

BOOK REVIEW

THE DOLLAR TRAP: HOW THE U.S. DOLLAR TIGHTENED ITS GRIP ON GLOBAL FINANCE

ESWAR S. PRASAD

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The great mystery of international finance is how the U.S. dollar has managed to retain its dominance. This is a currency, after all, that has lost about 83 percent of its purchasing power since President Richard Nixon cut the dollar's remaining link to gold in August 1971. More recently, in the wake of the 2008 financial crisis, the Federal Reserve has sought to resuscitate the American economy by directly endeavoring to generate an abundance of dollars through the policy of quantitative easing. All the while, the level of the country's public debt has escalated above 100 percent of GDP, thus portending a continued outpouring of dollars from America's central bank to pay what is owed, with all that entails in cheapening the currency.

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Yet for all this, the greenback is still used in an overwhelming majority of transactions in the foreign exchange market. As of April 2013, its share of all trades stood at 87 percent, far greater than its closest counterpart, the Euro (Bank of International Settlements, 2014). When it comes to global trade in goods and services, the U.S. dollar was used to settle 81 percent of all transactions as of October 2013 (SWIFT, 2013). The latest figures for the first quarter of 2014 show the world's central banks retaining their confidence in the greenback as a store of value, holding 61 percent of their foreign exchange reserves in U.S. dollars, not much different from where that proportion was back in 1996, and still well ahead of its peers (International Monetary Fund, 2014). Topping it all off is the fact that investors the world over remain eager to purchase securities denominated in American dollars, with Treasury bonds a particular favorite despite these carrying historically low yields.

So what is going on? Are we witnessing the financial equivalent of a seemingly well-structured and prosperous city moments before a massive earthquake exposes the rickety foundations of its buildings? Or is the resiliency of the greenback reflective of forces assuring its paramouncy going forward? These are the questions taken up by Eswar S. Prasad, the Tolani Senior Professor of Trade Policy at Cornell University, in his book *The Dollar Trap*. Prasad argues the thesis that a confluence of politico-economic trends and seminal events over the past several decades, including the 2008 financial crisis originating out of the U.S. housing sector, have cemented the American dollar's reign over the global financial system. Though he acknowledges various threats to the greenback, Prasad does not think it will fall from its perch anytime soon. This will not be ideal, he concedes, but he does maintain that the continued supremacy of the U.S. dollar is the best we can expect under the present circumstances. It will be "suboptimal", as he puts it, but at least it will be "stable and reinforcing" (p. 307). Prasad tells a fairly convincing story about the recent strengthening of the greenback's position in global finance, but he is too accepting of the status quo.

First, some basic facts about the political economy of foreign exchange. Just as money exists to facilitate the trade of goods and services amongst individuals and firms, so foreign exchange exists to smooth that trade when it takes place between parties across

national borders. For as each nation often has its own currency, and sellers typically desire to be ultimately paid in their national unit, a market will emerge to exchange the different monies of the world. Inevitably, purchases and sales between various countries will not balance; on aggregate, individuals and firms in certain nations will buy a greater value of goods with money than they sell, while those in other nations will sell a greater value of goods for money than they buy. From the economic point of view, this is not a problem, inasmuch as the imbalances merely reflect an accounting by which people have been artificially sorted into national groups. One could just as easily carve up the population within national frontiers, by say tallying the transactions of those who reside in Long Island against those in southern California, and find an array of surpluses and deficits. What matters is how each of us fares irrespective of where we happen to live. Clearly, everyone benefits from cross-border trade, for they would not have otherwise engaged in it.

Politically, however, the imbalances have posed a dilemma because of the adjustment in the currency that is required. Prior to World War I, when the major currencies were backed by gold, the adjustment was supposed to be made through a change in the quantity of money. Countries that imported more than they exported were supposed to enable outflows of gold, whereas those that exported more than they imported were enjoined to tolerate inflows. After World War I, the world progressively moved away from this regime, eventually reaching the point with the breakdown of Bretton Woods in the early 1970s in which the advanced nations have opted to rely on price as the adjustment mechanism. This has spawned a gargantuan mart of floating fiat monies, where currency values can fall for countries with deficits and rise for those running surpluses, following the script laid out by Milton Friedman (1962, pp. 56–74) for a flexible exchange rate regime.

