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Why One Ivy League Economist Thinks The U.S. Dollar Is Invincible And What This Means For Investors

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Eswar Prasad, the Tolani senior professor of trade policy at Cornell University and senior fellow at the Brookings Institution recently sat down with me to discuss his views on the dollar and his new book, The Dollar Trap: How the U.S. Dollar Has Tightened Its Grip On Global Finance (Princeton University Press, 2014). A video and transcript of our conversation follows.

Steve Forbes: Dr. Prasad, thank you very much for coming by today. You wrote a book that came out earlier this year called, *The Dollar Trap, How the U.S. Dollar Tightened Its Grip on Global Finance* when by its very behavior it should've been the exact opposite. First, what do you mean by trap, and how this paradox, the more we misbehave, the more people seem to want our currency?

Eswar Prasad: It's remarkable to see. What happened of course, that the global financial crisis had its origins in the United States. Since the financial crisis the U.S. has issued a massive amount of public debt, and the Federal Reserve, the U.S. Central Bank, has been issuing a lot of dollars. All of this should logically lead to a decline in the dollar's value, and a decline in the dollar's prominence.

But instead what we've seen is that repeatedly, every time there is financial turmoil in emerging markets in the euro zone, or and this is the great paradox, in the U.S. itself, money comes to the U.S. in search of a safe haven. What happened since the financial crisis, the demand for safe assets has gone up. So financial safe assets, ones where you can expect at least your principal to be preserved, those are largely government bonds.

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Now, emerging markets want a lot more foreign exchange reserves, which need to be held in government bonds. Financial institutions have to hold more safe assets, and private investors want more safe assets. The supply has shrunk, the euro zone isn't quite what it seemed like it was—the safe part of the euro zone is quite small, actually. Germany and a handful of other countries. Japan and Switzerland, don't want money coming into their economies. So, who's left? The U.S. And the U.S. is doing its bit for the world by prodigiously providing large amounts of safe assets. That is U.S. government securities.

Forbes: Why didn't we see the same thing in the 1970s, when the dollar was severely weakened? It seemed to pay a price more then than it is today. What's the big difference?

Prasad: I think the nature of demand has shifted very significantly because at the time the emerging markets weren't playing such a big role, and it was thought there were alternatives. Now, the U.S. financial system has become the most important link in the entire global financial system, plus the emerging markets have now become very prominent, in terms of economic size. But their financial markets are not very deep, and as they open up more, the capital flows; they become more exposed to capital flow volatility. So, they want more protection, and because they are richer, they're able to buy this quote-unquote, "self-insurance" by accumulating foreign exchange reserves. Plus, of course, the regulatory changes mean that banks have to hold more financial safe assets. So, all of this is driving money in search of safe havens, and the U.S. really looks like the only safe haven left standing.

Forbes: So, the trap, why is it a trap rather than something else?

Prasad: The curious aspect here is that anytime there is financial turmoil, even perpetrated by the U.S. policies, that leads people to come to the U.S. for safety. So for instance, when we had the debt ceiling negotiations in October of 2013; one might thing that the possibility of a U.S. default, even if it was going to be short-lived and technical default, should lead people to flee from U.S. Treasury securities and from the dollar. Instead, because there was no other place to go, people came to the U.S. to hide from the turmoil.

And that's the paradox that when the U.S. policies create turmoil, people come back to the U.S. And just given the sheer amount of the U.S. Treasury securities and other dollar assets that the rest of the world holds, the rest of the world doesn't want the dollar to plunge in value. because if it did, then they would get hurt, in some ways even more than the U.S.

Forbes: This will lead to some interesting questions on the whole, I think, unfounded fear of China. But first, why is there this sort of neo-mercantilist mentality; in the 1600, 1700s, 1500s it was thought if you pile up silver and gold, you'll be rich. It was nonsense, Smith demolished it. Now today, it seems to be, gee, we pile up reserves and somehow that will make us rich?

Prasad: From the point of view of emerging markets, it's really not so much a question of being rich, as just of protecting themselves from volatile capital flows and from exchange rate volatility. The emerging markets have been scarred by memories of the Asian Financial Crisis of '97, '98, and many of the crises that these economies faced in the '80s and '90s. And they know they don't have a public institution globally that they can go to that would rescue them at times of crisis because the IMF (/companies/imf/) is not an institution they trust.

Because they see it as still in the pockets of the large advanced economy shareholders. So they say, where can we turn to for safety? They don't see any place, so they say, the only way we can get safety is by accumulating our own rainy day funds. But it's a double benefit for them, because if they intervene in exchange markets, and prevent the currencies from appreciating, first of all they can maintain the competitiveness of their exports, and they build protection. So, it's a double win for them. Of course, the downside is that they have to park their money in largely U.S. government bonds, which pay very low rates of return. But that's a price they're willing to pay.

