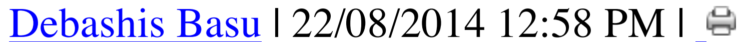
The Dollar Trap - Book Review

Debashis Basu | 22/08/2014 12:58 PM |

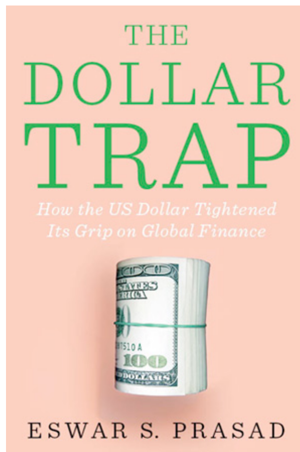


Why US dollar will continue to be the world's reserve currency, despite obvious flaws

The US dollar has been the king of currencies for decades. Foreign investors regularly pour billions of dollars in financial assets denominated in dollars, allowing the US government and households to maintain high levels of consumption through cheap borrowing, something that many experts have declared to be unsustainable.

Therefore, numerous articles and books have appeared over the past decade which predict that the dollar would crash creating global instability. However, one of the most obvious questions to ask is: Crash against what? A currency's value is relative. It is expressed in relation to other currencies. Euro is as weak. Renminbi is not a global currency as the US dollar and the gold standard is too restrictive for modern financial world. And, so, disappointing many forecasters, the dollar remains the king of currencies.

But the deep flaws in the dollar-dependent global system cannot be wished away. Eswar Prasad, a professor at Cornell University, formerly the head of China division of the International Monetary Fund, has done work on the Indian financial sector reforms. He makes a nuanced argument that, while the dollar is flawed as a global reserve currency, it can't be replaced and we will, therefore, have to live with it, with all its potential dangerous implications.



The book starts by setting the context in which the dollar has to be analysed—the global financial economy. Prasad provides a guided tour through some key analytical concepts of the international monetary system and the framework economists use to study capital flows.

He also analyses how rising integration into global financial markets has affected these economies' external balance sheets. Emerging markets are now less reliant on foreign debt and more on foreign direct investment. But these economies face new dangers—portfolio flows and asset market boom-burst cycles fuelled by those flows. This, paradoxically, explains the dollar's strength, defying the predictions after the 2008 crisis, that the dollar would crash.

With hindsight, two factors explain the continued dominance of the dollar. One, frequent global scares in financial markets, coupled with geo-political tensions, have meant a growing importance of 'safe assets', investments that at least protect investors' principal and are relatively liquid (i.e., easy to trade). Two, emerging economies have a strong incentive to accumulate a massive war chest of foreign exchange reserves to insulate themselves from volatile capital flows. Indeed, the global financial crisis shattered conventional views about the level of reserves needed to protect an economy from the spill-over effects of global crises. Even countries, that had a large stockpile, found their reserves shrinking rapidly during the crisis, to protect their currencies

from collapse. So, now, the new cry of policymakers in many emerging markets is: We can never have too much of reserves.

Prasad asks, "Does it make sense for other countries to buy increasing amounts of US public debt, when the amount of the debt is ballooning rapidly and could threaten US fiscal solvency?" There are no answers to this. Countries have no option but to buy dollars and so they are sending more and more money into the US. Prasad argues that "foreign investors, especially the central banks of China and other emerging markets, are willing participants in an ostensible con game set up by the US." After all, foreign investors hold about half of the outstanding US Federal government debt.

In this situation, the US can theoretically act like other indebted countries—print more dollars, thus reducing the value of that debt. The US has been presumed to be doing this but, surprisingly, has escaped the consequences of such action: higher inflation. Indeed, this is what many experts predicted would happen after 2010, some even predicting hyperinflation. But inflation has been low and US is now reducing the quantitative easing without any impact on bond yields—another surprise.

So, what happens to the dollar's future? Domestic inflation will not rise much and foreign investors would continue to be frustrated as they have no option other than the dollar even though they know that the dollar would weaken over the long term and they are destined to lose money. It's an uneasy relationship, with no end in sight. END