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BUSINESS DAY

The Greater the Turmoil, the Stronger the Dollar. Again.

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Strategies

By JEFF SOMMER

Chronic problems have been flaring up in financial markets lately, and some of them may emanate from the United States. Yet none of these issues have seriously damaged the exalted status of what Washington Irving once called "the almighty dollar."

In fact, a familiar pattern has been emerging: When the world's financial system runs into trouble, the position of the dollar as the world's crucial currency becomes more formidable.

Eswar S. Prasad, a Cornell economics professor and senior fellow at the Brookings Institution, has written a thoughtful new book that clarifies this counterintuitive phenomenon. Its title is "The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance" (Princeton University Press).

In a conversation last week, Professor Prasad, formerly the head of the financial studies and China divisions of the International Monetary Fund, said: "There's a dollar paradox. You might think that after the global financial crisis — after the world experienced so much financial turmoil because of U.S. policy actions — that the dollar would be losing some of its importance. But the truth is the opposite of that. We're seeing this today as emerging markets run into trouble. It's just making the dollar stronger."

It's not that the dollar is universally viewed as an ideal linchpin for global finance, or that other countries believe that the United States should enjoy the "exorbitant privilege" of minting the world's money. That's what Valéry Giscard d'Estaing called it when he was French finance minister in the 1960s. Mr. d'Estaing and Charles de Gaulle, the French president, sought unsuccessfully to reduce the dollar's clout.

The United States, de Gaulle said, was using the dollar to expand American influence, making it cheaper for American companies to operate and for the American government to finance its activities. All of this, he said, amounted to hidden subsidies paid by the rest of the world.

Similar critiques have continued sporadically ever since. The euro, the Chinese renminbi and even a kind of synthetic currency, the Special Drawing Rights of the I.M.F., have been proposed as alternatives in some aspects of world finance. All of them have a role to play, and perhaps a larger one in the future. But as Barry Eichengreen, an economist at the University of California, Berkeley, has written, no viable challenger to the dollar's dominance has yet arisen.

Professor Prasad takes the argument further: What we have been seeing lately is that even after a global system centered on the dollar has undergone the greatest stress since the Great Depression, the dollar has become more central in world affairs, not less so. And this happened as America's fiscal deficit soared, and as the federal government repeatedly flirted with a default of its sovereign debt — developments that might have reduced the dollar's international relevance. "The problem for the rest of the world," he told me, "is that for safety and for ease of transactions, in many cases, there's really been nowhere else to go."

Consider some of the issues that have grabbed headlines recently. For starters, turmoil has been erupting in a vast and diverse group of emerging-market nations. Countries like Argentina, Brazil, Indonesia, the Philippines, South Africa, Turkey, Ukraine and Venezuela have been struggling with shaky currencies, capital flight and plummeting stock markets. Local issues are at play, of course, and cause and effect is sometimes hard to pinpoint.

Nevertheless, when searching for the immediate reasons for their current predicament, it's hard to exclude the announcements and actions of the Federal Reserve in Washington. In fact, the Fed has been moving markets worldwide for a very long time. After years of flooding the planet with liquidity, it is now ratcheting down its monetary policy. Until it began reversing course late last year, it had been explicitly encouraging investors to put their money into riskier assets, and some of the funds ended up in emerging markets. Now, investors are paring down risk and many emerging-market nations are hurting.

In Argentina, while the stock market is up 5.3 percent so far this year in local currency terms, it's down 20.1 percent in dollars, reflecting the devaluation of the peso. After resisting for months and depleting its foreign exchange reserves, Argentina devalued its currency in order to combat capital flight and to account for some of the effects of rampant inflation. Undoubtedly, it brought some of its problems on itself. But the ebb and flow of global money, heavily influenced by the Fed, has exacerbated them. Investors have responded to global turmoil in a familiar way: by moving money from other currencies and asset classes to the United States dollar and to Treasury securities.

Interest rates in the United States have been driven extraordinarily low. Ten-year Treasury yields, which move in the opposite direction as prices, have declined to 2.68 percent, from 3.03 percent on Dec. 31. Rates had been expected to rise because of the Fed's tighter monetary policies. Flight to safety investing explains at least some of this, and it has helped keep rates relatively low for several years.

This "exorbitant privilege" has been a mixed blessing for the United States. It has, for example, hurt retirees who rely on fixed-income investments, which are generating very little money. And it's allowed the government to operate with relatively little fiscal discipline, because foreigners have been ready and able to finance the debt. Still, it has made it easy to fund the federal budget deficit and has helped corporations, small businesses and homeowners who have been able to get loans and mortgages at very low rates.

Richard Madigan, the chief investment officer of J.P. Morgan Private Bank, agrees that many of these developments have occurred because of a "global dollar trap."

"People have moved money into Treasuries and made interest rates on U.S. government debt much lower than they probably ought to be," he said. "It's counterintuitive, but even when finances are unsettled in the United States, it's still the center of the global financial system and it's where people go for safety."

It's where they go, even though in some ways the United States is a very odd place to seek financial security. On Friday, after all, the Treasury had to resume its now-familiar routine of taking "extraordinary measures" to avoid a sovereign debt default. Yet investors were generally not alarmed. That's because the Treasury was repeating a frequent pattern of recent years, as Republicans in Congress have refused to raise the statutory limit on the federal debt ceiling in an effort to obtain concessions from the White House. In previous episodes, the ceiling has been raised, debt payments have been made and the dollar has remained strong. Still, this "Perils of Pauline" routine seems an unusual way to ensure the stability of the currency at the global system's core.

Why it continues isn't simple, but Professor Prasad provides a very useful way of thinking about it. "What we're seeing isn't pretty, but it's the best system we have," he said. "And at the moment, until there's something better, the world just seems to be stuck with the dollar."

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