Who Owns the Dollar?

Our currency and our economy are held hostage by Asia.

By Paul Craig Roberts

CHINA IS THE LEADING scapegoat for America's economic ills. On May 20, *New York Times* columnist Paul Krugman blamed China for the U.S. housing bubble. If only China were not lending us so much money, mortgage rates would be higher, forestalling a housing bubble. Krugman says China is a poor country and should be investing its capital at home, not lending it to the U.S.

Krugman could just as well have said, "If only U.S. manufacturers produced in America instead of outsourcing to China, the Chinese would not have any money to lend us. Thus, no housing bubble."

Krugman is correct that if foreign lending to the U.S. slows, interest rates will rise, putting a speculative housing market in trouble. But the interest of the U.S.-China relationship goes far beyond the effect on the U.S. housing market. Economists set in traditional ways of thinking miss the really important aspects of the relationship.

For example, Krugman notes that China is a poor country and is slowing its own development by lending to the U.S. We do think of China as a Third World country with large supplies of underemployed labor. China's trade relationship with the U.S., however, suggests the opposite. The U.S. trade deficit with China is larger than with any other country, including highly industrialized ones such as Japan and Germany. Think of all those Toyotas, Hondas, Nissans, office machines, and video games that Americans buy from Japan. Yet in the first quarter of this year, the U.S. trade deficit with China is running 50 percent larger than the deficit with Japan. Indeed, the U.S. trade deficit with China is larger than the deficit with all of Europe. It is larger than with Canada and Mexico combined, two countries in which U.S. corporations manufacture cars, appliances, and a variety of big-ticket items for American markets.

What are Americans buying from China? With China a poor country and the U.S. a First World superpower, you would think China would have a trade deficit as a result of selling us cheap goods and importing high value-added manufactured goods. Instead, it is the other way around. The U.S. is dependent on China for manufactured goods, including advanced technology products. In the first quarter of 2005, U.S. imports from China are 5.7 times higher than U.S. exports to China. Last year, U.S. exports to China were $34.7 billion. Imports were $196.7 billion for a U.S. trade deficit with China of $162 billion.

It was not always this way. In 1985, U.S. trade with China was in balance at $3.8 billion. Ten years later, U.S. imports from China were four times U.S. exports to China.

The U.S.-China economic relationship is a highly unusual one between a First World and a Third World country. Moreover, the U.S. trade deficit with China in manufactured goods and advanced technology products is growing rapidly. What explains the U.S. dependence on a poor country for First World products?

The answer, and the key to China's rapid development, is that corporations in First World countries—American businesses chief among them—use China as an offshore location where they produce for their home markets. More than half of U.S. imports from China, and as much as 70 percent from some of China's coastal regions, represent offshore production by American firms for U.S. markets.

What economists overlook is that when we speak of the Chinese economy, we are speaking in large part of the relocation of American manufacturing to China. Those millions of lost domestic manufacturing jobs were not lost. They were moved. The jobs still exist, only they are not filled by Americans.

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In a world where capital and technology are highly mobile internationally, these critical factors of production flow to countries with the lowest cost of labor. China has attracted manufacturing, and India has attracted professional services. This has left the American work force with job growth only in lower-paid domestic services, which provide no export earnings.

The rapid transformations that have occurred in some Indian cities, which have become high-tech centers, and along the coast of China are unprecedented in economic history. The changes are so rapid because they are driven by the relocation of First World businesses seeking the lowest labor cost.

Economics relies on automatic adjustments to rectify trade imbalances. The trade deficit with China should cause the Chinese currency to appreciate relative to the dollar, raising the dollar cost of Chinese labor. In the long run—in which, J.M. Keynes said, "we are all dead"—adjustments would occur until U.S. and Chinese wage rates and living standards equalized.

Considering the disparity between American and Chinese wage rates and living standards, the adjustment would be extremely painful for Americans. But the adjustment is forestalled by two factors.

China keeps its currency pegged to the dollar, so when the dollar falls, the Chinese currency falls with it and there is no adjustment. China does not permit its currency to be traded, and there is not enough of it in international markets for currency speculators to be able to force the Chinese off the peg.

The other factor is the dollar's role as world reserve currency. The reserve-currency role means that every country has a demand for dollars in order to pay its oil bills and settle its international accounts. The world demand means that the U.S. can run large deficits for many years before the chickens come home to roost.

In the meantime, Asian countries are accumulating hundreds of billions in dollar assets, making them America's bankers. Industrially developed countries such as Japan, Taiwan, and South Korea have little need to use the dollars that they earn from their trade surpluses with the U.S. to import American capital goods to fuel their further development. They use the dollars that we pay them for their goods to purchase U.S. government bonds and American companies, real estate, and corporate bonds.

China, which has been growing at about 10 percent annually for a number of years, could conceivably use its export surplus with the U.S. to expand its infrastructure more rapidly in order to develop even more quickly. But a 10 percent annual growth rate is probably the highest rate of change with which China wants to contend. As First World firms are flooding China with their capital and technology, China doesn't need to use its trade surplus with the U.S. to purchase capital goods.

OFFSHORE OUTSOURCING MAKES IT IMPOSSIBLE FOR THE U.S. TO **RECTIFY ITS TRADE IMBALANCE** THROUGH EXPORTS.

As a result of many years of persistent trade surpluses with the United States, the Japanese government holds dollar reserves of approximately $1 trillion. China's accumulation of dollars is approximately $600 billion. South Korea holds about $200 billion.

