Business Finance II – 40592 - Spring 2016
Book Review

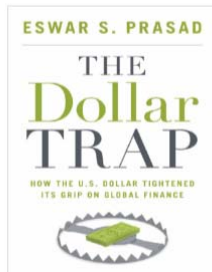
The Dollar Trap- How the U.S. Dollar Tightened Its Grip on Global Finance

Participants' Names & ERP:

Ilyas Farooq 10074
Muhammad Junaid Khan 10109
Muhammad Irfan 09742
Haris Ahmed 06732
Shumyla Javed 09

Book Title	The Dollar Trap How the U.S. Dollar Tightened Its Grip on Global Finance
Author(s)	Eswar S Prasad
Publisher &Publishing Year	PRINCETON UNIVERSITY PRESS (2014)

Author:



Eswar Prasad holds the New Century Chair in International Economics. He is the Tolani Senior Professor of Trade Policy at Cornell University and a Senior Fellow at the Brookings Institution. Prasad began his studies in economics at the University of Madras (B.A., 1985), and continued at Brown University (M.A., 1986) and the University of Chicago (Ph.D. 1992).

Synopsis of the book:

In his latest book, The Dollar Trap , Prasad examines the U.S. dollar's continuing dominance in the world economy following the global financial crisis. This book provides an effective framework for why the dollar is likely to maintain its grip on global finance.

Prasad focuses on the dollar's special role over the last half century and concludes that it will not change anytime soon.

The great mystery of international finance is how the U.S. dollar has managed to retain its dominance. This is a currency 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 endeavouring to generate an abundance of dollars through the policy of quantitative easing.

The game of international finance has created an environment that will continue to be dominated by the dollar as a reserve currency. There are no close substitutes or rivals, and the dollar's "exorbitant

privilege" will likely persist regardless of regular reports of its demise. On the basis of the importance of capital flows, currency management, and foreign central banks' demand for safe assets, the dollar will continue to be the dominant force in international finance even with the decline of US economic power.

The dollar's dominance is not a trade issue. Over time, the flow of goods and services has become more dispersed. Instead, the dollar's dominance is driven by capital flows and the growing demand for a global safe asset.

More integrated global capital markets have created greater capital flow volatility, as well as the potential problem of "sudden stops" in short-term foreign financing. This environment has driven emerging market countries to hold greater dollar reserves as a buffer against financial crises. In addition, emerging market central banks have been actively intervening in currency markets to protect exports and to follow modern mercantilist policies.

A case can be made that the financial crisis has actually strengthened the dollar's position as the predominant store of value in the world. Its role as a medium of exchange may shrink over time. Financial market and technological developments are making it easier to conduct cross-border transactions in other currencies. But financial assets denominated in dollars, especially U.S. government securities, are still the preferred destination for investors interested in safeguarding their investments.

How could it be that the financial crisis, which had its epicentre in the U.S., would have the effect of tightening the dollar's grip on global finance? By increasing the demand for safe assets even as the supply of them shrank in the rest of the world, it left America as the main provider. Emerging economies have a stronger incentive than ever to accumulate foreign exchange reserves as insulation against the consequences of volatile capital flows.

Financial regulatory reforms have added to the demand, because banks need a larger supply of liquid assets to meet cash flow needs. U.S. currency look even better when a stark question is posed: If not the dollar, then what? The government bonds of many other major economies, such as the euro zone, Japan, and the UK, look shakier in the aftermath of the financial crisis. Moreover, even central banks, such as the Bank of Japan and the Swiss National Bank, are engaged in monetary operations that will weaken their currencies. They are also intervening directly in foreign exchange markets to prevent currency appreciation—in other words, adding to rather than serving the demand from the rest of the world for safe assets.

The Chinese renminbi, for instance, is rapidly ascendant as a currency for settling international payments. With rising capital flow and currency volatility, hedging multiple currency exposures will become increasingly important. We should also expect to see the dollar's value resume its decline against the currencies of emerging economies, owing to differences in productivity growth between the United States and those economies. But don't expect a decline in the dollar's prominence. Mostly for want of a better alternative, it will remain the dominant reserve currency for a long time to come.

