Why Peak Oil threatens the International Monetary System

By Erik Townsend

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Introduction

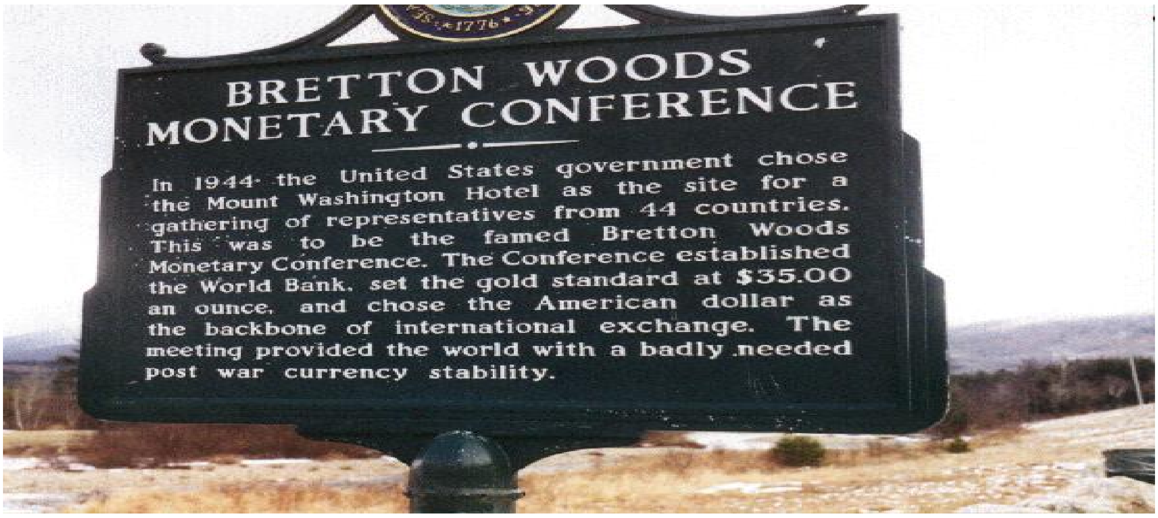
Having spent the last several years of my life engineering investment strategies to profit from the inevitability of Peak Oil, I've become obsessed with understanding the ramifications of radically different energy supply dynamics on the global economy. There are many facets to this, some obvious and some not so obvious. So when ASPO Executive Director Jan Mueller approached me at the end of this year's conference in Dallas and asked for an article discussing the *less* obvious economic impacts of Peak Oil, I knew instantly that the topic should be the threat Peak Oil poses to the International Monetary System (IMS). This connection is critically important, but far from obvious.

I assure you that this story is very much about Peak Oil, but please bear with me, as I'll need to start by reviewing what the IMS is and how it came about in the first place. Then I'll explain the role energy has already played in shaping the present-day IMS, and finally, I'll tie this back to Peak Oil by explaining why rising energy prices could very well be the catalyst that will cause the present system to fail.

What is the International Monetary System?

At the end of World War II, many countries were literally lying in ruin, and needed to be rebuilt. It was clear that international trade would be very important going forward, but how would it work? World leaders recognized the need to architect a new monetary system that would facilitate international trade and allow the world to rebuild itself following the most devastating war in world history.

A global currency was out of the question because the many countries of the world valued their sovereignty, and wanted to continue to issue their own domestic currencies. In order for international trade to flourish, a system was needed to allow trade between dozens of different nations, each with its own currency.



A convention was organized by the United Nations for the purpose of bringing world leaders together to architect this new *International Monetary System*. The meetings were held in July, 1944 at the Mt. Washington Hotel in Bretton Woods, New Hampshire, and were attended by 730 delegates representing all 44 allied nations. The official name for the event was the *United Nations Monetary and Financial Conference*, but it would forever be remembered as *The Bretton Woods Conference*.

To this day, the system designed in those meetings remains the basis for all international trade, and is known as the *Bretton Woods System.* The system has evolved quite a bit since its inception, but its core principles remain the basis for all international trade. I'm going to focus this article on the parts of the system which I believe are now at risk of radical change, with Peak Oil the most likely catalyst to bring about that change. Readers seeking a deeper understanding of the system itself should refer to the *Further Reading* section at the end of this article.

Why is an International Monetary System needed?