These sums give these countries enormous leverage over the United States. By dumping some portion of their reserves, these countries could put the dollar under intense pressure and send U.S. interest rates skyrocketing. Washington would really have to anger Japan and Korea to provoke such action, but in a showdown with China—over Taiwan, for example—China holds the cards. China and Japan, and the world at large, have more dollar reserves than they require. They would have no problem teaching a hegemonic superpower a lesson if the need arose.

Last year the U.S. trade deficit with the rest of the world was $617 billion. In the first quarter of this year, our trade deficit is $174 billion—$35 billion higher than in the first quarter of last year. If this figure holds for the remaining three quarters and does not increase, the U.S. trade deficit in 2005 will be $700 billion.

Offshore outsourcing makes it impossible for the U.S. to rectify its trade imbalance through exports. As more and more of the production of goods and services for U.S. markets moves offshore, we have less capability to boost our exports, and the trade deficit automatically widens. Economic catastrophe at some point in the future seems assured.

In the meantime, even a small country could pop the U.S. housing bubble by dumping dollar reserves—which is some fix for a superpower to be in, especially one that is disdainful of the opinion of the rest of the world. Comeuppance can't be far away.

The hardest blow on Americans will fall when China does revalue its currency. When China's currency ceases to be undervalued, American shoppers in Wal-Mart, where 70 percent of the goods on the shelves are made in China, will think they are in Neiman Marcus. Price increases will cause a dramatic reduction in American real incomes. If this coincides with rising interest rates and a setback in the housing market, American consumers will experience the hardest times since the Great Depression. ■

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Israel's Demographic Dilemma

Immigration and birthrates may redefine the Jewish state.

By Leon Hadar

TEL AVIV—They are Hebrew-speaking Israeli citizens who wave the national flag bearing the six-point Star of David. They sing the national anthem that celebrates the return of the Jewish people to their historic homeland. Their kids attend Hebrew public schools and after graduation serve in the Israeli Defense Force. They are proud Israelis who seem an integral part of Hebrew culture and, unlike many Arab citizens of Israel, they don't have any ambivalent feelings about Israeli identity. They are Israeli patriots who love their country and are willing to die for it.

But these Israeli Hebrews are not Jewish. In fact, they are observant Catholics, members of what the Vatican calls the "Hebrew-Speaking Catholic community in Israel." Indeed, recognizing the significance of this small but growing community of Catholics, the late John Paul II announced in 2003 that he was placing beside the Latin patriarch of Jerusalem, Michel Sabbah, an auxiliary bishop with a special task of "the pastoral care of the Catholic faithful of Jewish expression" living in Israel. Jean-Baptiste Gourion, who was ordained as the new bishop at the Catholic Church in Kiryat Ye'arim near Jerusalem, is a converted Sephardic Jew who was born in Algeria, received baptism at the age of 24, became a Benedictine monk, and moved to Israel in 1976. Since 1990, he has been responsible for the pastoral care of the Hebrew Catholics.

The appointment of Father Gourion ("lion cub" in Hebrew) as a Hebrew-speaking Catholic bishop in Israel is certainly a milestone, considering that since the middle of the second century, no Hebrew Catholic was named a Bishop of Jerusalem. The move ignited opposition among some Catholics who suspected that it was part of a strategy, backed by Israel and its allies in the Vatican, to divide the Church in the Holy Land into two parts, denying its predominantly Arab character and weakening Patriarch Sabbah, an Arab who has been an ardent champion of the Palestinian cause and who resisted the idea of creating within Israel a separate church for Israel's Hebrew-speaking Catholics.

When John Paul II decided to create a special ecclesiastical jurisdiction for the Hebrew Catholics, displeasing Sabbah and other opponents, he was taking the side of one of the leading figures in the debate, Franciscan Fr. David-Maria Jaeger. Jaeger is a canon lawyer who was born to Jewish parents in Tel Aviv and after converting to Christianity became a Catholic priest. In addition to being a spokesman for the Franciscans who govern the holy sites in Jerusalem, he was a lead Vatican negotiator for the historic 1994 agreement between the Holy See and Israel.

Jaeger has been one the first Catholic figures to recognize the dramatic demographic changes that have taken place in Israeli society in recent years, during which as many as 500,000 non-Jews, most of them Christians, have settled in Israel. Most are immigrants from the former Soviet Union, mainly Russia and Ukraine, while others include guest workers from countries like Poland and the Philippines.

Hence, at a time when the number of Christians has fallen sharply in the Holy Land—from 10 percent of the population of the area between the Jordan River and the Mediterranean a century ago to less than 2 percent today (130,000 in Israel and 50,000 in Palestine)—Jaeger and other Catholic leaders have concluded that the Jewish state could become a source of Christian salvation.

Consider the irony: since 1989, more than a million Russian and Ukrainian immigrants have arrived in Israel in what Jews call *aliyah*, the ascent to the Promised Land, with Israeli leaders hoping that the newcomers would help balance the demographic pressure of the rising Arab population on the Jewish state. Similarly, many businesses have imported close to 500,000 guest workers from as far away as China as part of an effort to replace Palestinian workers from the West Bank and Gaza. Now many of these non-Jewish New Israelis could help the Vatican and other Christian denominations contain the demographic pressure that the growing Muslim population is placing on a shrinking Christian community in the Holy Land. God, as they say, works in mysterious ways.

One of the main reasons the Vatican is raising its profile inside Israel is the recognition that many the newcomers from Russia and Ukraine are Orthodox Christians. "This has created an unforeseen opportunity for the initiative of the Catholic Church, which has hastened to send a dozen Russian-speaking and Ukrainian-speaking priests into this new area of evangelization, right in the