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Book review

Eswar Prasad, *The Dollar Trap: How the US Dollar Tightened its Grip on Global Finance* (Princeton University Press, Princeton, NJ, USA 2014) 432 pp.

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Eswar Prasad's latest book deals with a highly topical subject, relative to the ongoing financial turmoil and existing global imbalances. Indeed, how to explain that the dollar, which is the currency of the United States, has not been abandoned by international financial actors, given the level and pace of indebtedness of its issuing economy? Is the world economy blind to quantitative easing policies? Knowing the self-regulation principles and the virtuous nature of the market, the United States, according to the author, should have been punished and 'the dollar dominance should be under siege' (p. 26). Agents should have abandoned the dollar in favor of a more credible currency. Yet the reality is different. The dollar remains the leading international currency, far ahead of the other competing currencies. And paradoxically in appearance, this trend has persisted in the last decade, in line with the recurring current-account deficit of the United States and deepening global imbalances. This period has also witnessed the acceleration of financial liberalization, including in emerging countries increasingly integrated into globalized finance.

Prasad focuses on the store of value aspect of the international currency, which gives the most striking view of the 'trap' phenomenon (relative to the unit of account and medium of exchange roles).

The book is made up of fifteen chapters, which are divided into four parts. The first part, entitled 'Setting the stage,' is the shortest, and covers only two chapters. The 'Prologue' draws attention to some elements that have not hindered the dollar dominance: among them, the recurring US current-account deficits up to 2007, the US debt ceiling issue that brought S&P to cut the rating of US debt, and the US fiscal cliff. Quite paradoxically, not only did the dollar survive these crises, but it grew in strength after each one.

In the second chapter, 'What is so special about the dollar?', the author focuses on the different sorts of agents that need dollars. First, central banks accumulate dollars in order to face sudden capital movements, to support their exchange-rate policies and to fight against their currency appreciation. Second, private financial institutions and global investors also need a safe haven, and the dollar fulfills this function. Hence the dollar is reinforced by uncertainty through the search for safer assets. That can be observed with the volatility index, such as the VIX (see p. 19). According to Prasad, such a demand for safer assets is a recent phenomenon, starting in the 1990s and quickening pace during the Bush presidency. The dollar is demanded especially because of the confidence in US institutions, and the low risk of inflation policies in the country.

The second part of the book is entitled 'Building blocks.' Chapter 3, 'The paradox of uphill capital flows,' highlights the difficulties of standard economics reasoning to

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explain the realities of capital flows. In theory, 'developing' countries should import capital from 'advanced' economies. The chapter abounds with stylized facts exposing this paradox: for 20 years, the direction of flows of capital has been reversed: they flow from developing to developed, rich countries. This phenomenon has been made possible by developing countries speeding up their financial liberalization. This topic is addressed in chapter 4, 'Emerging markets get religion,' in which Prasad describes the situation of emerging countries in terms of external position. He grants importance to the flows and their devastating effects on the balance sheet of the emerging economies. Although the FDI are increasingly more significant than the portfolio and the external debt in the capital inflows, these flows make the emerging economies still more vulnerable to external risks and sudden stops.

Chapter 5 deals with 'The quest for safety,' in other words the accumulation of reserves by central banks in different countries of the world. This accumulation is not only justified by mercantilist purposes. Admittedly, it can avoid the appreciation of domestic currency. The reserves can also avoid signing an agreement with the IMF and its painful adjustment programs in the case of balance-of-payments difficulties. The author explains the quest for liquidity rather than yield in the current financial turmoil. Private assets have lost their liquidity ability in a time of crisis. Government bonds kept their value and have been strongly demanded by international actors, sometimes in spite of the degradation by rating agencies and always in spite of the economic cost of these reserves.

The dollar benefits from large, deep, and liquid US financial markets. 'A trillion dollar con game?' is the title of the sixth chapter, because the dollar-denominated US Treasury bonds are the elected safe assets. It deals with the risks supported by emerging markets that have placed their reserves in dollar and US government bonds: any dollar depreciation constitutes a loss. Prasad explains how this 'game' creates a wealth transfer from 'developing' to 'advanced' economies. In addition, the growing federal debt of the US is a subject of anxiety for investors. Yet, in order to preserve the value of their stock of reserves, emerging countries support the dollar in buying large amounts of US debt. This situation has an historical precedent that Prasad reminds us of, namely the 'Sterling trap,' which deals with the reserves of pounds sterling in France at the end of 1920 (p. 120). China, likewise, has a strong incentive to sustain the dollar in spite of growing tensions between China and the US.

Part 3 of the book is entitled 'Inadequate institutions' and covers five chapters. Chapter 7, 'Currency war,' deals with the monetary tensions between major economies of the world. Global imbalances are strengthened by mercantilist policies, which use exchange rates as a weapon to boost exports. The quantitative easing policies are annoyances for China and emerging countries in general, as they allow large outflows of hot money to revalue their currencies. The author sheds light on the Fed policies but also on the Bank of Japan (p. 151). Such a situation requires the intervention of international institutions. That is the subject of the eighth chapter, called 'Seeking a truce on currency war.' In this chapter, Prasad describes the difficulties of cooperation between the major economies, especially within the IMF. Chapter 9 puts the emphasis on the divergence of national interests, which make arrangements so difficult at the IMF or the G20 summits.