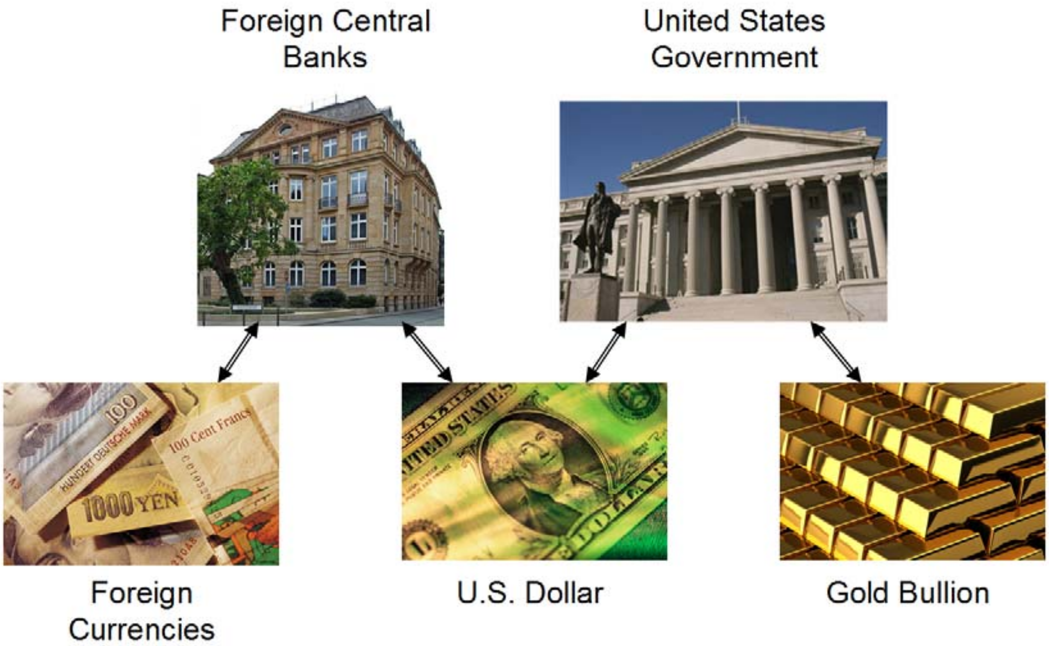
It simply wouldn't be practical for all countries to sell their export products to other countries in their own currencies. If one had to pay for wine from France in French Francs (there was no Euro currency in 1944), and then pay to import a BMW automobile in German Marks, then pay for copper produced in Chile in Pesos, each country would face an overwhelming burden just maintaining reserve deposits of all the various world currencies. The system of trade would be very inefficient. For centuries, this problem has been solved by using a single standard currency for all international trade.

Because a standard-currency system dictates that each nation's central bank will need to maintain a *reserve* supply of the standard currency in order to facilitate international trade, the standard currency is known as the *reserve currency*. At various times in history, the Greek Drachma, the Roman Denari, and the Islamic Dinar have served as de-facto reserve currencies. Prior to World War II, the English *Pound Sterling* was the international reserve currency.

Throughout history, reserve currencies came into and out of use through happenstance. The Bretton Woods conference marked the first time that a global reserve currency was established by formal treaty between cooperating nations. The currency chosen was, of course, the U.S. Dollar.

How does the IMS work?

The core of the system was the U.S. Dollar serving as the standard currency for international trade. To assure other nations of the dollar's value, the U.S. Treasury would guarantee that other nations could convert their U.S. dollars into gold bullion at a fixed exchange rate of $35/oz. Other nations would then "peg" their currencies to the U.S. dollar at a fixed rate of exchange. Each nation's central bank would be responsible for "defending" the official exchange rate to the U.S. dollar by offering to buy or sell any amount of currency bid or offered at that price. This meant each nation would need to keep a healthy *reserve* of U.S. dollars on hand to service the needs of domestic businesses wishing to convert money between the local currency and the U.S. dollar.



By design, the effect of the system was that each national currency was indirectly redeemable for gold. This was true because each nation's central bank guaranteed convertibility of its own currency to U.S. dollars at some fixed rate of exchange, and the U.S. Treasury guaranteed convertibility of U.S. dollars to gold at a fixed rate of $35/oz. So long as all of the governments involved kept their promises, each nation's domestic currency would be as good as gold, because it was ultimately convertible to gold. United States President Richard Nixon would break the most central promise of the entire system (U.S. dollar convertibility for gold) on August 15, 1971. I'll come back to that event later in this article.

Triffin's Dilemma

In 1959, three years after M. King Hubbert's now-famous Peak Oil predictions, economist Robert Triffin would make equally prescient predictions about the sustainability of the "new" IMS, which was then only 15 years old. Sadly, Triffin's predictions, like Hubbert's, would be ignored by the mainstream.

