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Author: Financial crisis cemented dollar's global role

Despite financial problems in U.S., the world perceives its currency as the only place to run when fearful

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In contrast to just a few years ago, you don't hear the shrill cry over the dollar much anymore.

In the early 2000s, during the 2008 financial crisis, and amid the political rancor over the U.S. debt ceiling in 2011, the doomsayers were out in force. They warned that the dollar and the U.S. bond market were going to collapse. Foreign investors were going to stop lending to the U.S. They were going to embrace the euro instead, and maybe even China's renminbi. Nervous Americans bought gold and braced for disaster.

Then, the opposite happened.

"Paradoxically, the global financial crisis cemented the dollar's dominant role," according to Eswar Prasad, professor of trade policy at Cornell University, a fellow at the Brookings Institution and former head of the International Monetary Fund's China division.

In his new book, "The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance," Prasad notes that instead of fleeing dollars, "a wave of money flooded into the U.S." when the U.S. appeared most vulnerable.

From September to December 2008, while the U.S. was at the epicenter of the financial crisis, panic over that crisis prompted people throughout the world to seek safety in the very area they feared. They poured half a trillion dollars into U.S. securities, largely Treasury bonds. That was three times the total in the first eight months of that year. And people pulled money out of other advanced economies, including Germany and Japan.

Given the script written by the doomsayers before the crisis, the expectation would have been that the dollar would have been anything but a safe haven. Instead, "we ended up in a topsy-turvey bizarro world where everything seems inverted and backward," Prasad wrote.

Now, despite valid concerns about ongoing U.S. government debt issues and economic growth, it's clear that the world perceives the dollar as the only place to run when fearful.

"There is no viable challenger to the dollar's status as the definitive safe haven currency," Prasad said in an interview. And he doesn't see that changing for decades.

But Prasad's belief in the dollar's ongoing eminent position is not based on an assumption of U.S. exceptionalism.

"There are many compelling and logical reasons why, in principle, the dollar's dominance in global finance should be under siege," he said. "These include rising levels of U.S. public debt and obligations to the rest of the world, ineffectual U.S. macroeconomic policies and the emergence of new currencies."

But, he noted, "The dollar has faced numerous threats in recent decades" and withstood them all. Simply consider the period in 2011, when Standard & Poor's downgraded U.S. debt as Congress squabbled over the nation's debt ceiling.

Many analysts anticipated that investors would respond by dumping bonds — potentially setting off substantial losses for U.S. bond investors. Instead, the negative view caused demand for Treasury bonds to increase as investors worried what a shaky U.S. would do to the rest of the world.

The popularity of the bonds resulted in extraordinary returns of more than 30 percent for long-term Treasury bonds that year.

"It's not about exceptionalism, but all about relativism," Prasad said.

In other words, it's as though the U.S., with all its problems, remains the best house in a sketchy neighborhood.

U.S. dollars are in demand because the U.S. is the largest economy in the world, has the deepest and most liquid market, and has an independent central bank, an independent judiciary and a democratic system, he said.

In contrast to some areas of the world, the deep, liquid market in the U.S. assures investors that they can buy or sell bonds easily on a moment's notice rather than getting stuck. And investors can deploy massive amounts of money in U.S. bonds.

China is on its way to making its markets more open, Prasad said, "but it will take a while." And to be a safe haven currency, a country "needs not only deep financial markets, but independent judiciary, independent central bank, and an open democratic system. That inspires confidence their money won't be expropriated from the government. The U.S. government can be taken to court and actually lose. In China, that's inconceivable."

Further, although some analysts have criticized the Federal Reserve for "printing dollars" and risking a spike in inflation, Prasad said there is confidence throughout the world "that the Fed will do what's needed" to avoid inflation. "That could go wrong, but the market expects it won't go wrong."

"Expectations are critical," he added. "The Fed still has the faith of the U.S. and foreign investors."

As Prasad meets with financial leaders in other parts of the world, he said, "they are a little worried about U.S. policies. But they can't act on those concerns, because they have nowhere else to hide."

In the early 2000s, analysts thought the euro might become a reserve currency and unseat the dollar in that powerful role in global trade. But Europe's debt crisis undermined that notion.

Europe remains plagued by banking and debt problems, and Prasad noted, "it may be a decade before Europeans get their act together. Building institutions that investors will trust takes a generation or so."

Prasad expects a gradual decline in the dollar over time and said that "eventually, the U.S. must stop buying so much from the rest of the world and stop getting cheap financing to do it." But for the foreseeable future, money will flow into the dollar "because there is no other place to go."

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