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Book Notes: The Dollar Trap, by Eswar S Prasad

A lively and compelling analysis on currency wars in the wake of the financial crisis – and the likely persistence of the US dollar as the world's pre-eminent currency.

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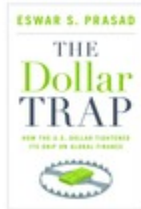

Eswar S Prasad, **The dollar trap: how the US dollar tightened its grip on global finance**, Princeton University Press, 2014, pages xix + 408.

Eswar Prasad, a Cornell University academic who has worked in the research department and as head of the China division at the International Monetary Fund, has written a lively and compelling analysis on currency wars in the wake of the financial crisis – and the likely persistence of the US dollar as the world's pre-eminent currency.

The fundamental theme is that the world financial system requires a safe asset and the US is uniquely equipped to provide it. Even doubts about the continued US position (because of fiscal worries) paradoxically create an uncertainty in which demand for the fixed asset increases further. US authorities can pursue policies that increase instability elsewhere, as cheap money pushes capital inflows into emerging markets and fuels commodity booms. The equilibrium that produced the dollar's pre-eminence is thus stable and self-reinforcing, but it is suboptimal. So, Prasad concludes the "dollar trap has become a protective, but prickly cocoon for a troubled world".

Prasad also investigates alternatives to a dollar-focused world, including gold, non-state currencies such as Bitcoin, and other currencies such as the euro and the renminbi. The verdict is appropriately sceptical. He also gives an interesting account of the extent of Chinese frustration with the dollar trap, and of efforts to internationalise the renminbi and create alternatives to the IMF. The narrative thus provides the background to the July 2014 creation of a new development bank, whose origins were prepared at a Brics (Brazil, Russia, India, China and South Africa) summit held in Durban, South Africa, in March 2013.

The discussion of the book is cast largely in terms of the pre-crisis debate, which developed around global imbalances in the 2000s: were they the consequence of Fed chairman Ben Bernanke's "global savings glut" or the result of an inappropriate mix of monetary and fiscal

policies in the large industrial countries, above all in the US? What was the responsibility of the surplus countries and, in particular, were they manipulating their currencies?

One of the most intriguing stories is the inside account of how the IMF tried to deal with China's currency policy, and of its decision in June 2007 to introduce new procedures for monitoring exchange-rate policies, as pushed by the US, which sparked a bitter Chinese reaction (and ended with a retreat on the part of the IMF). This incident combined with the story of the disintegration of G-20 co-operation after the highpoint of the April 2009 London Summit highlights the difficulties involved in international monetary co-operation. By the time of the 2011 meeting in Seoul, there were deep divisions, and Germany lined up with China in a rejection of a clumsy US move to set caps on current account surpluses.

Meanwhile, French efforts to reform the Special Drawing Rights so as to include the renminbi also ran into the sand. It is difficult to read Prasad's narrative and think that international co-operation really works well.

Policy reforms set out in the book to make the international system more robust or fairer (it is not quite clear which objective is more important to Prasad) include a more formal mechanism than which exists at present to consider spillovers of monetary policy and the development of an insurance scheme to offer a better substitute to self-insurance via reserve accumulation.

Both alternatives are worth thinking about. But the first one has really been at the centre of discussions of international monetary reform since the collapse of the par value system in the early 1970s, and the long history of the debate would suggest the problem is basically intractable.

Central banks in large countries – above all, the Federal Reserve System in the US – are legally set up so as to require them to serve primarily national objectives, and to think of spillovers only in terms of the implications for the wellbeing of the domestic economy. The insurance scheme would raise difficult issues as to how the insurance reserve should be invested to ensure the former is really solvent in a deep crisis, to which it is intended to be the antidote.

One surprising feature of the book is the absence of market perspectives on how the international monetary system works: in particular, an alternative view of US pre-eminence, which sees the outcome as less of a consequence of the ability of its government to produce safe assets than the size and power of its financial institutions. The extensive discussion of the provision of swap lines (and the interesting issue of which countries should receive swap line agreements) is also a question of where financial institutions exist that could possibly blow up the world.

An alternative account of the world's vulnerability might stress bank or credit gluts more than savings gluts. In this debate, the current account is an irrelevance: the expansion of bank balance sheets can occur in deficit countries (such as the US or the UK), but also in surplus countries (such as China). The stability of banks – and after the crisis, competition between national banking systems for an international role – has become a major part of the policy debate, and a source of tension on the international stage. END