The US Dollar: The Long Farewell?

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China pays heavily for not dumping dollar

> It's just straws in the wind so far. India's Ministry of Culture announces that foreign tourists can no longer pay in dollars when visiting the Taj Mahal and other heritage sites; they have to pay in good, hard rupees.

Iran and Venezuela call for a joint OPEC statement on the weak U.S. dollar, and Saudi Arabian Foreign Affairs Minister Saud Al-Faisal warns that any public reference to the U.S. dollar's problems could cause the troubled currency to "collapse". Rap star Jay-Z's latest video shows our hero flashing a wad of euros, not dollars.

Only straws in the wind, but all in the past couple of weeks. For the majority of Americans who do not travel abroad, the only visible effect so far of the dollar's steep fall has been higher fuel prices at the pump. The Chinese imports that fill the big-box stores still cost the same, because the Chinese yuan is still pegged to the American dollar. But that may be about to change, along with many other things.

At the beginning of 2003, one euro bought one US dollar. Eighteen months ago, it bought $1.20. Now it is pushing $1.50, and there is no reason to think that it will stop there. Three of the world's biggest oil exporters, Iran, Venezuela and Russia, are demanding payment in euros rather than U.S. dollars. Last week a Chinese central bank vice-director, Xu Jian, gave voice to the suspicion of many others, saying that the U.S. dollar was "losing its status as the world currency."

If that happens, then America loses a great deal. Other countries have to maintain large reserves of foreign currencies - most of which they keep in U.S. dollars - to cover their foreign debts, but the United States can pay its huge foreign debts in its own money. If necessary, it can just print more dollars. Having their own money as the world's reserve currency confers advantages that Americans would miss if they lost them.

The main reason for the collapse of the U.S. dollar is President George W. Bush's attempt to fight expensive foreign wars while cutting taxes at home. This involved deficit financing on a very large scale, and inevitably the value of the dollar began to fall - slowly at first, but with increasing speed as it became clear that the White House did not care. "Ronald Reagan proved that deficits don't matter," as Vice President Dick Cheney told then-Treasury Secretary Paul O'Neill. But they do matter to foreigners.

As the U.S. dollar fell in value, the price of oil (which is usually calculated in dollars) rose to compensate for it, but there was no comparable adjustment for foreign central banks that had huge amounts of U.S. dollars in their reserves. China, which was sitting on about a trillion U.S. dollars, simply lost several hundred billion as the currency's value fell. So various central banks started wondering if they should diversify their reserves, and some acted on it.

The downward pressure on the dollar will continue, because the United States is currently borrowing 6 percent of its Gross Domestic Product from foreigners each year to cover its trade deficit. Foreign banks were happy to go on lending so long as they had faith in the integrity of U.S. financial institutions, but that has been hit hard by the sub-prime mortgage crisis. Besides, other markets, notably China and India, now offer a better return - and Congress's resistance to foreign takeover bids, combined with tighter visa restrictions, make the U.S. a less welcoming place for foreign investors.

Above all, there are now alternatives to the U.S. dollar. The last time it faced a comparable crisis was in 1971, when a different Republican president was trying to run another unpopular war without raising taxes. Richard Nixon devalued the U.S. dollar and demolished the Bretton Woods system that had fixed all other currencies in relation to the dollar, inaugurating the current era of floating exchange rates.

There was no other candidate then for the role of global reserve currency, so the dollar stayed at the center of the system despite all the turbulence. This time, by contrast, there is the euro, the currency of an economic zone just as big as the United States, with the Chinese currency as a possible long-term rival. But nothing is likely to happen very fast.

The last time the world went through a change like this, it took over 40 years to complete. Before World War I, the British pound reigned supreme, accounting for 64 percent of the world's currency reserves and 60 percent of all international trade. Britain then impoverished itself in two world wars, but the U.S. dollar did not fully replace the pound until the 1950s.

Today the U.S. dollar accounts for 70 percent of both international trade and currency reserves, but it is probably starting down the same road. Many countries are replacing part of their dollar reserves with a basket of other currencies, and those who have pegged their currency to the dollar are starting to cut loose from it: Kuwait has already done so, and the United Arab Emirates is actively considering it. If China unpegs, things will move a lot faster, but in any case the long farewell of the U.S. dollar has begun.

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