The whole reason for choosing the U.S. dollar as the global reserve currency was that without a doubt, the U.S. was the world's strongest credit in 1944. To assure confidence in the system, the strongest, most creditworthy currency on earth was chosen to serve as the standard unit of account for global trade. To eliminate any question about the value of the dollar, the system was designed so that any international holder of U.S. dollars could convert those dollars to gold bullion at a pre-determined fixed rate of exchange. Dollars were literally as good as gold.

Robert Triffin

Making the USD the world's reserve currency created an enormous international demand for more dollars to meet each nation's need to hold a reserve of dollars. The USA was happy to oblige by printing up more greenbacks. This provided sufficient dollars for other nations to hold as foreign exchange reserves, while at the same time allowing the U.S. to spend beyond its means without facing the same repercussions that would occur were it not the world's reserve currency issuer.

Triffin observed that if you choose a currency because it's a strong credit, and then give the issuing nation a financial incentive to borrow and print money recklessly without penalty, eventually that currency won't be the strongest credit any more! This paradox came to be known as *Triffin's Dilemma.*

Specifically, Triffin predicted that as issuer of the international reserve currency, the USA would be prone to overconsumption, over-indebtedness, and tend toward military adventurism. Unfortunately, the U.S. Government would prove Triffin right on all three counts.

Triffin correctly predicted that the USA would eventually be forced off the gold standard. The international demand for U.S. dollars would allow the USA to create more dollars than it otherwise could have without bringing on domestic inflation. When a country creates too much of its own currency and that money stays in the country, supply-demand dynamics kick in and too much money chasing too few goods and services results in higher prices. But when a country can export its currency to other nations who have an artificial need to hold large amounts of that currency in reserve, the issuing country can create far more money than it otherwise could have, without causing a tidal wave of domestic inflation.

Nixon proves Triffin right

By 1970, the U.S. had drastically over-spent on the Vietnam War, and the number of dollars in circulation far outnumbered the amount of gold actually backing them. Other nations recognized that there wasn't enough gold in Fort Knox for the U.S. to back all the dollars in circulation, and wisely began to exchange their excess USDs for gold. Before long, something akin to a run on the bullion bank had begun, and it became clear that the USA could not honor the $35 conversion price indefinitely.

On August 15, 1971, President Nixon did exactly what Triffin predicted more than a decade earlier: he declared *force majeure*, and defaulted unilaterally on the USA's promise to honor gold conversion at $35/oz, as prescribed by the Bretton Woods accord.

Of course Nixon was not about to admit that the reason this was happening was that the U.S. Government had abused its status as reserve currency issuer and recklessly spent beyond its means. Instead, he blamed "speculators", and announced that the United States would *suspend temporarily* the convertibility of the Dollar into gold. Forty-two years later, the word *temporarily* has taken on new meaning.

Exorbitant Privilege

With the whole world conducting international trade in U.S. dollars, nations with large export markets wound up with a big pile of U.S. dollars (payments for the goods they exported). The most obvious course of action for the foreign companies who received all those dollars as payment for their exported products would be to exchange the dollars on the international market, converting them into their own domestic currencies. What may not be obvious at first glance is that there would be catastrophic unintended consequences if they actually did that.

If all the manufacturing companies in Japan or China converted their dollar revenues back into local currency, the act of selling dollars and buying their domestic currencies would cause their own currencies to appreciate markedly against the dollar. The same holds true for oil exporting countries. If they converted all their dollar revenues back into their own currencies, doing so would make their currencies more expensive against the dollar. That would make their exports less attractive because, being priced in dollars, they would fetch lower and lower prices after being converted back into the exporting nation's domestic currency.

The solution for the exporting nations was for their central banks to allow commercial exporters to convert their dollars for newly issued domestic currency. The central banks of exporting nations would wind up with a huge surplus of U.S. dollars they needed to invest somewhere *without converting them to another currency*. The obvious place to invest them was into U.S. Government Bonds.

This is the mechanism through which the reserve currency status of the dollar creates artificial demand for U.S. dollar-denominated treasury debt. That artificial demand allows the United States government to borrow money from foreigners in its own currency, something most nations cannot do at all. What's more, this artificial demand for U.S. Treasury debt allows the USA to borrow and spend far more borrowed foreign money than it would otherwise be able to, were it not the world's reserve currency issuer. The reason is that, if not for the artificial need to hold dollar reserves, foreign lenders would be much less inclined to purchase U.S. debt, and would therefore demand much higher interest rates. Similarly, the more that international trade has grown as a result of globalization, the more the United States' exorbitant privilege has grown.

