Anatomy of the US Dollar End Game

Hosted by Erik Townsend and starring Jeffrey Snider, Mark Yusko and Luke Gromen
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Erik: MacroVoices episode 95 was pre-recorded back in late November, 2017, to air on December 24, 2017. I'm Erik Townsend; happy holidays, everyone. We're not going to have a market wrap or postgame segment for the balance of 2017. We'll return to our usual format on January 4th, 2018. Instead, today's entire show will be entirely dedicated to Part 1 of our Year-end special, featuring Morgan Creek founder Mark Yusko, Alhambra Investments' CIO Jeffrey Snider, and Forrest for the Trees' founder Luke Gromen. I think you're really going to enjoy this 5-part series, which in my opinion is the *only* level headed, serious discussion you'll find *anywhere* about how and why the U.S. Dollar will gradually lose its position of prominence and hegemony over the global financial system, just as the British Pound Sterling fell from that position of prominence in the early 20th century. This series was *originally* conceived as a 2-hour special, and the *planned* topic was simply a debate between the secular dollar bull vs. secular dollar bear arguments, with Jeff Snider and myself slated to represent the dollar bull argument, and Mark Yusko and Luke Gromen slated to argue the dollar bear case. Now let's dive in to what were originally intended to be opening arguments. Keep in mind that as we were recording this first part, we still thought we were setting up a dollar bear vs. dollar bull debate. I'll be back after these initial arguments to explain why we re-framed the rest of the series after realizing we were all in violent agreement that the Dollar's age of hegemony over the global financial system is ending.

Joining me next on the program are Jeffrey Snider, CIO at Alhambra Partners, Luke Gromen, founder of Forest for the Trees, and Mark Yusko, founder and fund manager for Morgan Creek. I'd like to thank you guys for the time and energy you've put into this project. It really means a lot to us and our listeners. So thanks for joining us.

Jeff: Thanks, Erik.

Mark: Thanks for having me on.

Luke: Glad to be here.

Erik: Okay. Let's go ahead and dive right in here, guys. Our first order of business is I'd like to start with each of us sharing our view as to where we stand in the big picture story of the US dollar's hegemony over the global financial system. In other words, I think all of us see that everything has to come to an end. The dollar can't last forever.

Are we in the second inning and there's going to be another hundred years of the dollar serving as the world's global reserve currency? Or are we in the bottom of the ninth and it's all about to fall apart? Or is it something in between?

I think if we each start with a perspective on that – and, feel free, at the same time, if you have any feedback for Jeff on the Eurodollar University content, feel free to express that as well.

Luke Gromen, why don't we start with you?

Luke: Absolutely, thank you Erik. In terms of answering the question, where are we in terms of the dollar hegemony, I think we're much further along than most market participants realize. I would probably say in the later innings. Certainly the last third of the game. Maybe the eighth inning.

The reason I say that is that, given the Eurodollar system as it's structured, early on, if any nations or major parties wanted to move away from using the dollar for any number of reasons, ironically, what that moving away from the dollar would do would drive significant dollar strength. So, ironically, accelerating moves to dump the dollar in global trade usage, which in the long run is the most bearish development for the dollar, in the near term is the most bullish development for the dollar.

And so when we look back, we think, beginning in 3Q14 was when you started to see a marked acceleration in the dollar's share loss in global trade. And, in particular, in energy trade centered between China and Russia. And so we think things began to accelerate in 3Q14 and, like we've said, the process of moving away from the dollar, or the dollar losing share in trade, is a big positive for the dollar – until it's not.

And so we think it's a big positive part of this move we started in 3Q14. And then the "until it's not" part of this movie began over a year ago now, in 3Q16. The reason we say that is because from 3Q14 until 3Q16 you saw a rising dollar, rising Libor, and a pretty traditional dollar strengthening cycle up to that point.

Where it started to become non-traditional relative to what pretty much any market participant trading in markets today – or even alive today – was when in 3Q16 rising dollar, rising Libor, drove a year-over-year decline in US tax receipts and therefore an increase in the US deficit as a percent of GDP. And it did this before you had a major emerging crisis.

This was the first time the US's tax receipts declined before a major emerging market crisis, in a dollar-tightening cycle, in the post-Bretton Woods period.

And so, then, when you combine that with what has become effectively a system that requires as infinitum asset price appreciation in order to drive tax receipts for the US government, it sets up – beginning in 3Q16, where we started to get into late innings of this game. Where, not only are foreign creditors looking to move away from the dollar in trade usage for a number of reasons, but it also started to become a matter of national security for the US government for the dollar to weaken.

I'll stop there and open up for questions or pass the baton on to the next gentleman.

Erik: Why don't we move on to Jeff Snider next, just to get a contrast. And, Jeff, in your case, let's just broaden the question a little bit to the Eurodollar system, which you've taught us so much about in Eurodollar University.

Is it going strong? Is it falling apart? Is it something in between? And where do you see the big picture for the dollar, as we just asked Luke?

Jeff: I think all of us agree that the dollar system doesn't work. And it hasn't worked for a long time already, going back to 2007. So, eventually, something has to happen. And the question is what has to happen? And when?

My position is that the dollar system, the supply of dollars in the global network of trade, continues to be a problem. But it isn't a problem in a straight line. It's not like it's a straight-line decay from where you can draw a singular line from 2007 to 2013. Instead, it's more of an intermittent type of thing where we have these alternating periods where things tighten up. Then they loosen up relatively.

But, as we go through each of these periods, the system is worse off for having gone through each one. And so the last tightening episode, starting in 2014 and lasting through 2016, was severe. Especially in emerging markets like Brazil, Russia, and China, the BRICs, because that's where that part of the dysfunction was focused. More in FX and more into the Asian part of the system, as it has evolved since 2007 in that direction.

So, from my perspective, nothing has really changed except the system continues to get weaker. And I think right now where we are is we're waiting for the next tightening event to start taking place. That there's plenty of evidence that the system continues to decay, particularly with China and some of the other emerging markets.

So it doesn't add up to a bullish position, necessarily. And I think that's one of the things I want to define, is what exactly is a rising dollar? And it's not bullish. And I'm certainly not of the position that most dollar bulls take, which is that the dollar goes up because the US is going to strengthen either economically, financially, or otherwise. I think that's just not the case.

So if we couch these in terms of the Eurodollar system and its continued decay, it's not a bullish thing. But I think the dollar continues to go up, at least for the next little while. Because, frankly, there is nothing there to take its place. So we're kind of stuck with it.

Erik: Mark Yusko, let's give you the last word on this question. Where do you think we are in this story? Are we still in the middle of the game, as far as the dollar's role as the leading hegemonic currency in the global financial system?

Mark: You know, we are still in the game. And it's funny – I think we're going to have lots of disagreement later – but we do have pretty violent agreement here on the fact that the dollar system, and being the sole world reserve currency, is unlikely to persist.

You know, the interesting thing about world reserve currency is there have been lots of them over time. And I always joked that Americans are like Notre Dame football fans – they remember a past that never was. Notre Dame football fans think that we win all the time, which, clearly, we don't. I was down in Miami. That was horrible.

And, you know, Americans think that we've always been the world reserve currency, for some reason. And we clearly haven't. It's only been since 1944. What's interesting about that is the transition can last a long time. The sun never set on the British Empire for 70 years. They had the world reserve currency. They had the strongest navy.