That the architecture of global finance has evolved in this direction is a sign that it better suits the needs of politicians. Rather than stand by as the money supply fluctuates with the international activities of their citizens, policymakers would much prefer to have a free hand in influencing its quantity in order to swing the economy in their political favor—which is precisely what the current system gives them. But as the exertion of this control over quantity also impacts the prices of currencies, the present framework has had

the baleful consequence of turning the movements of the US dollar, Euro, Japanese yen, Chinese renminbi and all the rest into a political battleground. Instead of furthering economic co-operation between the peoples of the world as it ought to do, the foreign exchange market has become a source of national discord.

Prasad nicely details this conflict. The chief protagonists are the U.S., the Euro zone, along with the developing world, principally the so-called BRICS nations, which include Brazil, Russia, India, China, and South Africa. Echoing all the discussion of late concerning the renminbi's ascent in currency markets, China looms large in Prasad's account, due to that country's size, rapid economic growth, and geopolitical ambitions. As the leading player, the U.S. dollar attained its status in the 20th century, assuming it from the British pound that dominated in the 19th century, and consolidating it after World War II with the establishment of Bretton Woods. When this exchange rate system fell apart with Nixon's 1971 decision to abandon gold, one might have expected the US dollar to lose its preeminence. That it instead gained influence Prasad explains by observing that everything is relative in international finance. Though the U.S. government effectively devalued its currency with respect to gold, what mattered for the dollar henceforth was how it stood compared to other fiat currencies in the eyes of investors, businesses, central banks, and governments.

On this score, the greenback has consistently trounced the rest of the field. According to Prasad, this is owing to the extent and depth of America's financial markets, which offer a multitude of highly liquid alternatives to deploy any funds set aside for future uses. Prasad also believes it reflects the superiority of America's political and legal institutions. For all the hue and cry about partisanship and gridlock in Washington, the U.S. democratic system, with its various checks and balances, gives assurance to holders of the country's debt that a default is unlikely, whether done explicitly through non-payment or implicitly through higher inflation. Likewise, property rights and the sanctity of contracts are protected by America's courts.

Reinforcing the dominance of the greenback are the policies of developing nations. As Prasad well observes, there are both insurance and neo-mercantilist motives at work here. Mindful of the balance of payment crises that befell Mexico, Thailand, Indonesia among

others during the 1990s, developing nations have taken to bulking up their foreign exchange reserves. The greater these are, the more wherewithal governments have to defend their currencies, as well pay for imports and any maturing external debt, should foreigners suddenly decide to take flight with their capital. To perform this insurance function, however, foreign exchange reserves have to be invested into something safe and no instrument in the financial markets is thought to have a better guarantee of repayment than U.S. Treasury bonds. Bolstering this demand for American dollars is the penchant among developing nations of pursuing growth through export promotion, a neo-mercantilist strategy best executed with a low currency. However, any country that succeeds in exporting more than it imports will invariably come head on against the economic reality that surpluses push the currency upwards, everything else remaining equal. How governments deal with this is to intervene in the foreign exchange market by purchasing another currency using their own and then adding it to reserves. Again, the dollar is preferred for this purpose on the belief that it can be parked safely in U.S. Treasury bonds. China is exhibit A of this practice, as Prasad duly notes. By 2013, its central bank had amassed an eye-popping \$3.8 trillion of foreign exchange reserves.

Prasad points out, too, that there exists a wider demand for safe assets. From pension funds, insurance companies, commercial banks to private investors with a low risk tolerance, the desire for securities bearing a guaranteed return of principal is always present in financial markets, making itself felt especially in periods of uncertainty and turbulence. As such, the demand for safe havens has risen since the recent financial crisis. At the same time, the economic carnage that ensued in the aftermath of that crisis has diminished the supply of safe assets. Over the past five years, bonds issued by numerous governments around the globe once thought to be secure have come to be seen as risky bets. U.S. Treasury bonds now compete with fewer debt securities for the title of sure thing, further strengthening the greenback's position. Prasad recognizes the irony of the country that started the financial crisis being the one whose currency has gained the most prestige from it.