Have you ever wondered why China, Japan, and the oil exporting nations have such enormous U.S. Treasury bond holdings, despite the fact that they hardly pay any interest these days? The reason is definitely *not* because those nations think 1.6% interest on a 10-year unsecured loan to a nation known to have a reckless spending habit is a good investment. It's because they have little other choice. The more their own economies rely on exports priced in dollars, the more they need to keep their own currencies attractively priced relative to the U.S. dollar in order for their exports to remain competitive on the international market. To achieve that outcome, they must hold large reserves denominated in U.S. dollars. That's why China and Japan – major export economies – are the biggest foreign holders of U.S. debt.

The net effect of this system is that the USA gets to borrow money from foreigners at artificially low interest rates. Moreover, the USA can become over-indebted without the usual consequences of increasing borrowing cost and declining creditworthiness. Other nations have little choice but to maintain a large reserve supply of dollars as the international trade currency. But the U.S. has no need to maintain large reserves of other nations' currencies, because those currencies are not used in international trade.


Valery Giscard d'Estaing

By the mid-1960s, this phenomenon became known as *exorbitant privilege*: That phrase refers to the ability of the USA to go into debt virtually for free, denominated in its own currency, when no other nation enjoys such a privilege. The phrase *exorbitant privilege* is often attributed to French President Charles de Gaulle, although it was actually his finance minister, Valery Giscard d'Estaing, who coined the phrase.

What's important to understand here is that the whole reason the U.S. can get away with running trillion-dollar budget deficits without the bond market revolting (a la Greece) is because of exorbitant privilege. And that privilege is a direct consequence of the U.S. dollar serving as the world's reserve currency. If international trade were not conducted in dollars, exporting nations (both manufacturers and oil exporters) would no longer need to hold large reserves of U.S. dollars.

Put another way, when the U.S. dollar loses its reserve currency status, the U.S. will lose its exorbitant privilege of spending beyond its means on easy credit. The U.S. Treasury bond market will most likely crash, and borrowing costs will skyrocket. Those increased borrowing costs will further exacerbate the fiscal deficit. Can you say *self-reinforcing vicious cycle?*

But wait… Wasn't Gold convertibility the whole basis of the system?

If the whole point of the Bretton Woods system was to guarantee that all the currencies of the world were "as good as gold" because they were convertible to U.S. dollars, which in turn were promised to be convertible into gold… And then President Nixon broke that promise in 1971… Wouldn't that suggest that the whole system should have blown up in reaction to Nixon slamming the gold window shut in August of '71?

Actually, it almost did. But miraculously, the system has held together for the last 42 years, despite the fact that the most fundamental promise upon which the system was based no longer holds true. To be sure, the Arabs were not happy about Nixon's action, and they complained loudly at the time, rhetorically asking why they should continue to accept dollars for their oil, if those dollars were not backed by anything, and might just become worthless paper. After all, if U.S. dollars were no longer convertible into gold, what value did they really have to foreigners? The slamming of the gold window by President Nixon in 1971 was not the only cause of the Arab oil embargo, but it was certainly a major influence.

What's holding the IMS together?

Why didn't the rest of the world abandon the dollar as the global reserve currency in reaction to the USA unilaterally reneging on gold convertibility in 1971? In my opinion, the best answer is simply "Because there was no clear alternative". And to be sure, the unmatched power of the U.S. military had a lot to do with eliminating what might otherwise have been attractive alternatives for other nations.

U.S. diplomats made it clear to Arab leaders that they wanted the Arabs to continue pricing their oil in dollars. Not just for U.S. customers, but for the entire world. Indeed, U.S. leaders at the time understood all too well just how much benefit the USA derives from exorbitant privilege, and they weren't about to give it up.

After a few years of tense negotiations including the infamous oil embargo, the so-called petro-dollar business cycle was born. The Arabs would only accept dollars for their oil, and they would re-invest most of their profits in U.S. Treasury debt. In exchange for this concession, they would come under the protectorate of the U.S. military. Some might even go so far as to say that the U.S. government used the infamous Mafia tactic of making the Arabs an "offer they couldn't refuse" – forcing oil producing nations to make financial concessions in exchange for "protection".

With the Arabs now strongly incented to continue pricing the world's most important commodity in U.S. dollars, the Bretton Woods system lived on. No longer constrained by the threat of a run on its bullion reserves, the U.S. kicked its already-entrenched practice of borrowing and spending beyond its means into high gear. For the past 42 years, the entire world has continued to conduct virtually all international trade in Dollars. This has forced China, Japan, and the oil exporting nations to buy and hold an enormous amount of U.S. Treasury debt. Exorbitant privilege is the key economic factor that allows the U.S. to run trillion dollar fiscal deficits without crashing the Treasury bond market. So far.

