of deposit from EverBank. Butler argues that the yawning U.S. deficits and bloated foreign debt levels will eventually force the dollar's value much lower. We'll look at how the end of the gold standard that freed the dollar to fuel the world's economic expansion also gave rise to these debts and deficits that have thrown the global economy into imbalance. That's raised the prospect that too many dollars may be circulating the planet and could be setting the greenback up for a big fall. With the equivalent of about \$1 billion in EverBank's foreign-currency products, Butler is testimony that many middle-class people in the United States share some of his concern.

And well they should. Americans probably won't realize how good they had it under the dollar's reign until the day that reign is over. French president Charles de Gaulle once complained bitterly that the dollar's central role accorded the United States an "exorbitant privilege." Those hundreds of billions of dollars held abroad represent an interest-free loan to the U.S. government. America faces no foreign exchange costs when buying commodities as long as they are priced in dollars. Its businesses face little currency risk abroad because most of their transactions are also conducted in dollars.

"No other country in the world can run deficits as large as we have without having to tighten fiscal and

monetary policy,” says Benjamin Cohen, professor of international political economy at the University of California, Santa Barbara. Even average Americans enjoy this “exorbitant privilege” through lower interest rates on home and car loans that are made possible by the low interest rates the dollar can enjoy while still attracting foreign capital.

For how much longer, though? Whatever happens next, the dollar’s grip on the world appears to be slowly loosening. You can see it for yourself. Russian law now prohibits restaurants, clubs, or merchants from listing their prices in dollars. I found in Hungary that store owners can tell you right away how much something costs in euros, but many are unaware these days of even the dollar exchange rate. Black market money-changers in Seoul say people now request Chinese yuan as often as they do dollars.

People abroad may consider that a welcome change after so many years under the dollar’s thumb. But foreigners won’t get off scot-free in the event of the dollar’s demise, either. The world benefits from the use of one main currency—whether it is the dollar or another—because cross-border investment and trade costs fall when participants don’t have to convert currencies repeatedly. An evolution to a euro bloc, a dollar bloc, and an Asian currency bloc, as some predict, may appeal to the world’s sense of fairness. But it’s likely to hurt everyone’s wallet.

To my surprise, even Schinkel, the Dutch economics journalist, told me he never meant his film as a rallying cry for an end to the dollar standard. Rather, he insisted, it was meant to raise awareness about the complexity of the

world financial system that has evolved under the dollar and, more important, to prod the United States to behave more fiscally responsible so that the currency wouldn't succumb to panic. "The system is good right now," he summed up. "It functions well. We would not be better off without the dollar."

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### *Paperback Introduction*

The e-mail emitted an innocent "ping" as it surfaced in my in-box early one September morning. But that innocuous sound was more like an air-raid siren, urging everyone to take cover. For it warned of a financial catastrophe about to hit.

Mind you, the state of the markets at that moment already looked as dire as anyone could remember. In recent days, the federal government had seized control of the mortgage giants Fannie Mae and Freddie Mac, sticking the American taxpayer with billions of dollars in losses from bad home loans. Lehman Brothers, the 158-year-old brokerage firm, had gone out of business. Then, Washington was back, rushing to rescue American International Group (AIG) with a pledge to lend the crippled insurer \$85 billion. The stock market was plunging regularly, wiping away trillions of dollars in investor wealth. Even more frightening, the credit markets had seized up, meaning that financial firms were afraid to lend to one another, or much to anyone else. When that happens, an economy can hardly breathe.

And yet this e-mail, sent by a well-regarded financial

analyst and author, predicted something even worse. “This is The Dollar Crisis,” read the subject line. The note itself was brief. It suggested that the distressing chain of events would claim as its final scalp America’s greatest source and its most obvious symbol of economic might: the dollar’s unrivaled dominance as the world’s primary currency.

Sure enough, hours after his missive arrived, the dollar was under attack in the foreign exchange market. With America’s record foreign debt growing ever higher under the heavy burden of new government action, there was little wonder currency traders were concerned. Overseas investors held dollar-denominated securities of nearly \$10 trillion. That meant our currency’s fate was now in someone else’s hands. If too many overseas dollar-holders wanted to dump the currency at once, we would indeed be staring at a dollar crisis.

As the paperback edition of this book went to press, things had hardly improved for the U.S. economy. American capitalism, it seemed, was being stretched to the breaking point. The financial crisis looked far from over, even after the government approved a \$700 billion bailout plan and pledged equity injections into the major banks still standing. AIG required more government aid to stay afloat. A recession was a near certainty. All this made the world more distrustful of the dollar than at any other time since it became the world’s primary currency in 1944, following the Bretton Woods agreement.