Forbes: Well, and in terms of that, why this idea, first on the IMF, is it really just the shareholders, or the fact that the IMF comes in and practices medicine? I know I'm treading on tender ground here. Practices medicine of bleeding the patient. They always come in and say, devalue, raise taxes, take away subsidies at a time of political turmoil, which is the worst time to do it. So, they know when the IMF comes in it's curtains for the government.

Prasad: Yes, usually by the time a country comes to the IMF, it has managed to run bad policies so badly that it's run the country into the ground. So, yes, it is true that the IMF does ask a lot of these countries, but these are reforms that ultimately the IMF sees in the interest of these own countries. And the fact that the IMF asks countries to do this at a very difficult time is sort of unavoidable, because the reason countries come to the IMF is because they have lost the confidence of financial markets.

And you need to take some drastic steps to enable the confidence of markets. But it is politically very toxic, so it is true that countries, emerging market countries don't want to be in a position where they have to go hat in hand to the IMF. India, for instance, had to go to the IMF in 1990, 1991, when it ran out of dollar reserves. They don't want to be in that position again, because at the time the IMF did ask India to devalue its currency because it was being maintained at an artificially high level. So, perhaps it was good medicine for India, but it was very painful medicine. So, countries don't want to be subject to that anymore. So, they are looking for self-protection.

Forbes: Well, in terms of keeping a currency stable, they really don't need a lot of reserves. Because what seems to happen is they go on the market, they use dollars say, to buy rupees, or rupiahs, whatever country you want to go to, and then instead of reducing their monetary base, they do what the Thais did in '97, and other countries, and reissue the money in effect in the domestic market.

So, they run down their reserves, the monetary base doesn't change, the speculators see it, and know these people do not know what they're doing, and they just come in and pound. Why don't they know how to defend the currency? Which means, temporarily reducing their monetary base?

Forbes: You know, that's absolutely right. In many of countries that would make a lot more sense. But the difficulty again is that these countries often have to do it under very difficult domestic circumstances when the economy is grinding to a halt, when there are big pressures on domestic demand, and there is no other room to move other than through monetary policy.

So, yes, monetary policy if run the right way, supported by other policies like fiscal and structural policies, wouldn't have that much of a problem. But usually by the time a currency is being attacked it's already in a difficult situation.

Forbes: Does that mean because certainly theoretically a central bank, even if a government's running deficits, so what? They can keep the currency stable. Government may pay a price. But they can keep it stable, they can sell bonds. I mean, they can do it, because the governments pressure the banks to say, reissue the money?

Prasad: Yes, technically you're absolutely right, Steve. But one thing again that emerging markets have learned is that once markets start turning against them, it becomes very difficult to manage these pressures. So, it is true that there are alternative mechanisms through which you can run monetary policy.

But the way monetary policy is run in these economies, particularly ones where you target inflation, for instance, is that you do try to use the reserves as a first line of defense. And the problem is that very quickly reserves can start evaporating. And there's document in the book, during the financial crisis, emerging market countries that lost reserves, not all of them did–China continued to accumulate reserves.

But of a group of about 13 countries that lost reserves, they lost about 30% of their reserves over an eight month period. And for a central bank, those are scary numbers. You're absolutely right that they could use monetary policy domestically in a different way. But that doesn't seem to be their preferred approach, partly for institutional reasons, and partly because they feel that other policies are not going to support them. So, it's better to fight the fight using their reserves.

Forbes: Not to keep beating this horse, but with Thailand, and Mexico before that, they had more reserves than the size of their monetary base. They could've bought up the whole monetary base if they wanted to, and yet they played right into the hands of the speculators?

Prasad: That's right. I think you're right, that central bankers tend to be very conservative and the notion of using reserves to protect their economies does come at very significant costs. And when you think about the alternatives that could be used through domestic monetary policy, I share your view that there are different ways that things can be run. So again, these institutions and other reasons that cause central bankers to create in some sense, problems for themselves, I think need to be dealt with.

Forbes: Reminds me of J.P. Morgan (/companies/jp-morgan/) , when we had the panic of 1907, and he brought bankers in and said, "Here are the institutions we save," and the bankers said, "That means we have to dip into our reserves" and Morgan says, "That's what reserve's for. Use them."

Prasad: Right, yes.

Forbes: Dealt with the panic. Why do you think the U.S. started to cheapen the dollar, weaken the dollar a little over ten years ago?

Prasad: I think it was a natural process that in fact would be good for the U.S. at one level. because the U.S. is still running a large trade deficit. And the rest of the world has been riding the U.S. coattails, in terms of aggregate demand. I think we need a much more balanced demand around the world, and for the U.S. to be running these large trade deficits is not sustainable.