There’s a limit to how long this can last

But how long can this continue? The U.S. debt-to-GDP ratio now exceeds 100%, and the U.S. has literally doubled its national debt in the last 6 years alone. It stands to reason that eventually, other nations will lose faith in the dollar and start conducting business in some other currency. ***In fact, that’s already started to happen, and it’s perhaps the most important, under-reported economic news story in all of history.***

Some examples… China and Brazil are now conducting international trade in their own currencies, as are Russia and China. Turkey and Iran are trading oil for gold, bypassing the dollar as a reserve currency. In that case, U.S. sanctions are a big part of the reason Iran can’t sell its oil in dollars. But I wonder if President Obama considered the undermining effect on exorbitant privilege when he imposed those sanctions. I fear that the present U.S. government doesn’t understand the importance of the dollar’s reserve currency role nearly as well as our leaders did in the 1970s.

The Biggest Risk We Face is a U.S. Bond and Currency Crisis

To be sure, *Peak Oil* in general represents a monumental risk to humanity because it’s literally impossible to feed all 7+ billion people on the planet without abundant energy to run our farming equipment and distribution infrastructure. But the risks stemming directly from declining energy production are not the most imposing, in my view.

Decline rates will be gradual at first, and it will be possible, even if unpopular, to curtail unnecessary energy consumption and give priority to life-sustaining uses for the available supply of liquid fuels. In my opinion, the greatest risks posed by Peak Oil are the *consequential* risks. These include resource wars between nations, hoarding of scarce resources, and so forth. Chief among these consequential risks is the possibility that the Peak Oil energy crisis will be the catalyst to cause a global financial system meltdown. In my opinion, the USA losing its reserve currency status is likely to be at the heart of such a meltdown.

A good rule of thumb is that if something is unsustainable and cannot continue forever, it will not continue forever. The present incarnation of the IMS, which affords the United States the exorbitant privilege of borrowing a seemingly limitless amount of its own currency from foreigners in order to finance its reckless habit of spending beyond its means with trillion-dollar fiscal deficits, is a perfect example of an unsustainable system that cannot continue forever.

But the bigger the ship, the longer it takes to change course. The IMS is the biggest financial ship in the sea, and miraculously, it has remained afloat for 42 years after the most fundamental justification for its existence (dollar-gold convertibility) was eliminated. How long do we have before the inevitable happens, and what will be the catalyst(s) to bring about fundamental change? Those are the key questions.

In my opinion, the greatest risk to global economic stability is a sovereign debt crisis destroying the value of the world’s reserve currency. In other words, a <u>crash</u> of the U.S. Treasury Bond market. I believe that the loss of reserve currency status is the most likely catalyst to bring about such a crisis.

The fact that the United States' borrowing and spending habits are unsustainable has been a topic of public discussion for decades. Older readers will recall billionaire Ross Perot exclaiming in his deep Texas accent, *"A national debt of* ***five trillion dollars*** *is simply not sustainable!"* during his 1992 Presidential campaign. Mr. Perot was right when he said that 20 years ago, but the national debt has since more than *tripled*. The big crisis has yet to occur. How is this possible? I believe the answer is that because the U.S. dollar is the world's reserve currency and is perceived by institutional investors around the globe to be the world's safest currency, it enjoys a certain degree of immunity derived from widespread complacency.

But that immunity cannot last forever. ***The loss of reserve currency status will be the forcing function that begins a self-reinforcing vicious cycle that brings about a U.S. bond and currency crisis.*** While many analysts have opined that the USA cannot go on borrowing and spending forever, relatively few have made the connection to loss of reserve currency status as the forcing function to bring about a crisis.

We're already seeing small leaks in the ship's hull. China openly promoting the idea that the yuan should be asserted as an alternative global reserve currency would have been unthinkable a decade ago, but is happening today. Major international trade deals (such as China and Brazil) *not* being denominated in U.S. dollars would have been unthinkable a decade ago, but are happening today.

So we're already seeing signs that the dollar's exclusive claim on reserve currency status will be challenged. Remember, when the dollar loses reserve currency status, the U.S. loses exorbitant privilege. The deficit spending party will be over, and interest rates will explode to the upside. But to predict that this will happen right now simply because the system is unsustainable would be unwise. After all, by one important measure the system stopped making sense 42 years ago, but has somehow persisted nonetheless. The key question becomes, *what will be the catalyst or proximal trigger that causes the USD to lose reserve currency status, igniting a U.S. Treasury Bond crisis?*

Elevated Risk

It's critical to understand that the USA is presently in a very precarious fiscal situation. The national debt has more than doubled in the last 10 years, but so far, there don't seem to have been any horrific consequences. Could it be that all this talk about the national debt isn't such a big deal after all?