Chapter 10, 'The siren song of capital controls,' relates to the temptation of restoring some controls on capital flows in countries hit by crisis. In this short chapter (twelve pages), Prasad expounds his view of capital controls, which he does not consider as an efficient solution to the problem of financial instability. The author would rather highlight the positive discipline effect of capital flows on macroeconomic policies.

Thus, Prasad seriously believes in neither international coordination nor in unilateral capital controls. Therefore, accumulation of reserves is destined to a brilliant future where central banks will play an important role. The main thrust of the eleventh chapter, 'Safety nets with gaping holes,' is the failures of international financial institutions. The IMF is controversial because of its recommendations and the strings attached to its loans. The role of the Federal Reserve is in using monetary weapons to sustain the world economy, acting as a global lender of last resort, but its swaps agreements have been signed only with a few economies in the world. The rest of the world that wants an insurance against uncertainty has been constrained to accumulate safe assets, even if some emerging countries are trying to develop some alternative monetary funds (for example, the Chiang Mai Initiative). It is also in this chapter that Prasad explains his proposal of insurance coverage for crises-induced damages, financed as any insurance is, by fees paid by the member countries.

The last part covers four chapters, the first of which being 'Is the Renminbi ready for prime time?' Prasad studies the likelihood – often evoked in recent academic works – of the internationalization of the Chinese currency. He analyses the evolution of Chinese policies and reforms – with which he is familiar given his role as the head of IMF China's division – and especially the financial side. Despite macroeconomic indicators encouraging internationalization of Chinese currency, full convertibility of the renminbi is missing. Moreover, the lack of supply of a safe asset associated to the renminbi inhibits its internationalization. Finally, Prasad is critical of Chinese political institutions, another obstacle to the full confidence in the renminbi. In chapter 13, Prasad gives his opinion on other currencies or reserve assets sometimes viewed as possible alternatives to dollar, such as emerging currencies, gold, or bitcoins. In the contest for the status of international reserve currency, all of these are far behind the dollar.

In the fourteenth chapter, Prasad reflects on the 'tipping point,' which corresponds to a drop of the dollar and a change of the international reserve currency. It could come from China and its 'atomic weapon' represented by the amount of its dollar-denominated assets (p. 287). However, such a game is risky for China to the extent that a drop of the dollar would bring about a huge loss in the value of Chinese assets.

Chapter 15, 'Ultimate paradox: fragility breeds stability,' summarizes the book and re-emphasizes the author's overarching thesis. The dollar is still the reserve currency and should remain the dominant one for a long time. Institutions are the main explanation for the initial choice of the dollar and such a situation is self-reinforcing in the frame of the dollar trap. Admittedly China has an attractive growth pattern, but remains, in Prasad's view, far from being ready to be the safe haven because of its financial and political institutions.

The book is stimulating to read and contains a wealth of references, found mostly in the notes. It includes many stylized facts that unequivocally back up the author's thesis.

The 'dollar trap' can be seen as the price the emerging economies have to pay as a compensation for their mercantilist strategies and their growing integration with international finance. Prasad underlines the importance of the notion of relativity: the dollar is still dominant because it is still the reserve currency which is associated with the safe haven, in comparison with other currencies or other assets.

While the book is an extremely valuable addition to the literature, it contains a few weaknesses. For instance, the Keynes plan is not alluded to in the text as a possible solution for global imbalances. Such a proposition could have been a relevant addition to the book, because it targets directly the financial instability, which makes the accumulation of reserve currency so vitally necessary. Of course, it would be necessary to admit controls on capital flows. Readers may also be disappointed in the third part of the book, in which Prasad denounces the mercantilist behaviors of several economies in the world that contributed to global imbalances. He appeals to cooperation rather than competition – even quoting Keynes in this purpose (p. 135). Yet he praises in the same chapter the ex-chancellor Gerhard Schröder, thought of as a courageous politician who has implemented structural 'reforms,' especially with regard to the labor market (p. 156). Those reforms have nonetheless crushed the internal demands in Germany, amplifying the export-led growth strategy and consequently the internal imbalances within the euro area.[1] Thus, although the treatment of the burning issue of global imbalances could have brought us to heterodox conclusions, Prasad does not follow this path. His conclusions are wholly un-Keynesian. One way or another, 'advanced' economies should implement austerity measures to reduce their budget deficits. According to him, the most important deficiencies preventing China from becoming the 'safe haven' are appropriate institutions, that is to say institutions that guarantee property rights and inhibit arbitrary expropriations. In this way, the author conveys the orthodox view of institutions.

Nonetheless, *The Dollar Trap* offers a useful retrospective look at the recent great crisis and is a meaningful contribution to the understanding of the current contradictions within the global monetary and financial system.

1. See for example Jörg Bibow, 'Global imbalances, Bretton Woods II, and Euroland's role in all this,' The Levy Economics Institute, Working papers, No 486, December 2006.