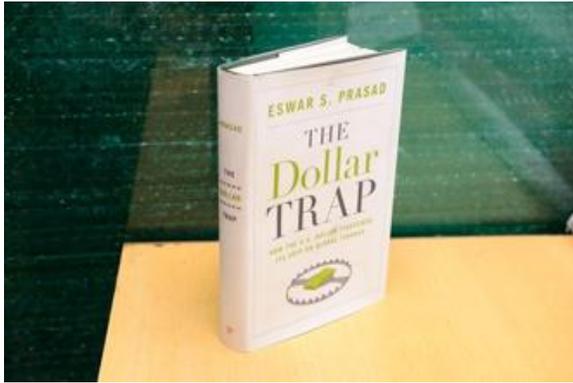


The exorbitant privilege of being Uncle Sam

The increasing clout for the greenback during economic distress continues to distinguish the dollar as the world's reserve currency



Eswar S. Prasad, a professor at Cornell University, explores the intriguing phenomenon of clamour for the dollar in his latest book *The Dollar Trap*.

The economic crisis that originated in the US in 2008 and later spread its tentacles through the world should have led risk-averse investors out of the world's largest economy. This, in turn, should have caused borrowing costs of the US government to increase and the dollar to depreciate. But, quite remarkably, that's not how things turned out. As the crisis worsened, US treasury rates got pummelled even as the corporate bond market froze and private borrowing costs in general rose. The US dollar appreciated as a wave of capital flowed to the US in search of safety.

The fall in Uncle Sam's borrowing costs, and the concomitant appreciation of the dollar, following a crisis of such enormous magnitude comes to be even more surprising given the shape of the country's public finance—US public debt has now grown larger than the country's gross domestic product.

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To be clear, the dollar has experienced a gradual depreciation in recent decades against major currencies—most notably the Chinese yuan. This is explained largely by the increasing difference in productivity as the developing world catches up with the US (not to forget the country's own economic follies). Yet, the increasing clout for the greenback during times of economic distress continues to distinguish the dollar with the unique status of the world's primary reserve currency.

While the US economic track record in recent times has been nothing to write home about, competitors vying to take the place of the dollar are a long way from achieving the status of the dollar. In other words, the developing world—and the emerging markets in particular—may be experiencing impressive growth, but achieving the status of reserve currency requires a different set of merits.

A feature that differentiates the US from other major economies, Prasad argues, is the country's sound institutional framework that imbues confidence in investors. This explains the capacity of the US government to borrow in enormous amounts from domestic as well as foreign lenders. Ironically, the lack elsewhere of a large, liquid debt market like the US further reinforces the dollar's pre-eminent role in international finance and supports frivolous borrowing habits of the US government.

China's role in this picture is crucial. The country holds dollar reserves worth trillions and has funded the US government's profligate ways for years now. Prasad argues it may not make much economic sense for China or any other country with significant holdings to dump US treasuries as the chances of a sharp drop in price and resultant loss are substantial. The lack of alternative investments too could stop China from dumping US treasuries. But that's hardly any consolation, as in the event of a loss of confidence, China would have no option but to diversify its dollar holdings.

Also, the US may not have it good for too long if the country does not rein in its looming public debt. Both domestic and foreign investors may grow weary, leading to higher rates and potential turmoil in the future. That brings us to the role that the US Federal Reserve has played in financing the US government's debt since the onset of the crisis—in 2013, the Fed's purchase of treasuries was 150% higher than that of foreigners. The bond-buying programme has helped keep treasury rates low and saved the government from the headache of funding its deficit.

If the recent reaction to the taper of the Federal Reserve's bond-buying programme is anything to go by, with investors scurrying back to the US in search of higher yields, it seems like investors still consider the US government a safe bet. But as with any "black swan" event, when fundamentals start to falter, even things that seem "too big to fail" could eventually come crashing down.

Prashanth Perumal is Assistant Editor (Views) at Mint. Comments are welcome at views@livemint.com