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The dollar's dominance will continue

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Eswar S Prasad, Author, The Dollar Trap: How The U.S. Dollar tightened its grip on global finance Ralph Alswang

Cornell economist Eswar Prasad explains why the currency is still strong and what it means for global finance

Economist Eswar S Prasad is the Tolani Senior Professor of Trade Policy at Cornell University. He was previously head of the China Division of the IMF. In his recent book, *The Dollar Trap* (Penguin Portfolio), Prasad looks at how the US currency came to have a central role in the world economy and argues that it will remain the cornerstone for global finance for some time to come. In an e-interview, Prasad — an alumnus of Vivekananda College, Chennai, and a PhD from the University of Chicago — explains how the dollar has emerged resurgent despite challenges. Excerpts:

The dollar strengthened when the US and global financial systems were on the verge of collapse in 2008. Could you explain this paradox?

The financial crisis has strengthened the prominence of the US dollar and, specifically US government securities, as a safe haven to protect the value of investments, especially during times of financial market turmoil.

It comes down to shifts in the demand for and supply of financial safe assets —investments that at least protect investors' principal and are relatively liquid. The demand for such assets has risen since the financial crisis even as supply has shrunk.

Emerging market economies have a strong incentive to accumulate more foreign exchange reserves to insulate themselves from volatile capital flows. Regulatory reforms that require financial institutions to hold larger buffers of safe and liquid assets are adding to this demand.

While the demand has risen, the supply of safe assets has shrunk. Private sector securities and government bonds of other traditional safe haven economies like Japan and the euro zone look less safe. With its deep financial markets and rising public debt, the US government has become the primary global provider of safe assets.

And the Euro crisis further enhanced the dollar's dominance...

In the aftermath of the euro zone debt crisis, euro zone government bonds look a lot shakier as the countries in the zone contend with weak growth prospects and sharply higher debt burdens. This has substantially weakened the euro's prospects of matching the dollar's role in global finance. Moreover, it substantially increased the perceptions of risk in the global financial system, increasing the demand for safety from both private and official investors.

It is a singular paradox that investors turn to US government debt as a safe haven even when the US is itself the source of financial turmoil. When the US Federal Reserve engaged in quantitative easing — flooding the financial system with dollars — capital flowed to emerging markets, fuelling inflation and asset bubbles in those economies.

The hint of a tapering of quantitative easing sucked money out of emerging markets in anticipation of rising US interest rates.

Thus, in effect, foreign central banks are storing money in the US partly to protect themselves from the spillover effects of US policies!

What ails the Euro?

The euro's share of global foreign exchange reserves rose sharply in the first five years after its inception but then the share levelled off. The euro faltered in its rise as it turned out that euro zone financial markets are less deep and liquid than those of the US.

Moreover, the euro zone debt crisis revealed that the zone is only part way towards becoming a true economic union. To punch at its true weight, the euro zone needs to go beyond monetary union to having more unified fiscal, banking, and regulatory systems.

How does this dominance of dollar influence US economy?

The dollar's status as the dominant reserve currency is a mixed blessing for the US. The US has for a long been able to borrow cheaply from the rest of the world to finance its consumer spending and budget deficits. Foreign investors' eagerness to buy US government debt has kept interest rates low, which translates into cheaper mortgages and consumer loans. But low rates also reduce discipline on US fiscal policies and fuel financial market shenanigans built on cheap borrowing. This contributed to the financial crisis. The recent strength of the dollar against other currencies has held back US exports and job growth.

What is the future of countries signing bilateral agreements to settle trade transactions in their own currencies rather than the dollar?

The dollar's roles as a unit of account (for denominating transactions across countries) and medium of exchange (for settling payments on those transactions) are likely to erode over time. Oil and the other commodities have for a long been priced and traded almost exclusively in dollars as it was by far the most widely-traded currency. This situation is unlikely to persist. Financial market and technological development are making it easier to conduct cross-border financial transactions using other currency pairs, reducing the need for the dollar. Countries such as China, South Korea and Japan have signed currency pacts that will allow them to trade with each other using their own currencies.

By contrast, the dollar's position as the predominant store of value in the world is secure. US financial assets remain the preferred destination for investors interested in safekeeping of their investments.

Your preface says the fear of a collapse of the global financial system may make the equilibrium stable, and you leave it to the reader to judge whether this conclusion is comforting or not. What's your personal take?

The present system is certainly not the system one would design if starting with a blank slate. An ideal system should feature multiple major currencies, with no dominant one. Even the notion of a reserve currency might then be irrelevant if major economies, including emerging markets, had sound financial systems and good economic policies. But now all countries have a strong incentive to protect the dollar-centric global financial system, much as they dislike it, because the alternative could be chaos. Other advanced economies look weak and emerging market economies have underdeveloped financial systems.

The dollar's continued prominence is ultimately less a parable about American exceptionalism than about weaknesses in the rest of the world and deep problems in the structure of the global monetary system. Until those deeper structural problems are fixed, it might, in fact, be a blessing at a time of crisis to have a central bank like the Federal Reserve that everyone trusts and can provide massive amounts of liquidity in a currency that is easily accepted worldwide.

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