The critical point to understand is that while the national debt has more than doubled, the U.S. Government's *cost of borrowing* hasn't increased at all. The reason is that interest rates are less than half what they were 10 years ago. Half the interest on twice as much principal equals the same monthly payment, so to speak. This is exactly the same trap that subprime mortgage borrowers fell into. First, money is borrowed at an artificially low interest rate. But eventually, the interest rate increases, and the cost of borrowing skyrockets. The USA is already running an unprecedented and unsustainable $1 trillion+ annual budget deficit. All it would take to <u>double</u> the already unsustainable deficit is for interest rates to rise to their historical norms.

This all comes back to exorbitant privilege. The only reason interest rates are so low is that the Federal Reserve is intentionally suppressing them to unprecedented low levels in an attempt to combat deflation and resuscitate the economy. The only reason the Fed has the ability to do this is that foreign lenders have an artificial need to hold dollar reserves because the USD is the global reserve currency. They would never accept such low interest rates otherwise. Loss of reserve currency status means loss of exorbitant privilege, and that in turn means the Fed would lose control of interest rates. The Fed might respond by printing even more dollars out of thin air to buy treasury bonds, but in absence of reserve currency status, doing that would cause a collapse of the dollar's value against other currencies, making all the imported goods we now depend on unaffordable.

In summary, the U.S. Government has repeated the exact same mistake that got all those subprime mortgage borrowers into so much trouble. They are borrowing more money than they can afford to pay back, depending solely on "teaser rates" that won't last. The U.S. Government's average maturity of outstanding treasury debt is now barely more than 5 years. This is analogous to cash-out refinancing a 30-year fixed mortgage, replacing it with a much higher principal balance in a 3-year ARM that offers an initial teaser rate. At first, you get to borrow way more money for the same monthly payment. But eventually the rate is adjusted, and the borrower is unable to make the higher payments.

The Janszen Scenario

When it comes to evaluating the risk of a U.S. sovereign debt and currency crisis, most mainstream economists dismiss the possibility out of hand, citing the brilliant wisdom that "the authorities would never let such a thing happen". These are the same people who were steadfastly convinced that housing prices would never crash in the United States because they never had before, and that Peak Oil is a myth because the shale gas boom solves everything (provided you don't actually do the math).


Eric Janszen

At the opposite extreme are the bloggers on the Internet whom I refer to as the *Hyperinflation Doom Squad.* Their narrative generally goes something like this: Suddenly, when you least expect it, foreigners will wise up and realize that the U.S. national debt cannot be repaid in real terms, and then there will be a panic that results in a crash of the U.S. Treasury market, hyperinflation of the U.S. dollar, and declaration of martial law. This group almost always cites the hyperinflations of Zimbabwe and Argentina as "proof" of what's going to happen in the USA any day now, but never so much as acknowledges the profound differences in circumstances between the USA and those countries. These folks deserve a little credit for having the right basic idea, but their analysis of what could actually happen simply isn't credible when examined in detail.

Little-known economist Eric Janszen stands out as an exception. Janszen is the only credible macroeconomic analyst I'm aware of who realistically acknowledges just how real and serious the threat of a U.S. sovereign debt crisis truly is. But his analysis of that risk is based on credible, level-headed thinking complemented by solid references to legitimate economic theory such as Triffin's Dilemma. Unlike the Doom Squad, Janszen does not rely on specious comparisons of the USA to small, systemically insignificant countries whose past financial crises have little in common with the situation the USA faces. Instead, Janszen offers refreshingly sound, well constructed arguments. Many of the concepts discussed in this article reflect Janszen's work.

Janszen also happens to be the same guy who coined the phrase *Peak Cheap Oil* back in 2006, drawing an important distinction between the geological phenomenon of Hubbert's Peak and the economic phenomenon which begins well before the actual peak, due to increasing marginal cost of production resulting from ever-increasing extraction technology complexity.

"But there's no sign of inflation…" (Hint: It's coming)

Janszen has put quite a bit of work into modeling what a U.S. bond and currency crisis would look like. He initially called this *KaPoom Theory*, because history shows that brief periods of marked deflation (the 'Ka') usually precede epic inflations (the 'Poom'). He recently renamed this body of work *The Janszen Scenario*. Briefly summarized, Janszen's view is that the U.S. has reached the point where excessive borrowing and fiscal irresponsibility will eventually cause a catastrophic currency and bond crisis. He believes that all that's needed at this point is a *proximal trigger*, or catalyst, to bring about such an outcome. He thinks there are several potential triggers that could bring such a crisis about, and chief among the possibilities is the next Peak Cheap Oil price spike.