And then in 1913 they invaded Mesopotamia, incurred a bunch of debt, the pound sterling collapsed, the dollar ascended. We, 31 years later, became the world reserve currency. And then in 2013, we (coincidentally) invaded Mesopotamia, incurred a bunch of debt, the dollar collapsed, and the Renminbi ascended.

Well, that hasn't all happened yet. But I think it's on its way to happening. And when I look around the world, I think it's supremely clear that China has a plan. And for the last 50 years, their stated goal was a harmonious rise. Doesn't that sound poetic? It's beautiful. It's non-confrontational.

And President Xi just changed that, a couple of weeks ago, to global superpower by 2050. So they clearly have a goal. And they became *A* world reserve currency a year and a half ago. And we think they will become *THE* world reserve currency at some point in the future. But that's what we're going to talk about over the next couple of hours.

Erik: Just to add my perspective to this, there's absolutely no doubt in my mind that the US dollar is going to lose its status as the world's hegemonic reserve currency and the dominant currency in the world, in our lifetimes. I made the mistake about ten years ago of thinking because it was inevitable that that meant that it was imminent. And of course it wasn't imminent.

Erik: I was just starting to explain our intended 2-week debate format when Luke and Mark called a time-out and said look, if you want us to disagree strongly with somebody on the air, it's not going to be Jeff Snider. They observed that all three of them are basically in violent

agreement that the dollar's hegemony over the global financial system is slowly ending. The only real point of contention is that as Luke put it in his opening argument, the global dollar shortage - which all three of our guests agree exists - is bullish for the dollar initially, but eventually you reach the point where it stops being bullish and the Dollar starts to decline relative to other currencies. Jeff and I don't think we've reached that point yet; Mark and Luke think it already happened when the Dollar Index hit its recent high around 103. But frankly, our disagreement ends there!
After discussing this off-the-air, we realized a much more interesting topic for this series would be a four-way discussion, effectively analyzing the end game for the U.S. Dollar as global reserve currency. Now again, I want to be clear: None of us see this as a catastrophic crisis or overnight event. Big ships take a long time to change course, and to this day scholars argue about which *decade* marked the end of the Pound Sterling's hegemony over the global financial system. The Dollar's fall from prominence will happen over a period of years, and it's not the end of the world. But it is a major monetary system transition that will have epic impacts not only on financial markets and investors, but on the global economy and society as a whole.
So we decided to "Go deep" on this subject, using the slide decks each guest prepared for our planned debate as talking points to frame a discussion about how the Dollar's fall from prominence in the global financial system is likely to occur, and what some of the major signposts along the way are likely to be. It quickly from the 2 hours we planned to almost 6 hours of total content.

So at this point, we reset the agenda to an open conversation about how the Dollar End Game is likely to play out, using all three guests' slide decks to frame the conversation, starting with Jeff Snider's deck. The remainder of this episode and all of the second episode will be dedicated to an open conversation based on Jeff Snider's presentation. The third and fourth episodes will be guided by Mark Yusko and Luke Gromen's slide decks, and the final two episodes will bring together conclusions from all three guests about how the Dollar end-game is likely to go down, how long it will take, and what the landscape will look like after the dust settles when it's over several years into the future.

Please be sure to download Jeff Snider's slide deck before listening to the rest of this episode, because it will be the basis for the first major discussion between our three expert guests. Registered MacroVoices listeners will find the download link in your Research Roundup e-mail. If you're not yet registered, just go to MacroVoices.com and look for the download instructions in this episode's description on our homepage. Jeff doesn't mention slide numbers in every instance, but if you follow along in the slide deck you'll find the conversation basically follows that outline. Be sure to stay tuned at the end of this conversation, when I'll be back to announce the accelerated release schedule for the remaining episodes over the holidays.

So with this new agenda in place, let's continue without further ado. Alhambra Investments' CIO Jeffrey Snider will lead the conversation for the remainder of this episode.

Let's make this, gentlemen, as interactive as possible. Let's not have Jeff just give us a lecture but, by all means, please interrupt. And Jeff has gone way out of his way in email to ask me to please encourage you guys to be as critical as possible. Don't try to be polite. If you disagree, let him know.

With that, Jeff, why don't you take it away?

One of our listeners posted a question that I really think sets you up for this. Which is, is it possible that this Eurodollar system, which so many people don't understand, that's created so much money supply for so many years, could eventually break down and go into reverse and start causing the destruction of money supply that people don't understand?

So that's probably a good way to set you up. Go ahead and take it from there. And reference your slide deck as much as you'd like. And, by all means, Mark and Luke, speak up if you disagree and want to argue any of the points that Jeff brings up.

Mark: We won't be shy.

Jeff: Well let me start out by agreeing with Mark, just to put it on the wrong foot here. Mark, you said something that I think is very important: There have been several different reserve currency formats throughout the years, and a lot of them don't really last very long. And they don't end all at once. There is usually a transition period between what was and what is.

Even if you think about the Bretton Woods system, in my view it only lasted 16 years until 1960. The formation of the London Gold Pool in 1960 was the default event, certainly, from the original terms of Bretton Woods. And so between 1960 and 1971 – it wasn't as if President Nixon all of a sudden closed the gold window on Bretton Woods and that was it. There was a transition period over, actually, more than 11 years, so that, by 1971, what happened was almost inevitable.

So I think that's where we are now is we're in a transition period between what was and what is. And the reason is, as Erik's alluded to from the listener feedback, is that we had this massive offshore hidden – however you want to term it – Eurodollar system that for decades grew and grew and grew. Not just quantitatively, but qualitatively in how it actually interacts and how it actually works among different parts of the system. Until 2007.

And once 2007, everything that happened then, the system hasn't been able to function since then. And that's the reason why central banks keep doing various stimulus programs, whatever, and they never seem to get anywhere. They never seem to work. It's because they're quantitatively and qualitatively ill-suited to the actual monetary system.

And so I think what that's left us with is this so-called rising dollar, which is really nothing more than a short squeeze. If you want to put it in terms of a synthetic short position, the world has a synthetic short position in US dollars. And that's easy enough to do and easy enough to handle when the supply of dollars is free and easy, flexible and dynamic, as it had been up until 2007.

Starting August 9, 2007, it was no longer the case. And, as I said earlier, it's been intermittently a problem ever since. So it's a problem that hasn't been fixed. And we go through these episodes of tightening and relative loosening.

Mark: This is Mark. Yeah, I guess, Jeff, I have one question on that, that you brought up earlier as well, which is that a dollar rise does not necessarily mean that the dollar is positive, or that it's bullish. It really could just be the race to the bottom. The other guys, particularly the euro and the yen, are weakening faster. And that's one of the perspectives I really come to – demographically, the developed world is basically hosed.

You know, they have bad demographics, we have too much debt, and therefore we're stuck and mired in this deflation. And the only way out is through massive devaluation of the currency. And, clearly, the leaders in that are the Japanese. But the Europeans are getting pretty good at it. And ours, by comparison, we're just not quite as good at devaluation as those guys are.

Any validity to that perspective?

Jeff: I would agree with that in terms of how the system actually operates on a risk-return basis. Before 2007, it operated as if there was no risk at all. In other words, you could add volume. Many banks grew exponentially, because the perception was that there was no risk to anything. And that's how we got a sub-prime mortgage problem, that's how we got an EM junk debt problem, was the fact that everybody just grew and didn't care how.

