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Dollar Dethroned By Red Ink

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***W**ill Congress allow President Bush to waste another year on his Iraq misadventure while serious problems overwhelm the United States?*

During 2006 while the US government focused on the deteriorating situation in Iraq, the US dollar declined sharply against many currencies. By December China's central bank was expressing its concern that the massive US trade deficit could lead to a run on the dollar and to an international financial crisis.

Since WW II the US dollar has been the world's reserve currency, the currency in which oil is billed and international trade accounts are settled.

The low US saving rate means that Washington's budget deficits must be financed by foreign lenders, who are awash in US Treasury bonds. The massive US trade deficit means that foreigners acquire US assets as payment for US consumption of goods made abroad.

Foreigners are worried about their large dollar holdings, because there is no indication that the US can reduce either deficit. The war against Iraq has run up the US budget deficit, and the practice of US corporations of producing offshore for their US markets has increased the US trade deficit. Every time a US company moves its production abroad, domestic output is turned into imports.

China has indicated that it will continue to accumulate dollars, but at a slower rate by trading some of the dollars for other currencies.

On December 18 Iran announced that it will cease to use the US dollar as reserve currency.

On December 28 United Arab Emirates, a close US ally, announced that the weakening US dollar has caused its central bank to move some of its foreign exchange reserves from dollars to Euros.

The decisions of foreign central banks to reduce the rate at which they acquire dollars implies higher US interest rates at a time when the US economy is slowing, making it difficult for the Federal Reserve to ease monetary policy and more expensive for the US to borrow.

If foreigners take the next step and begin dumping their dollar holdings, there is nothing the US government can do to avert the catastrophe. Washington must take steps before it is too late.

The only timely solution is to reduce the US budget deficit. This requires Congress to cut

spending or raise taxes or both. Raising taxes on a weakening economy is not a good idea. As entitlements (Social Security and Medicare) comprise most of nondefense spending, the easiest step for Congress to take is to stop funding Bush's pointless war. With less red ink to be financed, there would be less pressure on the dollar.

It is possible that Washington has waited too long to address the dollar problem. If 2007 brings recession to the US, the rise in the budget deficit from the loss of tax revenues could offset deficit reduction achieved by ending the war.

Many economists offer false solutions. We hear, for example, that a weaker dollar will lead to more exports and a reduction in the US trade deficit. This "solution" overlooks the impact of offshoring. With so many US brand name manufactures now produced offshore, there is less for the US to export. Some economists still believe that the gap can be filled by the export of services, but offshoring has also taken its toll on professional services. The US cannot simultaneously offshore the production of goods and services and reduce its trade deficit.

Other economists still think that the Federal Reserve can rescue the dollar by raising interest rates, thus making US Treasuries more attractive to foreigners. However, the US economy shows many signs of weakening. By stifling growth or provoking recession, higher interest rates can simply generate more red ink that must be financed by foreign borrowing, thus increasing the pressure on the dollar.

The US cannot afford the Iraq war, and it cannot afford the distraction from the serious economic problems that a war-obsessed government has permitted to accumulate. Offshoring is destroying the ladders of upward mobility that made America an opportunity society.

Economists, in their commitment to offshoring, offer "solutions" that conceal offshoring's real impact on Americans. For example, we are told that education is the solution to "America's competitiveness problem."

People who advance the education solution are obviously unfamiliar with the character of US job growth in the 21st century and with the Bureau of Labor Statistics' predictions of the areas of job growth over the next decade.

The problem America faces is not a lack of educated people, but a lack of jobs for educated people. In the 21st century, the US economy has been able to create net new jobs only in domestic services, such as waitresses, bartenders and health and social services. The vast majority of these jobs do not require a college education, and they do not produce tradable goods and services that could be exported or substituted for imports. Income inequality is worsening as CEO pay soars while median income stagnates.
This new year will be the fifth year that the American people will have let President Bush commit their country to an illegitimate war that cannot be won. Will the US extract itself from Bush's misadventure and address its real problems, or will the dollar's decline bring new economic hardships?

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