How Peak Oil could cause a Bond and Currency Crisis

There are several ways that an oil price spike could trigger a U.S. bond and currency crisis. Energy is an input cost to almost everything else in the economy, so higher oil prices are very inflationary. The Fed would be hard pressed to continue denying the adverse consequences of quantitative easing in a high inflation environment, and that alone could be the spark that leads to higher treasury yields. The resulting higher cost of borrowing to finance the national debt and fiscal deficit would be devastating to the United States.

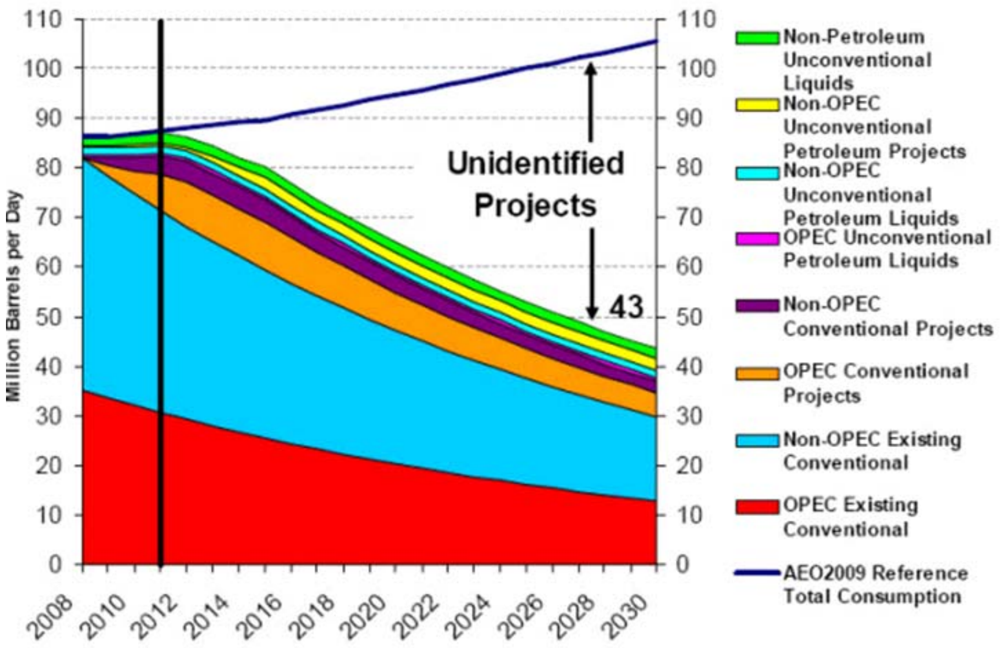
A self-reinforcing vicious cycle could easily begin in reaction to oil price-induced inflation alone. But we must also consider how an oil price shock could lead to loss of USD reserve currency status, and therefore, loss of U.S. exorbitant privilege. In the 1970s, the USA represented 80% of the global oil market. Today we represent 20%, and demand growth is projected to come primarily from emerging economies. In other words, the rationale for oil producers to keep pricing their product in dollars has seriously deteriorated since the '70s. The more the global price of oil goes up, the more the U.S. will source oil from Canadian tar sands and other non-OPEC sources. That means less and less incentive for the OPEC nations to continue pricing their oil in dollars for all their non-U.S. customers.

Iran and Turkey have already begun transacting oil sales in gold rather than dollars. What if the other oil exporting nations wake up one morning and conclude "Hey, why are we selling our oil for dollars that might some day not be worth anything more than the paper they're printed on?" Oil represents a huge percentage of international trade, so if oil stopped trading in dollars, that alone would be reason for most nations to reduce the very large dollar reserves they now hold. They would start selling their U.S. treasury bonds, and that could start the vicious cycle of higher interest rates and exploding borrowing costs for the U.S. Government. The precise details are hard to predict. The point is, the system is already precarious and vulnerable, and an oil price shock could easily detonate the time bomb that's already been ticking away for more than two decades.

What if U.S. Energy Independence claims were true?

There's another angle here. Peak Oil just might be the catalyst to cause the loss of U.S. exorbitant privilege, even without an oil price shock.

Astute students of Peak Oil already know better than to believe the recently-popularized political rhetoric claiming that the USA will soon achieve energy independence, thanks to the shale oil and gas boom. To be sure, the Bakken, Eagle Ford, and various other U.S. oil and gas plays are a big deal. The most optimistic forecasts I've seen show these plays collectively ramping up to as much as 4.8 million barrels per day of production, which is equivalent to about ½ of Saudi Arabia's current production.



But the infamous "wedge of hope" chart from the EIA projects production declines from existing global resources of 60 million barrels per day by 2030. By the most optimistic projections, all the exciting new plays in the U.S. will replace less than 5 million barrels per day. Where the other 55 million barrels per day will come from remains a mystery! And of course the politicians never bother to mention such minor details when they make predictions of energy independence.

