January 24, 2014 6:59 pm

‘The Dollar Trap’, by Eswar Prasad

Review by Henny Sender

The Dollar Trap: How the US Dollar Tightened its Grip on Global Finance, by Eswar Prasad, *Princeton RRP£24.95 / RRP$35, 432 pages*

Early in 2009 Luo Ping, an official at the China Banking Regulatory Commission, was asked whether Beijing would continue to buy US government debt. “There is nothing much we can do,” he replied. “For everyone, including China, it is the only option.”

That seemed counter-intuitive then, in the febrile aftermath of the worst financial crisis since the Great Depression. As the Federal Reserve began aggressively printing money, the dollar was falling. Bader al-Sa’ad, the head of the Kuwait Investment Authority, captured the mood of foreign investors in September 2011 when he said he had been brought up to think of US Treasuries as risk-free but no longer believed that to be the case.

And yet, the dire outcome many expected hasn’t transpired. The dollar remains relatively strong against most currencies, US equity markets are at highs and the debt market is robust. Indeed, the crisis has actually strengthened the dollar’s role in world finance.

To understand why, a reader can do no better than to turn to Eswar Prasad’s *The Dollar Trap*. Prasad, an economist who holds the chair in trade policy at Cornell University, builds on the work of others such as Stanford’s Ronald McKinnon and Barry Eichengreen of Berkeley in examining the role of the dollar in world economy; as a former head of the International Monetary Fund’s China division, he brings to the task a deep understanding of the country whose currency now represents the main challenger to the status quo. His conclusion is that “the equilibrium in which the dollar remains the dominant global reserve currency is suboptimal but stable and self-reinforcing”.

Having the world’s reserve currency, as Prasad explains, is a mixed blessing. Because of the demand for dollars and dollar-denominated investments, interest rates in the US are lower than they would otherwise be. America can live well beyond its means, a source of resentment for many of those who find themselves facilitating that profligacy. Yet at the same time, the fact that the dollar is stronger than the fundamentals would suggest damages the competitiveness of its exports. For the US, with its huge domestic market, that may not matter as much as it would to smaller countries – but it still hurts.

The thirst for dollar securities stems in part from the need of emerging markets for safe liquid assets with which to defend their own currencies from volatile capital flows, and the absence of any other obvious source of supply. The more troubled the times, the greater the need for assets that can be turned into cash at a moment’s notice to scare away speculators. As Prasad points out, it may not seem wise for foreigners to buy the debt of a country that already has so much of it, especially when the long-term trend has to be for the dollar to fall, but the lack of a better alternative makes for a perverse kind of stability.

Prasad’s analysis of why the Chinese renminbi isn’t about to displace the dollar is similarly compelling. While the renminbi is increasingly being used for trade transactions and held in the reserves of trading partners, this alone is not sufficient to make it a reserve currency. The problem is that Beijing still isn’t ready to surrender control of capital flows, whether because it fears that too much appreciation will hurt exports or because it wants to prevent money from flowing out of China in search of higher returns. Steven Englander, a Citi analyst quoted in *The Dollar Trap*, puts it pithily when he notes that China would like the renminbi to become a reserve currency “but doesn’t want anyone to buy it without permission”.

Moreover, China still isn’t ready to handle financial volatility. Its banks are big but not necessarily strong and its regulators as well as its bankers are still learning the art of risk management. And finally, China lacks a deep government bond market, so those in search of relatively safe renminbi assets don’t have many choices of investment vehicles yet.

There are many areas that Prasad might have explored further, such as whether central banks are coming under increasing political pressure in the post-crisis world and, if so, what the long-term consequences of that pressure will be. Some readers may find his book pitched too squarely at insiders in its attention to the minutiae of IMF politics. But these are small quibbles. To understand how the world of international finance works, what the agendas are and what is at stake, this work is indispensable.

Henny Sender is the FT’s chief international financial correspondent

RELATED TOPICS United States of America, Global Trade