The name of the game was get bigger. And so that's what happened. Everybody got bigger.

And starting at 2007 we started to have an inward reflection of what exactly was going on in the system. And I think that's part of it, Mark, is that part of it was there's a lot of inherent contradictions here. Now, this is not a risk-free system. In fact, it may be a return-free system in that there's a lot of risks that were not appreciated before then.

Luke: I guess my question on it, Jeff, is the idea, the point you made about the London Gold Pool. The setup of that in 1960 was really the first default under Bretton Woods. And of course made '71 inevitable. Which I thought was a really interesting point. Because your ensuing point, that the Eurodollar system began to break down in August of '07. We've talked in our research that what has happened post '08 – and there's been a lot of analogs to that period of time.

Where, if the first default under Bretton Woods was the setup of the London Gold Pool, the first default of the Eurodollar system was '07–'08, when you had to take rates to zero and you had to grow balance sheets the way you did at the Fed and around the world.

And so if you say, all right, the 1960 to 1967 period was the first default – and, say, that's akin to the '07 through 2013 period – then, of course, beginning at the '67-'68 timeframe, the US's creditors at that point were in the EU. And they began to look at guns and butter, what LBJ was doing, and how Vietnam was going. And they said, we're done. We're done here. Give us our gold.

And so then you had the breakdown of the London Gold Pool, and a lot of gold flowed out of the US at an accelerating pace to try to hold that system up, before Nixon closed the gold window. But that closing of the gold window by Nixon was going bankrupt slowly and then going bankrupt all at once.

And so, I look at it again – this time around '08 to '13 was sort of the London Gold Pool timeframe. And then in early '13, after the Fed came out in 3Q12 and said we're going to QE forever, then you had in 1Q13 China (who is the creditor this go-around) showed up and said we're done here, give us our gold.

And you saw this massive run on physical gold out of London, most of it going east as best we can tell. And so – I guess a longwinded way of introducing the question – which is, if we think about the London Gold Pool setup in '60 as '07, and the breakdown of the Gold Pool as 2013, do you think (a) do you think that's a valid comparison?

And (b) do you think we could get that same sort of binary dénouement to the whole situation where we get, over a weekend, a Sunday night surprise or something?

Jeff: Yeah, I think the analog is a – it's a good analogy. In general terms. I think there's a big difference, though, that we have to consider. During the 1960s there was an alternate settling mechanism for Bretton Woods that had developed in the '50s.

And that's what the Eurodollar was. The Eurodollar was a way of providing global liquidity so that, in many ways, central banks could circumvent Bretton Woods. The rise of the Eurodollar system in the '60s had as much to do with foreign central banks circumventing Bretton Woods as it did with banks increasing their balance sheets.

What I mean by that is there was – 1971 happened, there was already an alternate means in place, operating for a very long time, and which all of the global participants were used to. So that when Nixon ended convertibility it was – I don't want to say it was a seamless transition, but in operational terms it was. Because there was already another mechanism in place, in operation, at the time.

And I think that's what's missing here. We don't have another settlement mechanism that is actually in place and operating right now that can replace the Eurodollar. I think that various parties want to do something about that. But they're running into problems, because – you look at Western central bankers, and Western officials in particular, and none of them even think there's a problem.

And so, if you're China, you're essentially negotiating with yourself. Because you're not going to get Janet Yellen to the table to talk about replacing the dollar, because she doesn't think there's a dollar problem at all. And there isn't any other kind of settlement mechanism available at this moment that would allow for something to happen tomorrow. Any kind of weekend surprise would be catastrophic. Because there's no way, there's no mechanism currently in place to allow that to happen.

So that's why I think that we're earlier in the process of transition between reserve currencies than later.

Erik: Jeff, why don't we go ahead and dive into your slide deck. Give us a tour of what's on your mind with the bull argument. And, I guess, let's change our terminology. It's not a bull argument. Let's describe the reasons why you think the dollar may appreciate relative to other currencies as part of the process of its demise, which is what I think we're really talking about here.

Jeff: Yeah, I think a better terminology would be short squeeze. It's sort of a dollar short squeeze. And, again, if we think about the Eurodollar development from things all the way back as – some things like banker's acceptances – it's essentially a short dollar system, where every participant in it is short the dollar.

They roll over funding every day, whether it be in repo or unsecured or in FX – or however it's done – essentially everybody around the world needs dollars and therefore they're short of them. So when the dollar supply becomes less malleable, less pliable, less dynamic, it becomes a problem for certain parts of the system being able to roll over their commitments.

And what happens when you have to roll over your commitment and it's not as easy to do so, the price of it goes up. And, in terms of currencies, a short squeeze in the dollar means a rising dollar or a falling counterpart currency.

So I think a good place to start, to really kind of describe and put some real-world examples to this process, is Russia. One of the things about central banks going back for the last couple of years – and this was Ben Bernanke's (supposed to be) his great legacy – was opening up central banks to be more transparent in how they conducted monetary policy.

And some central banks take that to heart. Some central banks don't. In 2014, the Russians, for example – the central bank of the Russian Federation very explicitly and very publically started auctioning off Eurodollars and euros – which in this case would be euro-euros. The reason they did so was because Russian banks were having trouble securing dollar funding, primarily in the second half of 2014.

So, essentially, what the Russian central bank was doing was becoming a redistribution point for local Russian banks that were being shut out or couldn't afford the terms of Eurodollar financing.

They were, in essence, being squeezed out of the dollar market. And as that was happening, of course, the Russian ruble started to devalue. Because, again, the price of participating in a short squeeze is you have to pay up for it. So the Russian ruble in the second half of 2014 and throughout 2015 and 2016 underwent severe crisis. The devaluation was severe because the dollar shortage had become severe for them.

They were not alone in that position. In fact, it became a widespread thing. You go to Brazil, for example. The Brazilian real (R$) had started devaluating all the way back in the 2011 dollar crisis. But that really came to a head in 2013. The Banco do Brazil, the Brazilian central bank, chose to deal with their dollar squeeze a little bit differently. Or a lot differently, really, than the central bank of Russia.

Rather than deplete their reserves, they decided they would go into, essentially, a dollar subsidy. They're technically not swaps, but a lot of people think of them as dollar swaps. Without really getting into too much of the details, what the central bank essentially had to do was to subsidize Brazilian banks borrowing in the Eurodollar markets to make it cheaper so that they could borrow more on the Eurodollar market to bring dollars into Brazil.

And what happened was, in 2013 and especially 2014, they did so many of these swaps, or these synthetic swaps, that it threatened to use up all of Brazil's reserves. I think at the worst part it was about $120 billion in non-deliverable swaps – compared to about, I think it was $380 billion in Brazilian reserves.

So as soon as they cut off the subsidy in late 2014, the Brazilian real, the bottom essentially fell out from it. Without the subsidy, there was no way for Brazilian banks to easily obtain dollars on the dollar market. And, of course, the short squeeze hit Brazil.

Mark: Jeff, this is Mark. I just wanted to come back to your point on, I think it was Slide 5, on the ruble. It seems to coincide pretty nicely with the collapse in oil prices.

Is that a contributing factor to the dramatic weakness in the ruble? Was it just that they couldn't get enough dollars because the export of oil just wasn't bringing in enough revenues?