Yet two weeks after that foreboding e-mail circulated, the buck had reversed course and began one of its most powerful rallies in years. Suddenly, the dollar was trading at a one-year high against the euro and a basket of other major currencies.

What happened?

For one, world currency traders still looked to U.S. Treasury bonds as a safe haven during periods of crisis (even, apparently, one of America's own making). Despite the many problems here, the rest of the world didn't look so great, either. With property prices falling in Asia, banks collapsing in Europe, and weaker commodity prices weighing on Latin American exporters, the recession was likely to be global. Traders piled into the dollar not for love of the greenback but for a lack of attractive alternatives.

But the buck's rally in the foreign exchange market was only a small part of the story. As this book asserts, the dollar's role in powering the global economy is like nothing else in financial history. Dollar doomsayers were reminded yet again that shaking the U.S. currency loose from its role as the nexus for financial markets and international trade would be a tremendous undertaking. It would require a vast reworking of the global financial system that has been established over decades, one that few parties seem prepared to confront. Perhaps even less so during a financial crisis.

It should come as no surprise, therefore, that press reports in early 2008 said that the United States, Europe, and Japan set up an emergency plan to rescue the dollar in case it went into a free fall. While such a plan was not put into use—or even officially acknowledged by any government—it resonated because the major powers would indeed pull out all the stops to prevent a dollar crisis. As the world's main currency for central bank reserves, trade, and finance, the pain from a dollar collapse is in no one's interest.

So engrained is the dollar in commodities trading, to

pick just one prominent example, that the currency prevails even in markets where the United States is only a bit player. More than 80 percent of exports from places like Thailand and Pakistan are invoiced in dollars, even though less than a quarter of their exports go to the United States. Take the case of palm oil. Malaysia and Indonesia account for nearly 90 percent of world production. China is the world's biggest importer. The United States buys less than 3 percent of the global total, making it a smaller customer than Egypt. But when Malaysia's stock and derivatives exchange launched a new palm-oil future contract in 2008, it did so in dollars. "The global trade is still conducted in that currency," said Raghbir Singh Bhart, head of global markets at Bursa Malaysia.

The same holds true in Latin America. Brazil is responsible for about 40 percent of global sugar exports, and almost none of that cane is shipped to the United States. That hasn't stopped Brazilian producers from conducting all their international sugar trade in dollars. "When I sell to my client, they want to pay in dollars," Felipe Vicchiato, executive director for investor relations for Grupo São Martinho, told me. His company sells sugar from Russia to Dubai, and the transactions are always settled in dollars, he said. "We don't have any other option."

Then, there is America's much-maligned \$700 billion dollar bailout. It's too soon to know how effective it will be: whether taxpayer dollars were wasted or, as some predict, the plan will ease the crisis and ultimately make money for the country. But in the end, the United States put aside—however briefly, and after first muffing it—party and ideological differences to find a solution to

the financial crisis. That action stands in stark relief to the recent record of other major economies. Japan had perhaps the world's most dynamic economy in the 1980s, then stood by helplessly as its housing and banking crisis steadily worsened. Its stock market sits at about one-quarter the level of its peak at the end of 1989, while its economy has been in hibernation for nearly two decades. Only too late did Tokyo officials realize the financial sector needed help, and by then the erosion in consumer confidence had ossified.

European leaders, it's true, devised their own individual plans for injecting money into their banking systems. With French president Nicolas Sarkozy speaking grandly of creating a new Bretton Woods agreement for twenty-first-century capitalism, the Europeans even managed to grab some of the global leadership role from the United States. But there is less to this continental coordination than meets the eye. European leaders at first dithered, denying that the crisis was more than a U.S. problem. Once it became clear that the region had its own banking catastrophe, France and Germany argued publicly about the best way to act, while German officials grumbled that any joint action would stick Berlin with the bill. Hardly the sort of pan-European response to bolster the case for the euro as a superior world currency. Finally, European governments didn't so much come together as fall in line behind a rescue plan inspired by Britain—a country that is notable for rejecting the euro as its own currency.

So perhaps one day I'll receive an e-mail warning of a dollar crisis that will hit the mark. But the argument in this book is that the dollar's demise—while probably in-

evitable in our lifetime—won't be so easy to pin down. Rather than collapsing spectacularly like a burning building, the currency's declining influence is more likely to unfold piecemeal, over time, as America's debts and deficits mount and the developing world moves closer to equal footing. The dollar's role may first ebb in the foreign exchange market, then as a reserve currency, and finally as a lubricant for international trade. Instead of being overtaken by a single successor, we might see a number of currencies eat away at the dollar's former monopolistic roles. And one day we'll have to explain to those younger than us that there once was currency that was accepted everywhere without question. It may be hard for them to believe.

—Craig Karmin, New York City, October 2008