Now, it's a mixed blessing for the U.S., if it has a strong dollar because yes, it provides cheaper goods, it provides cheaper financing for the goods. But it hurts export growth and job growth. So, in that sense I think a gradual weakening of dollar is not necessarily a bad thing for the U.S.

Forbes: Isn't that like trying to change weights to try to get an advantage in the marketplace, instead of doing it through productivity, you try to manipulate contracts?

Prasad: No, ideally there is no question about it. The way you want to do it is through productivity growth. But here again, the U.S. is a very mature economy, and even if it were to do quite well in terms of productivity growth, in principle it cannot match the productivity growth in emerging markets. It's true; the emerging market economies are going through a very rough patch right now.

But just for catch-up reasons, you would expect the emerging markets to generate much better productivity growth, which should mean that eventually the dollar should decline in value against those currencies related to those countries that are experiencing high productivity growth. But from the point of view of the U.S., certainly it will be a much better outcome if the trade deficit adjustment could come because the U.S. is able to be more productive, and therefore compete more effectively in global financial markets, rather than through a currency depreciation.

Forbes: Let me ask you a seemingly question of heresy. What's wrong with a trade deficit? Forbes has trade deficits with our printers; we've had them for 97 years. So what? I buy something, I get something, you get something. It's an accounting mechanism, it ignores capital flows. Why are we focused on this mercantilist thing of a trade deficit?

Prasad: Now, presumably eventually Forbes is going to pay its suppliers and those you do business with. And the problem with the U.S. is that the trade deficits have been accompanied by current deficits and a very large build up of debt to the rest of the world. So, right now the U.S. owes more than $4.5 trillion to the rest of the world.

The rest of the world doesn't seem very concerned about this because they've continued to put money in the U.S., because they have a lot of faith that the U.S. will ultimately pay back. So, the U.S. could in principle run a trade deficit with the rest of the world forever, if the world is willing to provide goods to the U.S., and provide cheap financing for those goods. One question is, whether at some point the rest of the world will tire of financing U.S. trade deficits, and then borrowing cost in the U.S. could rise.

But it's a share of GDP, if you had a small trade deficit, that's not necessarily something that has to be driven away in the long run. The big question relates exactly to what you've mentioned, which is capital flows and how much external debt the U.S. is building up.

Forbes: We have gross assets in this country, well over $100 trillion. What's $4 trillion?

Prasad: The net position ultimately matters a great deal. Now, the good thing for the U.S. is that many of the U.S. assets are denominated in foreign currencies. And in fact, the U.S. is doing quite well, in terms of the returns it gets on those assets. So, even though the U.S. is a net debtor to the rest of the world, to the tune of $4.5 trillion, it's actually making money on its net position.

China by contrast is a net creditor to the tune of about $1.7 trillion, but it's losing money because it's mostly put a lot of its investments in the U.S. Treasury securities, and other very low yield securities, and its paying formulas has pretty good returns. So, even if the U.S. is in net negative position on its investments, the U.S. is certainly not doing too badly.

Forbes: Talking about capital flows. You talk about uphill capital flows. You've mentioned Dr. Lucas, who noted the paradox of money going, at least for the '90s, to developed countries. Where you would think would go to the opportunities in emerging countries. Could you discuss that?

Prasad: So, theory does this and the economists like theory, that capital should be flowing from capital rich countries, that is typically the advanced economies like the U.S., Japan, and the Euro Zone, where there is a lot more capital and much less labor, to countries where there is a lot more labor, and a lot less capital.

Because that should make everyone better off. It would make investors in the advanced economies better off, because they get higher returns on their capital. It should allow the developing countries to invest more and grow faster. But the curious paradox that I documented in some of my research is not only that capital flowing uphill from the poorer to the richer economies. But the countries that are exporting capital, China being a prime example, are actually not suffering for it. They're in fact growing faster. One possibility is that if you're exporting capital in you're not importing capital from the rest of the world; you're less exposed to capital flow volatility.

So, foreign investors do not send you money anymore. You're less hurt if you're not that dependent on foreign capital. But it does imply that there is also a mercantilist notion underlying all of this that countries are intervening in foreign exchange markets, accumulating foreign exchange reserves, and that's how they end up exporting capital.

So, private capital still is coming into the emerging markets. But the central banks don't want the exchange rates to appreciate. So, they're shipping that capital out to the advanced economies. And it's not obvious that this is very good for the world at large.

Forbes: Discuss for a moment currency treaties. China's done with South Korea, I believe, Japan, trying to get around the dollar?

Prasad: There is a great deal of frustration in the world at being so tied to the dollar. And the dollar still dominates right now as a unit of account for denominating transactions, as a medium of exchange for settling payments, and as a store of value. So, at least in terms of the unit of account and store of value, various countries are trying to get away from the dollar.