Jeff: I think it's a self-reinforcing thing. Especially for a country like Russia. Because Russia depends on the oil business to obtain a lot of their dollars. And so there's a mercantilist component to it as well.

If you're selling oil for fewer dollars, it makes it much more difficult for you in a position of a borrower, where the banks who are lending you dollars for all sorts of other things, you become much more riskier of a borrower in their eyes. So, yeah, it's a self-reinforcing thing for especially Russia.

But it isn't just the problem of demand, it's the problem of supply. So it puts Russia at the very front of the risk list. In other words, if you're a Eurodollar bank supplying dollars on the global market, and you're having trouble with – for whatever reason it is particularly that you're cutting back your dollar business, you're going to cut back from Russia right at the start. Because they're one of the most riskier aspects of the Eurodollar business.

And so it makes sense to charge them more to continue doing dollar business with them. And the oil price is definitely a big part of that.

Luke: It's interesting, Jeff and Mark (this is Luke of course) when you look back to September – and we put this in our slide deck (which we can touch on later) – but if you look back at the actual timing of events it's kind of interesting. And it's, to me it hints to motive. So I'd love to get your thought on it, Jeff or Mark, of – if you go back to August of 2014, actually back even to May of '14, you had the Holy Grail gas and energy deal signed between China and Russia. It was rumored that that deal was going to be done in non-dollars, but no proof of that. It was later proven to be the case.

In August of 2014, Putin announced that they wanted to start moving away from the dollar in oil trade, because the dollar's monopoly in the global energy trade was damaging their economy. And, what's kind of interesting – and we wrote about this at the time – at this point oil is still $100 a barrel. And then, all of a sudden, by late September, with oil still $96 a barrel, $95 a barrel, Russia's having dollar shortages.

Russia was still – and they weren't the only ones – Venezuela, Ecuador, a couple of others – you have three major oil exporters that are running still current account surpluses in the low- to mid-single digits at this point, starting to run into dollar shortages.

And it was, I think, an underappreciated point at the time that, basically, if you're an oil exporter you're only selling in dollars, you're running a current account surplus. And so, if you're only selling in dollars, in theory, there's only two explanations for that, for those dollar shortages that began to pop up well before the price of oil crashed.

Which was (#1) Russia and other places got dramatically more corrupt in the three months versus the three months before. Or they were starting to sell energy at an accelerating rate in non-dollar terms. And, as a result, you were seeing – where you were getting $100 before, now you were getting whatever, $90, $80, whatever the mix was.

And at that point, then you started to see some of the devaluations etc. I guess I'd love to hear your thoughts on that.

Jeff: Luke, I think there's a third option there. The third option is dollar supply. And if you look at the rising dollar of 2014, it didn't just begin in 2014. That's why I bring in Brazil. There was dollar problems going back to 2011. And a lot of that came to a head. And with taper summer of 2013, which was as much a currency crisis as anything else, because that's where banks really started to ask questions about their exposures overseas.

I think there were a couple of reasons for it. A lot of the assumptions that prevailed in the dollar business after 2008–2009 were tested and challenged by 2012. One of the assumptions was – you see this in a lot of the dollar figures – the developing world, the US, and the European economies are going to struggle. And there was a very big consensus that that was the case.

And so a lot of the dollar business moved toward Asia and the emerging markets in the intervening years. And the reason was because everybody thought, well, China would just return to growth. The emerging markets are always going to be emerging markets. And so there's relatively less risk in those places. And so dollar business grew in Asia as it shrank in Europe.

By 2013, however, it became clear – at least it started to dawn on some people – that maybe that wasn't the case. Maybe the emerging markets were not going to go back to normal. Maybe China was going to have continued economic problems. And so it wasn't as much of a risk-return scenario as thought prior.

So when all of those things started to be reevaluated in 2013, that's when you started seeing more and more currency devaluation as a result of global Eurodollar banks pulling back – not only on their own balance sheets, but also becoming more preferential about their counterparts.

And so, again, that's why I reference Brazil. Yes, Brazil has a heavy oil exposure. But they're not exclusively an oil exposure like Russia is. In Brazil they started doing their swaps in May of 2013, long before any of that other stuff. So there was clearly a dollar problem in Brazil going back to, I would say, 2011. But really it amplified in 2013.

And, so, to get back to your point, Luke, I think there's a third option here.

Luke: I was going to say – it's Luke again – just a follow-up question. Why do you think the Fed went from September 2012 "we're going to re-up QE again" to all of a sudden, whatever, early May or late April 2013 "uh-oh, we're going to taper"? Right?

Because the consensus at that time was, hey, there's no ill effects from this. We can do this as much as we want. Was that political? To me it's just always been fascinating that the Fed says in September of 2012, we're going to QE forever. And then in February–March, China shows up in London and starts buying everything that's not bolted down in terms of gold.

And all of a sudden you see an inversion – an unprecedented inversion in gold forward rates. And you see, effectively, a run on physical gold take place throughout the world. And then in May the Fed goes, okay, we're going to taper.

Why do you think they reversed themselves so quickly?

Jeff: Yeah, I think that was a big shock to a lot of people. Because they were – going back to

2012, the Fed was kind of panicky. I mean, the whole idea of open-ended QE was for that reason. They wanted to help the market, psychologically at least. It didn't do anything monetarily, but psychologically, I think, they wanted to let the markets know that they would at least stand behind them for a long period of time.

And then just a few months later, in February 2013 you had a speech by Fed governor Jeremy Stein that said, hey, there's some things wrong here. This reach for yield thing is real. And not only was it just reach for yield, in the speech that he gave he also referenced collateral swaps with junk debt. So I think the Fed kind of scared itself on both sides.

In 2012, the Fed was concerned about the economy falling into re-recession so soon after the Great Recession. So they acted. But by early 2013 things looked a lot better and they started to notice all these irregular financial characteristics, including the stock market that just went insane that year.

And so I think it was a contradictory position where they were panicking in 2012, and then by 2013 they had reevaluated everything. And I think it didn't have anything to do with the Fed as much as it did the Eurodollar. The Eurodollar system had started to back toward reflation at the end of 2012 as the Fed was just starting QE3. So, coincident timing there.

Mark: It's Mark. I think the other thing that people forget is we had some new actors come on the scene with their bazooka. You had Japan with Abe-san getting elected in November of '12. And then you had Kuroda-san whip out the bazooka and say, we are going all out. We are going to QQE (quantitative and qualitative monetary easing) like nobody's business.

And what's amazing about Japan is in 2007-08 they said they were going to trim their balance sheet. They were going to trim the Bank of Japan balance sheet from about 26% of GDP. And they did, to about 20% of GDP. The stock market went down about 55%. They had a recession. Things were ugly.

So then, finally, Abe-san comes in four or five years later and says, we've got to fix this. I think they had four prime ministers in four years before Abe-san came in. And, remember, he had gotten kicked out, you know, with his stomach virus – interesting topic for another day – before that.

So he comes in. I think that changed things. And we had that false recovery, so to speak, because there was a lot of money being injected. Now I actually have a thesis that all of this is being coordinated by Ms. Lagarde. We'll come back to that, I'm sure, later.

But I want to jump back to one other thing that came up that I – I don't want to go too far down this rabbit hole, but I think it's important. I had this thesis that – if we go back to the point, Jeff, you made about the gold window being shut in '71 – I have a thesis that that's what this whole thing is about.