Any system that produces this kind of outcome is bound to be subject to grumbling. A long standing sore point, going back to the French government led by Charles de Gaulle in the 1960s, is that the

dollar has an “exorbitant privilege” by which the Fed can simply issue currency to finance U.S. trade deficits instead of having to pay for imports with real goods. Both American consumers and governments can spend lavishly and rack up big debts because foreigners are willing to hold the country’s dollar denominated bonds. Developing nations, in turn, protest feeling the brunt of the Fed’s easy money ways. The added liquidity finds its way into their economies, boosting their currency to a level that renders their exports uncompetitive, while fomenting a transient boom that abruptly turns into a bust as soon as the Fed is compelled to tighten and the foreign money departs to safer locales. Understandably, developing countries have reacted by attempting to displace the dollar, with the BRICS nations going so far recently as to agree to pool their reserves. Even as the hegemon, the U.S. finds much to complain about, whether it involves shifting blame from the Fed’s monetary policy by admonishing developing nations to reform their economies or the regular allegations against countries (Japan twenty to thirty years ago and China nowadays) of harm to American companies from too low a currency.

This is a lot of tension for an international financial system to shoulder. What makes it all the more damaging is that capital ends up flowing in the wrong direction from the developing to the developed world. It is the Chinas and Indias of the world that have a greater need for capital in order to make their workers more productive; and it is there that holders of capital from places like the U.S. can obtain the highest return on their investments. Prasad’s only suggested fix is a global insurance scheme that would create a reserve fund which countries could tap into whenever they ran into balance of payments difficulties. Premiums would depend both on the size of the country’s economy and the quality of its economic policies. Prasad figures that such insurance would convince developing countries to stop bulking up their reserves. But lack of agreement among countries on what constitutes good policy is enough to make this proposal a non-starter. Will developing nations suddenly see the light and agree that the pursuit of neo-mercantilism deserves a higher premium?

Since even he concedes that the insurance scheme is unworkable, Prasad ends up defaulting to the current U.S. dollar standard. In part, he does so because he fears that its end would generate chaos in

the financial markets and wreak havoc on the economy. A decisive consideration for him, though, is how the quest for safe assets plays a stabilizing role in global finance. Whenever a crisis affects any part of the system, the demand that arises for a safe haven in the U.S. dollar serves to buttress that system at its most critical structural point precisely when that is needed the most. Still, the greenback can only serve this function so long as it is perceived as a gateway to the safety of U.S. treasury bonds. How long will that perception last as the U.S. public debt continues its relentless climb amid an aging population driving entitlement spending inexorably higher? Prasad acknowledges this threat without ever adequately explaining why it does not vitiate his model of a self-equilibrating financial order. Aside from arguing that China would only harm itself were it to dump its large US Treasury bond portfolio, he just clings to the idea that all is relative in finance and that, therefore, investors have no safer option than the U.S. dollar.

What about gold? The most disappointing part of this book is that Prasad never seriously considers a return to the yellow metal as the basis of the international financial system. He does consider the possibility, but dismisses it with a nod to Barry Eichengreen's (1995) contention that the gold standard worsened the Great Depression, as if a mere citation can resolve such a highly contested topic in economic history. Prasad's main objection, however, is that there is not enough gold in existence for it to function as a reserve asset. Yet scarcity is hardly an obstacle, since that can be dealt with by allowing the price of gold to appreciate. As this review is being written, half of the entire American money supply, as defined by M2, could be backed up by U.S. current official holdings of gold at a price of \$21,863 per ounce. The issue with reviving the gold standard is not so much about quantity as it is about political will. Prasad worries also about gold's price volatility, even though Britain somehow managed to keep it at 4.25 pounds per ounce for 93 years up to 1914. We are not trapped into the U.S. dollar.

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