It may seem that this "dollar trap" is an unstable equilibrium with big risks for the global economy. One can imagine various tipping-point scenarios that might precipitate a dollar crash. But any of them would have damaging repercussions for every single country in the world. As countries follow self-interested policies of currency management and capital controls, the global financial

environment could be considered on the verge of chaos, with no rules or mechanisms to stop behaviour that is harmful for the whole.

The author makes a strong case for institutional failure and the need for a coordination mechanism that can impose stability. Unfortunately, the history of global financial governance has been a story of failure. Such organizations as the International Monetary Fund, where the author worked for many years, have been ineffective at forming and executing an effective mission or creating a structure for global coordination. G–20 meetings have devolved into discussions without serious purpose. In a world where no dominant players can impose rules and there are no coalitions that can develop a new order, the dollar can continue its existing role as a reserve currency but can do nothing to help lead to a better global financial environment. It is a sad statement of reality — one that can explain continued dollar dominance through a lack of order.

The Dollar Trap ends with a scenario that shows how the dollar could hit a tipping point and slide into a crisis. Geopolitics could be the catalyst for a dollar slide, but the author believes the current fragile financial system has a certain stability that is unlikely to change. Many will disagree with this characterization of stability, given the strong, self-interested desires of some currency players for a new order. On the basis of a close review of what would be necessary for a new reserve currency to gain acceptance across the globe, however, any new financial order would be difficult to bring about.

Key Learning:

- The dollar dominance story is founded on a set of three paradoxes in international finance.
    - First, the biggest importers of capital are not the emerging markets but, rather, the developed markets. There is a substantial savings imbalance that continues to dominate global capital flows.
    - Second, emerging markets have looked to the dollar, in spite of the United States' troubles, as the safe asset for obtaining protection against volatile domestic capital flows.
    - Third, the huge dollar reserves held by foreign central banks make it all but impossible for the dollar to decline without causing significant losses on these banks' balance sheets. Pronounced foreign demand for dollar strength gives the world a vested interest in maintaining a stable dollar. The recent focus on the Fed's tapering and its implications for emerging markets is a clear example.

- It is unlikely for another currency to take the place of the dollar. The Chinese renminbi is just not ready for prime time. Simply being the currency for a large economy is not sufficient to take on the role of safe haven asset and to become the store of value for the world. The euro has also been talked about as a reserve alternative, but the EU sovereign debt crisis showed the global community that the euro must undergo further institutional growing pains before foreign central banks take on additional exposure to it.

- The Dollar Trap focusses that International investments are ultimately driven by the value of the dollar, the core currency around the globe. Currency movements are a primary determinant of international fixed-income diversification and are important for any international equity decision.
- Free-floating exchange rates are largely a myth in the currency markets. Central banks are engaged in "dirty floats" that attempt to control or dampen currency movements, and the purchase and sale of dollars is fundamental to this process.
- The United States faces high and rising public debt, risks created by the Fed's aggressive use of unconventional monetary policies, and political dysfunction. Such factors might be expected to set off an economic decline, eroding the dollar's importance.
- Dollar behaviour has not followed fundamental data. Forecasting difficulty is further exacerbated by the convolutions associated with the dollar being a reserve currency central to the global monetary system.
- Emerging markets' desire for a stable dollar has also raised fears of currency wars between countries. A Fed policy of flooding the world financial markets with dollars should lead to a dollar decline and appreciation of emerging market currencies. These countries often have export-driven growth policies that can ill afford their export goods becoming more expensive in competitive global markets. The result has been foreign central banks buying more dollars in order to stop the dollar supply onslaught. These export-driven countries are at war against a cheap dollar, but they facilitate dollar dominance in the process. Yet, dollar dominance does not mean US financial hegemony. The United States is unable to impose its policy on others.
- Conflicts over the global monetary system, or lack thereof, have led to what seems like never-ending predictions of the dollar's demise, which has yet to come to pass. The dollar may be on a long-term downtrend, but along the way, there have been years of range-bound behaviour and significant spikes in the opposite direction.
- The Dollar Trap focuses on explaining the counterintuitive dollar behaviour observed during the recent financial crisis. In spite of the financial turmoil that engulfed the United States, the dollar saw massive inflows in the fourth quarter of 2008. The European debt crisis produced the same result: dollar inflows.