And it's why I come to my worldview of the dollar, is that the petrodollar system was created in 1971. We cut a deal with the Saudis. We said we would protect them. They said, well, as long as – and we said we'd protect them as long as they denominated all currency transactions globally of oil in dollars.

And every single time a country has threatened to denominate oil or gas transactions in another currency, we attack them.

So Iraq tried it. Libya tried it. Now Russia was trying it. Now we didn't attack Russia per se, physically, like Iraq and Libya, but we certainly did all the sanctions coordinated with Europe in March. And I think that had a lot to do with what was going on. And I would say that everything always comes back to oil. That's been the currency of choice to back up the fiat since we closed the gold window.

So I think oil becomes a very important topic as we think about the future going forward.

Luke: I think that's a really good point, Mark. It's interesting, a good friend of mine was at a conference overseas about – I guess it was about almost two months ago now – where a very wealthy Chinese businessman stood up and publically said that if Saddam or Gaddafi had nuclear weapons both of them would still be alive. Which is very, very interesting to hear, right? In terms of somebody who – if you're a billionaire in China, you have to be connected to the government.

And (#2) to say that publically in the United States would be considered (to your point) down the rabbit hole. But it's, elsewhere in the world (because this was in a European location that this Chinese businessman said this) it's sort of taken as given.

You know, we can certainly touch on this later in the presentation. I certainly get into it later in mine. But I think from some of what we were seeing in the currency markets as you got into '12–'13 was geopolitical in nature, right? The Russians do have nukes. And so you can't do what you did. So you have to try to use a different weapon, which, you know, the dollar has been a remarkably effective weapon over time.

Jeff: Okay, if we go back to the slide deck and pick it back up on Slide 11, I think what it shows us – and this, by the way, it's the Russian ruble mapped against the US tick data, the foreign official holdings of Treasuries. What it tells us is that the foreign officials sector – which is foreign central banks, foreign Treasuries, foreign finance ministries – they started selling Treasuries, or at least using their reserves, to help with their dollar supply issues in 2013 as things started to become more problematic in that case.

They were somewhat successful in, at least, that they bought some time. Which is, again, what central banks do. No central bank expects to run up against a chronic issue. When they intervene in any market, they do so with the intention that it will be temporary. I think that was the expectation in 2013, was that central banks would intervene and then the problem would go away.

Except it didn't go away. In fact, in 2014 for various reasons (and we can get into those various reasons), and maybe there's geopolitical considerations in those as well, and I think we do have to consider them certainly as, perhaps, unintended consequences. Maybe intended consequences. Either way, by 2014 the dollar problem became that much worse.

But global central banks, especially those in certain locations where the pressure was most acute like Brazil and Russia, they had already done what they had done and they had no ammunition left to offset what was coming. Which was the rising dollar. The major, the real short squeeze.

So 2013 was just the warmup act, the warning for the real event that happened in 2014–15 and the early part of 2016.

The way that this central banking and the foreign officials sector tried to deal with those problems was by mobilizing reserves in various fashions. I think that's what's important about looking at both Russia and Brazil, is that there's more than one way to do this. If you have a dollar problem, you don't just need to sell your Treasuries. You can go through the repo process like the Bank of Russia did. You can go through a derivative process like the Bank of Brazil did. And I think when we get down to it, coming up, we don't really know what the Chinese did. But we know that they probably did some of both of those things.

Luke: I was just going to ask, in terms of specific to Russia, as I look at this chart, you definitely would watch them sell their Treasury position down. What was really interesting is – one thing we noticed in that '13–'14 time that was really different, which was unlike, say, 2008 when oil prices collapsed, Russia sold some Treasuries and they sold gold reserves as well.

In 1998 you saw, when they had problems, same story. Sell Treasuries, sell gold. In 2013-2014 something really interesting happened, which was they sold Treasuries but they bought gold. And they kept buying gold. And it was really interesting at the time. You know, there was talk in gold markets that the Russians would have to sell their gold reserves, and that was negative for gold. But they did exact opposite than (a) that people were expecting and (b) that you would intuitively expect – if they're short dollars, the last thing you'd expect them to do is buy gold.

And also very different than what they had done in prior oil price collapses in both '08 and in '98. So, I guess – why do you think they did that? And is it possible that speaks to some of the geopolitical side of some of what was happening that Mark raised?

Jeff: I think there has to be. I mean, look, the Russians and the Chinese, the Brazilians, all these other people outside the United States – as we talked about before – they realize what's going on here. They're at the wrong end of all of this, and so they have a very good intuitive sense that things are not working.

And for them things are really not working. So there has to be some kind of geopolitical backlash against the system that doesn't work. Whether that manifested in gold, I can't answer that question because I don't really know. Maybe that is an important thing.

Well, from what I would tell you –

Luke: I think you'd agree it was sort of strange –

Jeff: Oh absolutely. But there's a lot of things that changed in that time period, which is what you're alluding to. I think a lot of it was because there was a shock there. The shock was that the emerging markets were not as immune as people thought.

And the people in those emerging markets, official in those emerging markets, had a front seat to that shock that Western central bankers or Western monetary officials are still in denial about. Janet Yellen doesn't think there is a dollar problem out there. I think the Russians know that there is a dollar problem. Because they have lived through it.

You know, the ruble crisis was a massive wakeup call. That stuff was coming in 2013. You had this sense that something was very wrong there. And that somebody on the inside of the central bank of Russia would have knowledge that this is going to be bad. This is probably not going to be good. We need to do something.

And so it would not surprise me if that were part of what happened there. Because they thought, well, hell, we're going to get killed here. How long do we want to keep going through this? You know? And that's the disconnect, I think, between us and the rest of world.

People in the United States and Europe have a sense of things that is badly skewed. The dollar is manifestly a huge problem. We don't know it, though. And I think part of that is the privilege of being the dollar issuer – well, it's not the dollar issuer, but being in that denomination – there's a privilege there that has essentially kept us in a sort of bubble about the consequences of the dollar's failure.

So, Luke, I wouldn't be surprised if that was a geopolitical thing where foreign officials are saying to themselves, this just doesn't work. And we know it doesn't work.

Erik: Jeff, I'd like to throw a question in myself, which is five-ten years ago I was reading a lot of people who made an argument that I thought was very persuasive at the time. They said, look, here's what's going to happen someday. China and Russia and Japan – who are huge, huge holders of US Treasuries – are going to sell them off. And it is going to utterly collapse the US Treasury market. We're going to see runaway yields on Treasuries to 15% because it's going to be a crisis.

What's crazy to me is, it happened the way they predicted. And the opposite seems to have occurred in terms of Treasury yields. How is that possible?

Jeff: Because it did happen in the way they predicted. I want to get into this a little bit later if we have time. The Chinese can't just sell Treasuries. They can't. Because the PBOC's balance sheet – at the time 3/4 of their balance sheet was foreign assets. So, just in terms of simple accounting, you sell the asset side down, you have to sell the liability side down.

So that's exactly what the Chinese did in 2014. They mobilized their foreign reserves at first and allowed the asset side of the central bank balance sheet to decline, which – as we know from all the quantitative easing out there, at least what quantitative easing was supposed be – amounts to quantitative tightening. And so the level of bank reserves – and if you want to just skip ahead we can do that right now –

Erik: That's okay. If it's coming, let's save it for the right point. I just wanted to get to that topic before we're done today.

