The Fall of the Almighty Dollar

By William R. Polk

A secret ceases to be a secret if it is once confided, wrote the American humorist known as Josh Billings, "it is like a dollar bill, once broken, it is never a dollar again." Breaking the dollar is what is now happening on a grand scale.

What has happened? What does it mean to people in America and Europe? And what is likely to happen now? These are questions everyone is asking.

What has happened is simply that the dollar has fallen by about a third of its value in terms of the Euro in the last six months. Just before the turn of the year, before the invasion of Iraq, the dollar was trading at 1.12 Euros. Today it is about 0.87 Euros.

What caused the fall? Economists tell us that it resulted from two events. First of all, the Bush administration began to spend a great deal more money. The initial cost of the invasion of Iraq was $67 billion and no one expects that to be the final cost. Estimates go up to four or five times that amount.

The second event was the determination of the Bush administration to cut taxes. Even before the war, it pushed through Congress legislation for a $1.3 trillion ten-year tax reduction. Everyone likes to hear that taxes are being cut and most people believe that government is wasteful; so the action was very popular. It then proposed and began organizing support for further cuts aggregating over $726 billion.

What was important was not just the amount of the tax reduction – that is the income of the Federal government – massive though that was, but also the "shape" of the tax program. The most controversial aspects of the bills was the reduction of taxes on corporate dividends and capital gains. These measures obviously favored the wealthy and particularly Bush's major supporters. Of course, the administration could not justify the cuts on this basis; its argument was that by cutting taxes so drastically, business would be stimulated and new jobs would be created.

Creating new jobs is crucial to winning the next presidential election in November 2004. The unemployment rate is now, by American standards, high and is growing. The official figure is 6% of the work force without jobs; however, that figure does not count people who have given up trying to find jobs.

The statistics do not give the whole picture. It is not just that relatively poor "blue collar" workers are out of luck, but that the middle class is now deeply affected. As various huge corporations have made massive cuts in their employees or have gone out of business, thousands of previously affluent "white collar" men and women have lost their income. This, in turn, has impacted on their ability to pay the upkeep of mortgages on houses, the financing of cars and the schooling of their children. Many cases have been reported of highly skilled engineers who had made $300,000 a year suddenly finding themselves with no income at all. That has produced not only an economic shock but also a psychological shock: suddenly the future seemed to them to be bleak and dangerous. People stopped buying new cars, refrigerators and houses. That, in turn, caused the businesses making all these consumer items to lay off their workers. And so the economy plunged.

President Bush's answer turns out not to be an answer: the way his administration has divided up the benefits of a cut in taxes, only the very rich will benefit. The government agency with the most direct knowledge of what people are actually earning, the Internal Revenue Service, reports that about 70% of the American workers will not benefit from the cuts while the highest paid executives, the top three men in each of the 100 largest American corporations, will each get about $500,000 in reduced taxes.

Depending on how you look at it, this may be a political problem or even a moral problem, but regardless of that, economists point out that the way the tax reduction will operate will not do much about the economic slump. The reason is simply that the very wealthy are unlikely to spend more on the products of the industry; if they already have two refrigerators and three cars, they are unlikely to rush out to buy another. Rather, the "windfall" they get, they are likely to save. While saving may be a virtue, it does not stimulate the economy.

It is the lower 70% who will not benefit or even the lower 90% who will benefit but little who should be encouraged because they are more likely to buy more goods and services and so, in turn, create new jobs. Unfortunately, they will not be encouraged by the shape of the tax cut since they will not have more expendable income.

Consequently, economists warn that the tax incentive package will not halt the downward trend in the American economy, and, taking their cue from this estimate, most prudent and well-informed investors expect that the economy will not perform well for months or perhaps even years to come. Evaluating the risks versus the rewards and despite incentives like the current low rate of interest set by the American central bank, the Federal Reserve Board, many corporations and individuals are not investing in ways that create new jobs or even not investing at all.

This disquiet among investors shows up in another statistic: the notes issued by the United States Treasury, that is the most basic and presumably the safest form of investment in America, fell early this month to the lowest yield in the last 45 years, only 3.52%. High risk obligations by companies, the so-called "junk bonds," fell even more drastically. Because they are risky, they were yielding nearly 12.3% last fall and are now down about a quarter to less than 9%.