But let's just pretend for a moment that hyperbole is reality, and that the USA will achieve energy-independence in just a few years' time. Now consider the consequences to the IMS. The oil-exporting nations would lose the USA as their primary export customer, and would no longer have an incentive to price their oil in dollars, or to maintain large dollar reserves. They would start selling off their U.S. treasury bonds, and pricing their oil in something other than dollars. Large oil importers like China and Japan would stop paying for oil in dollars, and would no longer need to maintain present levels of U.S. dollar reserves. So they too would start selling U.S. treasury bonds, pushing up U.S. interest rates in the process. Once again, we have the ingredients for a self-reinforcing vicious cycle of increasing U.S. interest rates causing U.S. Government borrowing costs to skyrocket.

Without the artificial demand for treasury debt created by exorbitant privilege, the U.S. would be unable to finance its federal budget deficit. The Federal Reserve might respond with even more money printing to monetize all the government's borrowing needs, but without the international demand that results from the dollar's reserve currency status, the dollar would crash in value relative to other currencies as a result of excessive monetization by the Fed. The resulting loss of principal value would cause even more international holders of U.S. Treasury debt to panic and sell their holdings. Once again, a self-reinforcing vicious cycle would develop, with consequences for the United States so catastrophic that the 2008 event would pale in contrast.

Rambo to the Rescue?

Let's not forget that the USA enjoys virtually unchallenged global military hegemony. China is working hard to build out its "blue water navy", including strategic ballistic missile nuclear submarine capability. But the USA is still top dog on the global power stage, and if the USA was willing to use its nuclear weapons, it could easily defeat any country on earth, except perhaps China and Russia.

While the use of nuclear weapons in an offensive capacity might seem unthinkable today, the USA has yet to endure significant economic hardship. $15/gallon gasoline from the next Peak Cheap Oil price shock coupled with 15% treasury yields and a government operating in crisis mode just to hold off systemic financial collapse in the face of rampant inflation would change the mood considerably.

All the USA has to do in order to secure an unlimited supply of $50/bbl imported oil is to threaten to nuke any country refusing to sell oil to the U.S. for that price. Unthinkable today, but in times of national crisis, morals are often the first thing to be forgotten. We like to tell ourselves that we would never allow economic hardship to cause us to lose our morals. But just look at the YouTube videos of riots at Wal-Mart over nothing more than contention over a limited supply of boxer shorts marked down 20% for Black Friday. What we'll do in a true crisis that threatens our very way of life is anyone's guess.

If faced with the choice between a Soviet-style economic collapse and abusing its military power, the USA just might resort to tactics previously thought unimaginable. Exactly what those tactics might be and how it would play out are unknowable. The point is, this is a very complex problem, and a wide array of factors including military capability will play a role in determining the ultimate outcome.

I certainly don't mean to *predict* such an apocalyptic outcome. All I'm really trying to say is that the military hegemony of the USA will almost certainly play into the equation. Even if there is no actual military conflict, the *ability* of the U.S. to defeat almost any opponent will play into the negotiations, if nothing else.

Conclusions

The current incarnation of the International Monetary System, in which the USA enjoys the exorbitant privilege of borrowing practically for free, and is therefore able to pursue reckless fiscal policy with immunity from the adverse consequences that non-reserve currency issuing nations would experience by doing so, cannot continue indefinitely. Therefore, it will not continue indefinitely. How and when it will end is hard to say, especially considering the fact that it's already persisted for 42 years after it stopped making sense. The system will continue to operate until some catalyst or trigger event brings about catastrophic change.

The next Peak Cheap Oil price spike is not the only possible catalyst to bring about a U.S. bond and currency crisis, but it's the most likely candidate I'm aware of. I don't believe that U.S. energy independence is possible, but if it were, the end of oil imports from the Middle East would also be the catalyst to end exorbitant privilege and bring about a U.S. bond and currency crisis. To summarize, the music hasn't stopped quite yet, but when it does, this will end very, very badly. I'm pretty sure we're on the last song, but I don't know how long it has left to play.

Further Reading

Time Magazine's overview of the Bretton Woods system at http://www.time.com/time/business/article/0,8599,1852254,00.html offers an excellent discussion which anyone can understand.

For those seeking a more detailed discussion, Iowa State University's Professor E. Kwan Choi offers excellent course notes on the subject at http://www2.econ.iastate.edu/classes/econ355/choi/bre.htm.

Wikipedia also offers articles on both the Bretton Woods system and the actual conference held there in 1944.

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