Jeff: It's fine. You know, the dollar is the basis of so many central banks. The monetary system in China is predicated on the dollar. And so selling down US Treasuries or US dollar balances has the effect of tightening Chinese money.

And that's exactly what happened. Bank reserves in 2015 declined by some 3 trillion RMB, which is an enormous decline. So there was direct economic and financial consequences to that happening. Which is essentially the point. These countries are almost in the position of mutually-assured destruction here. They can't just sell off their own dollar holdings, because that would undermine their own currency. It would undermine their own monetary system.

So I think that's why we're getting into Luke's point, and to Mark's point as well – the geopolitical concerns here is that, okay, the dollar system doesn't work, but we're stuck with it. So what the hell do we do? You kind of sympathize with their position, because it's between a rock and a hard place.

My sympathy kind of ends, because they were certainly on board with all this while it seemed to be working. Up until August of 2007. So they kind of made a deal with the devil. And eventually the devil gets paid. And so the question is, how does the devil get paid? And in what form?

And so, from my perspective here, especially when we go through the Chinese stuff, is – what is their choice? They have to work almost behind the scenes to try to get something of a workable alternative. Because they don't have an alternative today. They cannot go with today getting rid of the dollar. Can't ditch the dollar today. I think they would want to.

Luke: Doesn't that speak to the binary nature, in your opinion? Like, if there's going to be a change, it's going to have to be – just by virtue of the fact that how much this is not working and how far away we still appear to be from a solution, right? Like I think of those things and it's like, we're running out of gas in the plane and we're nowhere near a landing strip, right? So that doesn't imply that we're going to get to the landing strip. It implies that we're going to fall straight down. No?

Jeff: Yeah, I agree. And I think that's what scares me the most. Maybe the analogy's a little different. To me the Chinese are increasingly desperate. You look at what they've done in '14–'15–'16–'17. They do increasingly desperate things. And it's possible – to get to your point about a binary option here – they get to the point where they say screw it. You know what? We've resisted de-dollarizing as best we can because we don't think there's an alternative. Let's just do it.

Let's just say tomorrow – I mean, because this isn't working. We're in a high-risk position. So why don't we just say screw it. We've been waiting patiently for those idiots in America to get their house in order, for somebody to take control of the Eurodollar system and do something about it. It's been ten years already, it's clear that's not going to happen, So let's just start reevaluating everything we do in RMB.

If they get to a point where they're desperate enough, maybe that happens. That is certainly a risk. That would be one of the worst risks, in my opinion, but that is certainly something that they might have to consider. They might just have to get to the point where they throw their hands up and say, screw it, there's nothing else we can do. So we're just going to do what we're going to do.

Erik: So we left off at, I'm thinking, Slide 11 or 12 in your deck. Let's continue.

Jeff: Getting back to Slide 12, it's nothing more than calibrating tick with something that's market-based. It shows the dollar supply issue – the US dollar ten-year swap spread, for example – which is an implied balance sheet capacity measure. It fits pretty well with what we see in the holdings – or the net changes in holdings – of US Treasuries, where there is an increasing shortage of how that's supplied across the world.

Slide 13 is just goes back even further into actual banking data. The tick provides US banking cross-border liability balances. As you can see, exponential growth up until 2007–2008. Since 2007–2008 there's been absolutely no growth. Not only just no growth, it's more volatile in these three episodes and how there is no growth.

And so when we started thinking about that in terms of China, there's a direct relationship between dollar inflows, or what people call hot money, and the supply of Eurodollars on the market. And the reason is, again, the Chinese monetary system is dollar-based. So when the Chinese bowed to international pressure in 2005 and allowed CNY to float, or at least partially float, that had the effect of allowing more dollars into the country. Which the central bank responded to by raising the reserve required by the banks.

In other words, more dollars meant banks could create more RMB. The way you try to control that as the central bank in China, is by increasing the required rate of reserves to lock up some of those created reserves so that didn't become runaway reflationary. And so it's a pretty good calibration internal China to external China. Because as CNY goes up that's dollars flowing in.

And then from 2014 forward, those are dollars flowing out. And the way in which the PBOC tried to deal with the dollars flowing out was the opposite of the prior conditions. Which kind of makes sense, at least on the surface.

If you have a problem with too many dollars then you raise the reserve requirement. If you have a problem with too few dollars you lower it. At least that was the idea. But it didn't really work out that way.

Slide 15 is just kind of a visual representation of how the Chinese system works.

Slide 16, again, Chinese currency exchange rate and the amount of PBOC foreign assets going onto the Chinese balance sheet, therefore underpinning the Chinese monetary system.

Then you kind of get into the problems of 2014, as we get to Slide 17, bank reserve growth. Again, the way they chose to deal with the dollar supply issue in 2014 and 2015 initially was a very passive approach, for several reasons. Part of it was the reform agenda that they adopted in 2013, which part of it was supposed to be to allow more market-driven conditions inside the system.

As the Chinese were dealing with their dollar problem by mobilizing their reserves in whatever fashion – some of it was swaps, some of it was repos, some of it was selling US Treasuries – that had the effect of reducing the asset side of the PBOC's balance sheet. Which, again, in simple central bank accounting, had the same effect of reducing the money side. They weren't going to print less actual currency, so they allowed the level of bank reserves to decline in the middle of 2015, toward the end of 2015. And it was a very severe amount.

And that lines up in Slide 18 with –

Luke: Okay, Jeff, can I stop you there real quick? Just to ask a question. As I look at that chart, it looks like you had – very consistently you saw the rise in PBOC Forex assets under, or moving in the same direction consistently with PBOC liabilities. And then, beginning right in, it looks like third quarter of '15, you saw what appears to be the first time in at least ten years this divergence where liabilities rose and FX assets continued falling.

What drove that?

Jeff: I think that was a conscious choice by the central bank monetary policy to try to deal with their dollar issue passively. In other words, they would mobilize reserves as best that they could, and allow the banking system itself – because what they did starting in late 2014 is they reduced triple R. So, even though the level of bank reserves would decline by about 3 trillion, the expectation was that the private internal RMB market would make up the difference by having less reserves locked up under statutory requirement.

And so, again, it's a simple idea that seems logical on its face – because if you're doing the opposite when the CNY is rising and dollars are flowing in, why wouldn't it work in the other direction? And the reason was, of course, that things don't work in a one-to-one basis. We live in a reflexive world where, if there's a dollar problem in China, that maybe Chinese banks internally aren't ready or willing to make up liquidity in RMB terms even if you lower the RRR.

In fact, I think that's what we saw. Even in the bigger banks, reluctance to supply even RMB, even though that's exactly what the PBOC wanted them to do. So it was a failed policy.

But I think it speaks to the way that they wanted to handle the dollar issue originally in 2014–2015 was very passively. They thought they could just let the private market absolve or alleviate any of that difference. And therefore they wouldn't have to get involved because central banks are always on the lookout for making problems worse.

And that happens in a lot of places. You know, the discount window, the stigma associated with that in the United States. There's a lot of that that goes on elsewhere too. If the central bank gets involved, investors get nervous because they think, well, there's really a problem here. And so I think they kept out of the problem originally in 2014–15 because they didn't want to make it worse. And of course it didn't work out so well in that direction.

