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The currency wars

A ringside view of the flow of international finance, and why the dollar reigns supreme

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IN OCTOBER 2012, then Reserve Bank of India governor D Subbarao had asked visiting US Fed chairman Ben Bernanke and treasury secretary Timothy Geithner for a rupee-US dollar swap arrangement. The two had refused, saying the Indian rupee was not fully convertible and so it would not be possible for a swap to work. Two months later, the RBI signed a swap deal for $15 billion with the Bank of Japan. It has now been extended to $50 billion.

A swap allows a country to offer its currency to the partner to get foreign exchange in return. When there is a run on a local currency, a swap is a great instrument to maintain sanity in the foreign exchange market.

For Asian economies, wiser after the run of 1997, a swap became a sought-after additional bulwark to keep the vicissitudes of an off-on flow of foreign capital at bay. And the key to these flows is the dollar, which is now unmanageable by any country, including the US, yet is the only means for trade and finance to flow across the globe.

The experience is one of the key reasons why the five BRICS nations sank their differences this week to sign up for the first multilateral bank outside the Bretton Woods system. It will be expected to provide the very support to counter the wash of $3 trillion that it inflicts on the financial shores of nations daily.

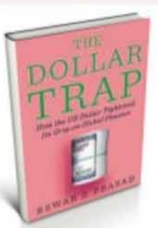
In *The Dollar Trap,* Eswar Prasad says the New Development Bank is the crystallisation of these regional pooling arrangements. Recounting the Subbarao incident, Prasad notes this was a key reason why some of the east Asian economies, keen to tie up with the US treasury for a swap window, had to instead look elsewhere. Indonesia, for instance, having failed in the same year for a US swap, obtained support from China, even though the yuan is not a convertible currency and so could offer only a limited support window.

BLOOMBERG

An employee loads a machine with sheets of $5 notes at the Bureau of Engraving and Printing in Washington, DC. The book offers a hard look at why with every wrinkle in the mosaic of global finance, investors rush to buy the US dollar

For both economies, the yuan and the yen window were stopovers to reach the security of easy access of dollars. Prasad's book, a ringside view of the flow of international finance, offers a hard look at why with every wrinkle in the mosaic of global finance, investors rush to buy the US dollar. So much so that they bought dollars whenever they were scared the international markets would seize up, including the point when the US debt ceiling was reached and Washington lost its triple-A rating.

The BRICS Bank, Prasad explains, potentially makes a pool of the reserves of these currencies "into a big enough bazooka to scare off speculators trying to drive down a particular currency's value". But he also warns that given the political differences among these countries, the bazooka might not fire. "These tensions among the BRICS are likely to intensify as China attempts to shift the balance of regional political power in its favour using its growing economic influence… the contract would have to be based on trust, which may falter in the midst of a global crisis."



THE DOLLAR TRAP: HOW THE US DOLLAR TIGHTENED ITS GRIP ON GLOBAL FINANCE
Eswar S Prasad
Penguin
₹699
Pp408

This is the craziness of global finance, he points out in *The Dollar Trap*. No country other than the US wishes to see it as a reserve currency; the US would much rather see it depreciate so that its exports become competitive. And, US politics is dysfunctional at best, creating frequent heart attacks like the fight over the debt ceiling. Yet the international money markets have an almost naive belief that makes them turn to the dollar whenever there is a crisis.

It is also the reason why the BRICS Bank makes sense. Behind the audio of infrastructure support, the key role of the bank will be to act as a force multiplier for the five, rather four, central banks when their markets see a surge in flow out of foreign money. It is difficult to see China in a similar predicament though. The establishment of the bank by itself takes the pressure off these central banks to keep on piling reserves.

The piling of reserves creates another cul de sac. The additional demand for dollar leads to flooding of the domestic economy with the local currency, which, in turn, leads to inflation and depreciation of the currency. This creates another reason for the demand for dollar to rise from all quarters, including local companies, to save the value of their capital and makes the dollar rise even further.

Through the book, Prasad takes no shortcuts. Instead, with fine details, he develops an almost antithetical position to all those who have been equating the diminishing of US economy with that of the eclipse of the dollar. He makes it clear that there is no alternative in sight, least of all the Chinese renminbi, so long as that economy does not stop trying to manage the supply and demand for the currency.

He accepts that there are plenty of arguments to demonstrate that a developing economy is helped by an undervalued currency, but it leaves in its wake no sign that it can act as the alternative means to run the world economy.

Prasad should know. Having worked at the IMF and as Tolani senior professor of trade policy at Cornell University, his perspective treads the fine balance of an insider's knowledge without being forced to defend any position.

There is a great chapter in the book, where Prasad recounts the bruising encounter IMF suffered with China in 2007. Prodded possibly by the US, Prasad narrates how the IMF tried to bully Beijing to move to a flexible exchange regime that made China suspend its annual surveillance report programme with it for two years. The IMF was caught in a position where it had to admit it had no oversight on the second-largest economy in the world. "The outcome of (the) episode was clear. The IMF had been defanged and would no longer publicly take on China or any of the major advanced economies on this issue. Each country was now on its own in the currency wars."