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Book Review: The Dollar Trap By Eswar Prasad

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Summary

- This book describes the workings of the dollar as the World's reserve currency in detail.
- It points out many counterintuitive phenomena which have confounded investors - especially the dollar's tendency to rise in times of stress.
- The author correctly concludes that the dollar is unlikely to be supplanted by any alternative in the foreseeable future.
- This creates a complex problem for investors; the dollar's valuation is affected by factors unrelated to the trade balance and dollar denominated prices may not make economic sense.
- In the immediate future, it appears that a rising dollar means less inflation, lower commodity prices and headwinds to economic growth. Interest rate sensitive equities should continue to do well.

Eswar Prasad has written an excellent book analyzing the dollar's unique role as a global reserve currency; every investor should read it carefully. He explains the dynamics behind the enormous accumulation of dollars by foreign central banks. He also describes some critically important mechanisms including swap lines and the efforts of certain foreign central banks to "manage" exchange rates and prevent local currencies from rising against the dollar. The book provides the reader with an in depth analysis of complex international currency markets and the coordination (or lack thereof) of central banks around the world. Prasad's experience at the IMF provides him with an insider's perspective on that agency's operations.

Prasad correctly concludes that no real alternative to the dollar looms on the horizon. Other currencies are either linked to smaller economies or countries lacking the institutional arrangements which tend to make the dollar "reliable". Ironically, the emergence of China may have cemented the dollar into its role as global exchange currency because of the "loose peg" maintained by the Chinese central bank. The very fact that China and many other growing economies have central banks which hold enormous amounts of dollars also strengthens the dollar's dominant position. This is the "dollar trap" Prasad refers to. If the Chinese central bank were to start selling its enormous stock of dollars, two very bad things would happen: 1. the Chinese currency would increase against the dollar making it much harder for China to export and 2. the remaining dollar reserves held by the central bank would decline in value providing authorities with a nasty and hard to explain loss. Thus, in a real sense, many foreign central banks are "trapped" in the dollar.

Prasad points out all sorts of counterintuitive phenomena. The dollar actually increased in value during the US banking crisis much to the consternation of pundits who predicted a dollar collapse and rampant inflation. In addition, interest rates on Treasuries were lower after the 2011 "debt ceiling" crisis than before it started even though there had been a downgrade by a ratings agency and a plausible risk of default. This is largely due to the fact that the dollar has become a global security blanket and tends to rise whenever a crisis looms regardless of whether economic analysis would suggest that the results of the crisis should lead to a higher valuation for the dollar. Another counterintuitive insight is that the high level of US government debt may actually reinforce the dollar's role as a global reserve currency because it provides those desiring to accumulate dollars with a large and liquid market of debt securities. Another unusual phenomenon has been "uphill capital flows" from poor or developing nations to rich nations. Again, this does not seem to make sense economically but has been a recurring pattern.

Prasad could have gone further and characterized the US Federal Reserve as the world's central bank. It certainly engaged in transactions with global reach during the recent crisis setting up swap lines with many foreign central banks. On the other hand, the Federal Reserve's legal mandate is focused on the domestic economy; the responsibility to maintain a "strong dollar" and address exchange rate issues is vested in the Treasury, not the Federal Reserve. But international trade has become so extensive and currency transactions so pervasive that even the purely domestic mandate of the Fed (stable prices and full employment) cannot be achieved without keeping one eye on developments abroad.

And so we return to the old question. What does all of this mean for investors? First of all, US investors look at the world "through the window of the dollar"; we think in dollar denominated terms. This means that lots of things become "less valuable" (at least to us) when the dollar rises. In a sense, a rising dollar "sinks all ships." Even US based companies are harmed by several effects - 1. the dollar denominated value of their foreign earnings and assets declines, 2. it becomes harder to export and 3. it becomes harder to compete against imports. And - guess what? - the dollar has been rising strongly the past several weeks. In fact, it may have been a factor in the Fed's decision earlier today to retain its language promising to keep rates low for a considerable time. Again, the Fed can't explicitly consider exchange rates in setting policy but - indirectly - it does not take Sherlock Holmes to figure out that a stronger dollar means less inflation and can create a headwind for the economy thus impacting the very metrics that the Fed must focus on.

There is an old saying that when the United States gets a cold, the rest of the world gets pneumonia. Well, the United States got pneumonia in 2008 and much of the rest of the world is still in intensive care. With other major central banks easing, there will be a tendency for the Euro and the yen to decline against the dollar. Commodity prices are getting weak and thus the leading emerging market currencies (as well as Canadian and Australian currencies) may also decline against the dollar. The Chinese will be reluctant to allow their currency to continue its modest and slow appreciation against the dollar because that would mean it would appreciate by even more against everything else. It is hard to imagine the Fed aggressively raising rates in this environment and, even if it starts, the impact of a rising dollar will start to show up in lower inflation and weaker GDP statistics.

It all leads me to stick with my prediction made here of no "2" handle on the federal funds rate until 2017. This means that interest rate sensitive equities should continue to do well. These include mortgage REITs like Annaly (NYSE:NLY), electric utilities, high dividend payers like AT&T (NYSE:T), business development companies like Ares Capital (NASDAQ:ARCC), equity REITs paying high dividends like Lexington (NYSE:LXP) and Hospitality Properties Trust (NYSE:HPT) and private equity managers like Blackstone (NYSE:BX). We also may see a period of relatively low commodity prices which should help the airlines and chemical companies. If you invest in companies with a high proportion of overseas income, look for equities like Yum! Brands (NYSE:YUM), which earns a great deal of its money in China where adverse exchange rate surprises are very unlikely. I have not been heavily in the bond market for some time but I think that some of the rate anxiety is overdone investors may actually do well with a laddered approach including some long term fixed rate issues.