Uncertainty itself breeds fear and fear causes economic slow-down. As President Franklin Roosevelt memorably encouraged Americans in that other great Depression in the 1930s, "we have nothing to fear, but fear itself." He was whistling against the wind: in fact, despite all the government did to stimulate the economy, America did not pull out of that depression until the beginning of World War II.

Some worried Americans and Europeans today fear that, taking the lesson that war is itself a powerful economic incentive, the Bush administration proposes to use the occupation of Iraq, where billions of dollars worth of reconstruction contracts are beginning to be passed out, and, more directly, other campaigns like Afghanistan and Iraq, perhaps in Syria, Iran, North Korea and elsewhere, to snap America out of its economic doldrums.

So what does the economic plight of America means to people in America and Europe?

In America, it certainly means a decline in material living standards. In the attempt to stave off crises caused by fiscal shortfalls, cities and states across America are cutting back on social services that have become so "normal" as to seem a civic right. Budgets for even essential services like fire fighting and police have been slashed. In some districts, prisoners have been let out of jail when the authorities did not have the money to keep them incarcerated. School budgets and public health facilities, already regarded by many as woefully inadequate, are under great pressure. And, with the decline in revenue of the Federal government, local and state governments can expect little or no help from it.

But short of creating massive unrest, the governments of the cities, states and the nation dare not push the cuts in services too deeply. No prudent politician will stake his career on what the numbers tell him he should do. He will almost certainly keep doing what the public demands regardless of the cost. Thus a recent study by the investment banking firm of Goldman Sachs projected deficits over the coming ten years of from $4.2 trillion to $6.7 trillion.

Bad news. But not the worst. That comes with the combination of lower government revenues and the aging of the population. As more and more Americans retire, they will expect – indeed demand – the benefits for which they have worked and to which they have contributed, Social Security and the Federal health insurance program known as Medicare. These so-called "unfunded benefit promises" will add up a decade from now to a staggering $25 trillion. While these sums are beyond the imagination of most of us, they come home in a simple figure: meeting them will require a rise in average individual payroll taxes far beyond any we have experienced since, at least, World War II. That is a tax about double the average even before the recent tax cuts.

Burdens of this magnitude will also limit the ability of the government to respond to shorter-term fiscal needs, will make the economy less able to devote funds to the creation of new industry and will cause long-term deprivation in basic investment in education and health.

So what difference does all this make to Europeans?

One difference is already clear. The value of the Euro has risen dramatically – nearly a third – in terms of the dollar. Currency traders have publicly proclaimed that the fall of the dollar has not ended. Some project a decline to just over half what the dollar was worth last year.

For a few Europeans, this will be good news. A Spaniard or a German planning a vacation in America will find it cheaper today than it has been for many years. His Euro will buy a third or a more than it did last year. And, as prices fall for American goods and services, it may do considerably better.

But, for most Europeans, the news is not good. American tourists will tend to stay in America. So hotels, airlines, restaurants, festivals and many other businesses depending on the millions of Americans who visited Europe every summer will be adversely affected. And, European products will become correspondingly more expensive for foreign buyers. A Volkswagen, Fiat or Seat that sold for the dollar equivalent of, say, 20,000 Euros – roughly $18,000 dollars last year -- will probably cost $22,000, or perhaps eventually, even $25,000 to $30,000. Inevitably, at least some Americans will either not delay buying a car or will try to find a domestic equivalent. So Europe will lose jobs as its goods and services become unattractively expensive.

Finally, what is likely to happen now?

Last month, a group of senior, experienced and highly respected Americans of both political parties made an urgent plea to President Bush and the Congress to reverse the current course of policy. The group included three former senators, two former cabinet secretaries and the former chairman of the Federal Reserve Board. But, they showed little hope that their advice would be taken: while they urged "fiscal responsibility," they limply said that if the administration and the Congress "decides it must approve a tax cut," it should do the minimum and should recognized that even that would "risk creating an insupportable tax burden for the next generation."

There seems little likelihood either that the American public will perceive the danger any time soon or that the Bush administration will heed the warning. I think we all can expect a very difficult time ahead.