Which gets us to about Slide 20 where we start to evaluate the different things the PBOC has done as the dollar shortage has manifested over those three years starting at 2014. And you go back to the original devaluation in early 2014, which shocked a lot of people. People were not used to CNY going in the other direction.

So there was a fundamental argument in the media and in various circles about what exactly was going on. And what we wrote about in March of 2014 was that this was, again, the manifestation of 2013 starting to become more serious. That China had a dollar problem on its hands, and what it was doing by expanding, first, in early 2014 by allowing their daily float to essentially double – was it was allowing Chinese banks to more aggressively bid for dollars that were becoming short in supply for them.

And so this was the setup for what became the rising dollar, which was, again, a short squeeze. Essentially. China was starting to be squeezed on the dollar market and they were starting to pay up for the privilege of having to do that.

Slide 21 shows us again the regularity of CNY's devaluation. Which isn't a devaluation. It's, again, a short squeeze. Which are the fingerprints and the telltale signs of the PBOC doing whatever it is they did. Unlike Brazil, unlike Russia, the People's Bank of China doesn't report much to the international community.

On the IMF call sheets for their reserves, most of it is blank. Especially Memo Item 4 where all the interesting stuff is – the swaps, the short positions and whatnot. If you go into their call sheet, there's nothing there. So they're doing something. We just don't know what it is they're doing. And I think the intention, quite honestly, is they wanted to arrest the short squeeze as best they could along the way. Except they were defeated every time, because the dollar problem was bigger than their effort.

Mark: Jeff, was this tied to the injection of the trillion dollars in liquidity into the economy too? You know, I have this thesis that the global economy was slipping into recession in 3rd quarter, 4th quarter of '15, into the first quarter of '16.

Everybody looks out at that first couple weeks of the markets in 2016. The US market was falling off a cliff, down 14%. Things were looking dark. Oil prices had collapsed all the way to $26. The whole dollar trade around the world drying up, because the big asset was now not worth anything. And China put a trillion bucks into the economy. I'll say, to save the world.

And do you think any of this change in exchange rate was because of that?

Jeff: I think that was it exactly. I think that was their panic attempt to try to get this thing to stop. I agree with you. The global downturn at the end of '15 was the consequence of this dollar shortage. It was starting to hit a lot of places. You know, Brazil's economy collapsed completely. The Chinese economy – people were starting to talk about, jeeze, is China going to have a hard landing? You can't have a hard landing in China. It just doesn't happen.

And so that's exactly what happened.

Mark: Haha, not before the 19th Party Congress, you can't. No way.

Jeff: Exactly. There's no way that can happen without heads rolling. So they did the 2015 approach, which – we're getting on to Slide 22 – that was the passive thing. And China let things develop, they tried to let the market happen, they've had to let the dollar problem manifest internally, they reduced the current reserve requirement on big banks, and that didn't work. In fact, in many ways it made it worse.

Because, I think, a lot of the Chinese banks in particular were looking for help. And they realized they weren't getting it. So that actually had an amplification effect on the negative side rather than a palliative effect. And so by 2016 –

Mark: This is when Kuroda-san lost his mind right?

Jeff: Yes.

Mark: This is when Kuroda-san went to negative interest rates and just threw everything up in the air.

Jeff: Right. January of 2016, they all did, they all panicked. Because they said, you know, this is really going in the wrong direction. And so – if we go to Slide 23, where that blue line jumps is January 2016. And that was PBOC opening up their liquidity spigot in RMB. Which is what they had avoided throughout 2015 and 2014.

Now they didn't just flood the market with RMB, they did a targeted approach where they used primarily the MLF, or the medium liquidity facility, something that they had just come up with in 2013, which meant they were primarily lending RMB on very generous collateral terms to the biggest banks. Which was their intent.

They wanted the biggest banks to then become the point of redistribution of RMB to the smaller banks. Because they thought that the bigger banks, at least if they're liquefied in RMB, that would help. They'll stop panicking, and then they'll be a little bit more picky about who they're lending RMB from there, and the repo, and then the interbank markets.

But overall you could see – 2015, the PBOC was passive. 2016 they said screw this, we're going to do something. And it wasn't just in RMB that they went in. They also did a massive fiscal stimulus that January, where they rapidly increased fixed asset investment through state-owned enterprises.

And so January 2016 is when things really started to get bad. The Chinese authorities panicked. They did it fiscally, they did it monetarily, and the net result of all of that was it didn't really work. It's debatable whether or not it did – you could argue that it did work in the fact that things stopped getting worse. At the very least that the market crash stopped, the economy started to stabilize – globally, not just in China. And so on that limited basis you could say, well, that worked.

But in terms of what actually people expect out of these kinds of things, it didn't work. Because it didn't start a recovery. It wasn't like growth has been accelerating since early 2016. In fact, at best it's been flat. Not only that, though, China's dollar problem – which is my bigger point here – didn't stop. They did the big RMB expansion throughout 2016, they did the fiscal stimulus in 2016, and still they had a massive dollar problem. Which kept the CNY devaluating all the way through the end of the year.

So they're still intervening in dollars, even though it seems on the surface like things are getting better.

And which brings us to 2017, which they now, either directly or indirectly, have encouraged or ordered local Chinese banks to start to increase their dollar borrowing through Hong Kong. And, again, that goes back to something I said earlier – to me that's a more desperate approach.

So you start out 2015 in a very passive position. 2016 you panic and the traditional textbook way, you know, you do the monetary stimulus, you do the fiscal stimulus. And none of those things really worked. The Chinese economy doesn't really accelerate. And so in 2017 they do this kind of crazy ad hoc Hong Kong workaround that, to me, sounds a lot more like Chinese officials that are increasingly desperate because the dollar issue is not a temporary condition. It's a chronic thing.

Luke: If their problem is that they're short dollars, how is the solution shorting more dollars in Hong Kong? Is that just a level of the desperation of just trying to buy some time? Am I thinking about that right?

Jeff: Yeah, you are. Again, that's – you know, when Brazil did it in 2013 I said that they're toast. Because it's insane is what it is. Because when you look at what the Brazilians did through their swap program, they essentially incentivized local Brazilian banks to go even more short the dollar into the teeth of a short squeeze. Which sounds like insanity.

But, again, the reason they did it – because Banco was in denial about the dollar problem – they thought it was a temporary issue. If you look at it from their perspective of just trying to buy time, it sort of makes sense. You think, well, I'm going to get the Brazilian banks to go more short for another year, and in a year's time this will all be something in the past. You won't have to worry about it.

Except that wasn't what happened. And as a chronic problem, you've actually made it that much worse. You've put yourself in a worse position.

And so it gets back to, I think, what we're going to talk about with you guys, is the Chinese know that they're moving in the wrong direction here. They're not moving toward a solution, they're getting deeper and deeper and deeper involved in this, because they have to. The reason I think that they have to is there is no alternative right now. There is no alternative to the dollar system. They have no choice but to participate in it, and to participate in it on the terms that are set by the dollar system itself.

And so, again, from the Chinese perspective, it's got to make you mad.

Mark: Or they can change it, can't they? I mean, maybe that's the whole point of this whole thing about, hey, we're going to denominate oil transactions in RMB going forward, and we're going to buddy up with Russia and other markets in Africa. We're going to start denominating not in dollars but in yuan.

Does this just accelerate the whole process?

Jeff: Yeah, and let's skip ahead to Slide 27 here. Accelerate, I don't know.

