

We Are the World—Darn It!

By John Tuccillo, PhD

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The fact is that the dollar has fallen by over thirty percent against the Euro is of interest to more people than just those traveling to Europe this year. The weaker dollar and the reasons for it are crucial to the fortunes of the entire U.S. economy. In brief, the weaker dollar will push up interest rates, increase inflation and reduce economic growth.

Let's start with the reasons why the dollar is weak. Because the United States has grown faster than the rest of the world and because we have outsourced manufacturing and assembly functions, Americans are buying far more goods from the rest of the world than we are selling. In February, for example, we bought \$2 worth of goods for every dollar's worth we sold. We make up the difference by asking other countries to accept our markers (We call them dollars and Treasury securities, but they're nothing more than IOUs). This creates an excess supply of dollars and reduces their value.

A similar process has resulted from our large and persistent Federal budget deficit. Right now, our borrowing needs resulting from these dual deficits—trade and budget—are soaking up nearly 80 percent of the world's savings. If you presented the financial accounts of the United States in ratio form—with all potential size and name identifiers removed—we would look very much like what we have derisively termed “banana republics”.

The consequences of this situation are straightforward and ugly. As we try to float more securities, we must pay foreigners—who currently hold a third of all Treasury debt (China alone holds \$600 billion)—more to hold them. That means higher interest rates in all markets, including sectors like real estate which live and die on rate levels. Higher rates increase the cost of doing business and reduce investment and employment growth.

A weaker dollar also means higher oil prices. By international convention, oil prices are denominated in dollars. If the purchasing power of the dollar falls, oil producers actually receive less for their product and they will be inclined to increase prices. This again has a negative impact on American economic growth.

The weakened dollar will act as a brake on economic growth and the trade and budget deficits will continue to weaken the dollar. In addition, if foreign holders of dollars begin to diversify their foreign exchange holding by switching from dollars to Euros (as the Prime Minister of Japan has recently suggested), then the dollar will go into free fall and the U.S. economy will nosedive as well. This unlikely but nightmarish scenario is guaranteed to keep anyone up at night.

But it's not only the direct effects of our financial exposure that hurt us. The presence of billions of dollars in the hands of other governments can be as potent a weapon of mass destruction as any armament. Without the debt, we probably would have thought twice about lifting textile quotas with China. With their holding of our debt, this was impossible. The upshot is that 70,000 U.S. jobs are in danger. This same reasoning can be applied to our relationships with any of our creditors. We are hamstrung in the execution of our foreign policy.

It seems like a long time ago when we could either safely ignore what was happening in the rest of the world's economies, or be pleased by the performance of the American economy in the world. In fact, as recently as the Nineties, the trade deficit was relatively small and the Federal budget was in surplus. It is now our fate to be tied tightly to the rest of the world and to be moving rapidly into a subordinate position in the world economy.

What to do? At the very least you need to be very conscious of the fate of the dollar. Pay attention to the monthly reports on the trade deficit. And, oh yeah, write Congress and tell them to stop the bleeding!