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Why size matters

BOOK REVIEW

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Of all the various disciplines in the social sciences, only economics has been obsessed with making immutable rules. Economists have liked to think of these as being like the laws of nature. The practitioners of other disciplines, on the other hand, have been content to describe and leave it at that.

While many of the rules of economics have possessed descriptive completeness and predictive ability, a much greater number have not. In general, the predictive failures can be ascribed to an insufficient accounting for all the non-economic factors that influence the behaviour of economic agents, acting singly or in groups.

Within this general failure, no single sub-group of economists has been more at fault than macroeconomists. In their anxiety to catch the eye of governments, they have tended to overlook that most frustrating of all human qualities — irrationality.

Eswar S Prasad's overly long and discursive but highly readable and comprehensive book is (I think) about this. He has provided a more or less complete account of the goings-on in the international monetary system in the 21st century, pulling together its many strands.

(It might not be a bad idea for someone to provide a summary of the book for the education of Prime Minister Narendra Modi, who needs to acquaint himself with these issues before he goes to Brazil for the BRICS meeting next month. His additional principal secretary, P K Mishra, who was a brilliant student at the Delhi School of Economics, might want to tutor his boss on this.)

The paradox

How on earth, asks Dr Prasad somewhat plaintively, could the dollar have become stronger when every single rule of economics predicted that after the massive financial crisis of 2008 it would become practically worthless? And what are going to be the consequences of this?

Dr Prasad has reason to complain. After all, even the monumental American fiscal profligacy since 2008 has not affected the dollar very much. It continues to rule supreme as the world's reserve currency, preferred even over gold.

The result is a paradox, says Dr Prasad, which has got economists wringing their hands in frustration: poor countries are actually financing America whereas it should be the other way round. They are even willing to accept lower returns when they sell their dollars. Forty-three years after it reneged on its rock-solid promise to pay an ounce of gold for every 35 dollars, the world still trusts America.

But this is not unprecedented. If only Dr Prasad had looked at the history of the pound sterling over the last 200 years – that is after the defeat of Napoleon in 1815 – he would see how hard it is to dethrone a reserve currency. The pound finally bit the dust – but not quite totally – only after 1945, even though it had decisively won the Second World War.

Dr Prasad thinks that the Chinese renminbi is well placed to partially replace the dollar as the global reserve currency now. He thinks this will happen in the next 10 years as countries start to hedge their risks against a fiscally weak United States.

Not just economic

As far as the economic reasons go, his chapter on this topic is well argued. But he leaves out the non-economic case against China, which is that it is going to take longer than just a decade for the world to trust it as a country and not just its bond markets and so on.

As the Kaiser realised a hundred years ago, faith in a country and its currency evolves only gradually. It can't be manipulated into existence by the actions of governments like China's.

Also, China is yet to win a decisive war like the one at Waterloo or Normandy. That is at least a necessary if not sufficient condition for providing the world with a reserve currency.

So what's the bottom line? Dr Prasad points to a paradox: the very fragility of the US economy is breeding financial stability. Against all rules and rational expectation, the vulnerability of the dollar is making the international monetary system more stable.

This, says Dr Prasad, is happening because the US economy is so very large. If it goes down, everyone else will go down with it. So, the others have a vested interest in funding American spending by lending vast sums to it even though they know they could make more money by lending elsewhere.

This is a seductive argument and probably right as well. But truth to tell, this is not the first time this is happening. Whether it was the local *zamindar* or the local sovereign, it has always been the same, everywhere.

Dr Prasad has written a good book on contemporary history. He may now want to look at the older histories to discover that there is more to economic outcome than mere economics.

THE DOLLAR TRAP
How the US Dollar Tightened its Grip on Global Finance
Eswar S Prasad
Penguin; 408 pages; ₹699