Erik: That was my thought exactly. From what you've said to be true, Jeff, if that was really true that they were trying to do that, then they would also be taking some steps to solve the problem that there's no alternative to the dollar. Well, look at what they're doing. They're doing everything they possibly can to try to create alternatives to conducting – oil is the biggest commodity in terms of dollar flow. I shouldn't say dollar flow – monetary amount – presently denominated in US dollars.

If the flow of oil could be persuaded by the efforts of the various nations not to be denominated in dollars, that changes the world global financial picture bigger than anything else. Because it is the most-traded and largest dollar amount commodity of anything that's traded internationally, anywhere.

Luke: If you're China, you're a net creditor to the world, with the exception of commodities. You're importing – off the top of my head I think the number is $600 billion a year in commodities, maybe it's $900 billion – it's a big number. But if you can reduce that bill for yourself by changing the terms of that trade, then it's another way you buy yourself time.

Instead of just the levers that they've been pulling since 2014, that you've highlighted so eloquently here, Jeff, if all of a sudden you have a whole second lever where you can go to Russia, or you can go to OPEC, or your copper suppliers, etc., and change the terms of trade.

We've highlighted – by looking at the gold/oil ratio, you know, if you expand the gold/oil ratio, then if you're China you can – your oil bill drops. And if your oil bill drops, your current account surplus rises. And if your current account surplus rises, then you buy yourself time in all of this.

Mark: Luke, you're exactly right. I was in Hong Kong in January, and your number's right on – $900 billion is the right number. If you go back to January of this year, everyone – and I am not exaggerating when I say everyone (except maybe the people on this phone call) – but everyone that I know thought that the RMB had to collapse. It had to devalue. Not this 2%–3%. I love when China moves their currency two or three percent, people call it devaluation. The yen moves by 40% and that's sound monetary policy.

Jeff: Right. What a world we live in.

Mark: It's just absolutely comical. And so I was at this meeting of – Merrill Lynch puts on this meeting every January and invites their biggest clients in Asia to come to Hong Kong for two days. And everybody has to give their best idea.

And it was actually an extraordinary two days. What was extraordinary to me – the range of ideas was cool. But what was really amazing is, to a person – and these are people who trade hundreds of billions if not trillions of dollars in Asia, most of them located in China, but some in Singapore and other places, in Tokyo – but they were to a person bullish on RMB and bearish dollar.

And that's how I kind of came away this year with my Ten Surprises being bearish on the dollar, and everybody thought I was an idiot. I took such grief on Twitter, and everybody ganged up on me and said I was just a dork.

Luke: I sympathize with you Mark.

Mark: That's right, you were my sole friend on Twitter.

Luke: I was right with you, Bud.

Mark: I know. And, what was amazing was these were smart people. And the point that a number of them made – and I'd love your opinion, Jeff, because you have obviously done the deepest dive on this – is they said that it really does come down to what Luke was just saying about the current account surplus. They said a strong economy – and they all said that the economy in China was much stronger than people think.

And there's this great – Li Hi Quan – I can never pronounce the guy's name – Li Hi Quan – Li Hi Quang index that Bloomberg put together. And it tracks things that they can observe. Right? They say the government's lying about their data so we're going to create our own. And they put together this thing on export prices and import prices and electricity usage and oil imports and all these things that they could track. And it actually came out that the Chinese economy was actually growing closer to 11% instead of 7%.

So they weren't lying, they were just understating. But they all said that the economy was stronger than people think, that they actually had their recession in 2015 that nobody knows about because no one's ever going to admit that we had one, and that the currency was going to be stronger, not weaker.

That just seemed like blasphemy back in January. And now we look and we see it's exactly what happened in 2017. So I want to know if you have thoughts on that.

Jeff: I want to get back to what you guys were saying about the Chinese position. If you go to Slide 27, that's exactly what they're doing. I mean, if you're between a rock and a hard place, you've got to do whatever you can. And what they've been doing this year has been, some of it, extraordinary. The thing about Hong Kong is, I think, a high-risk kind of a workaround rather than something a more well-positioned central bank might undertake.

And, again, I don't know for a fact, and nobody knows, is the PBOC directing local Chinese banks to borrow dollars through Hong Kong? I don't know. I don't think anybody knows. I think it's a fair bet that they are, probably being subsidized by forward cover in that respect.

But, regardless, what do you do if you're China? Well, one of the things you do is you try to increase the dollar supply as much as you can. So one of them is to go through Hong Kong. You try to stabilize the currency exchange to try to entice dollar suppliers back into your country.

Again, speaking to the current account thing, you want to get that hot money, which to me is a bad term, but, either way, you want to get hot money back flowing into China. So you stabilize the currency.

You also go into the Eurobond market. Last month – was it last month or the month before? – the Chinese federal government borrowed on the Eurobond market for the first time in 13 years. And it was a very minimal floatation. And the reason they did that was nothing more than to set a very low price for any Chinese corporates – hint, financial corporates – that might follow into the Eurobond market. So if you can't get money from the bank part of the segment, you go into the bond part of the Eurodollar market.

They also opened up their FICC business, or the securities business for the first time in 20 years.

Mark: That sounds like the Tesla strategy.

Jeff: Hahaha.

Erik: Now this was such a great conversation that it was hard to choose a place to cut it off, but believe it or not we're only half-way through the conversation our guests had over Jeff Snider's slide deck alone.

Here's the release schedule for the rest of the series, which was designed to give you plenty of MacroVoices content to listen to over the holidays. This first episode was released on December 24th. Part 2 will be released on December 25th, and will include the remainder of our conversation based on Jeff Snider's slide deck. Part 3 will air at our regularly scheduled Thursday timeslot on Dec. 28th, when we'll dive into Mark Yusko's slide deck and the beginning of Luke Gromen's slide deck. Then, on New Year's weekend, we'll be releasing Part 4 on Dec. 30th, where we'll wrap up our conversation about Luke Gromen's slide deck. Part 5 airs on Dec. 31st, when we'll bring all this together into some high-level conclusions about how the dollar's fall from hegemony is likely to occur, how long it will take, and what the world will look like after the dust settles. All of these first five episodes will be special episodes with no market wrap or postgame segment. Then, on Thursday evening Jan. 4th, we'll be back with our normal show format including a market wrap, and the final segment in this series where I ask all three guests how to actually manage money through this transition will air as our feature interview segment on January 4th.

This special series was originally conceived as only 2 parts, and was directly enabled by generous donations from our listeners. When we discovered that doing justice to the material would require five full hours of content, needless to say we overspent our production budget considerably. So if you're able to make a donation to help defray our production expenses this holiday season, it will be greatly appreciated and will make it possible for us to bring you even more special content in the coming year. We also urgently need your help rating and reviewing MacroVoices on iTunes, because these ratings control our ranking in the business podcast directory. To rate and review MacroVoices, simply open iTunes on your computer and click on the search box at the top right, choose Store, then type “MacroVoices” into the search box. Then click the large MacroVoices logo under the “Podcasts” heading, then click “Ratings and Reviews” to the right of our logo. If you’ve enjoyed MacroVoices, please choose 5 stars to the right of the words “Click to Rate”, then click on the “Write a Review” button just below.

We really appreciate your donations and your ratings and reviews, and all of us at MacroVoices wish you and yours a safe and happy 2017 holiday season!