So, when China signs bilateral currency pacts with Korea, Indonesia and say, Russia, the idea is that those countries could settle transactions in their own currencies and not use the dollar. So, China can buy Russian oil, and Russia's happy to get renminbi because they can pay for Chinese imports with that. That will, I think, take on increasing prominence, but it will still not have any effect on the dollar as its total value. Because that's where the dollar's real strength lies, and it's hard to see a viable competitor to the dollar in that function.

Forbes: Gets to the question of all the worry about China owning a lot of our debt. Some think it gives China power, another way to look at it is if we said, you now have nice wallpaper. They're as dependent on us as we are on them, if not more so. Give us your views on the so-called threat of China owning $1.3 trillion, which they have not added much to in recent years.

Prasad: That's right, but China holds about $3.8 trillion in foreign exchange reserves. And the reality is that probably a lot of this is in U.S. Treasury securities, although the official data suggests smaller numbers. But they miss out on a lot of money that China holds in the U.S. through various sorts of custodial accounts.

But even if you take that official number as fact, the reality is that China has nowhere to go with it. If you think about even 10% of that $1.3 trillion. They could take $100 billion and say, we don't like U.S. policies on say, Tibet or Taiwan, so it's going to hurt us if the value of our bonds falls. But we don't care. We're willing to shoot ourselves in the foot.

But where are they going to go with that $100 billion? There simply is no other place to go. And in the last half of 2013, they accumulated merely $320 billion worth of reserves. When you accumulate reserves of that sort through your foreign exchange market intervention, you really have no other home to go to but the U.S. dollar market, which still remains the deepest, the most liquid, and the most trusted in the world.

Forbes: Why haven't we seen Japan since the '80s, develop deep capital markets, and why hasn't Germany done more?

Prasad: Japan does have deep financial markets and in fact, the signs of the government bond market in Japan is very large but most of it is held domestically. Only about 11% of Japanese net debt is held by foreign investors, compared to the U.S. where that share is about 56%, if you exclude the amount held by the Fed and the Social Security (http://www.forbes.com/security/) Trust Funds.

So, the U.S. really stands out as being much more dependent on foreign investors for financing its debt. Japan again is very concerned about being seen as a safe haven, as is Switzerland. Because if money comes into Japan or Switzerland for safety reasons, that will cause the yen to appreciate, and Japan doesn't want the yen to appreciate because they would like their exports to be competitive. The same is true of Switzerland.

Germany, of course, is a rival competitor and Germany bonds are reasonably trusted. But it's a very small market compared to the U.S. So again, size and liquidity, if there is easy tradability, are hugely important in international finance, and the U.S. again is unrivaled in those two measures.

Forbes: In terms of Switzerland, one could understand small country that could not take anymore, and especially during the euro crisis. But in terms of Japan, if money comes in they could neutralize it through monetary policy. Why wouldn't they want their capital markets to be a magnet, and make them a power?

Prasad: I think right now in Japan the question isn't so much the need for capital. It's just the need to get aggregate demand going. So, I think the amount of savings in Japan is very high, and the fact that they're accumulating a lot of government debt, but financing it through government saving, means that capital isn't really the problem there.

They need to find a way to get aggregate demand going. And in order to boost the economy, there is a sense that they have little recourse but to have a weaker exchange rate. Now this certainly feeds into the whole notion of mercantilist policies. But Japan's been unable to put in place the structural reforms that are necessary to get the supply side working better. So, they're going back to the old mercantilist playbook. Which is certainly going to lead to a lot of tensions in Asia and around the world.

Forbes: And in terms of what happened in Europe, why was that called a euro crisis, when it was really a credit crisis? In this country, say Illinois defaulted, it won't but let's say it did, no one would speculate about Illinois leaving the dollar zone, because it's got bond problems. It wasn't the euro that was the problem; it was these specific credits, was it not?

Prasad: No, in the case of Illinois, of course it wouldn't be able to run a deficit. Most states in the U.S., of course, have balanced budget amendments. But what happened in the euro zone, of course, the protective umbrella of the euro zone and the lack of disciplining mechanisms allowed a lot of countries on the periphery to run policies that hurt them in terms of their fiscal positions.

But more importantly, they lost competitiveness because of their social welfare systems, which simply couldn't be financed. But was being financed through debt accumulation. So, I think, what the euro zone debt crisis at one level exposed was basically the fault lines within Europe itself. It was a monetary union, but without a fiscal union, or banking union to back it, and that meant that you did not have a good disciplining mechanism for countries in the periphery.

Forbes: What if you had normal markets, wouldn't they be disciplinary?

Prasad: But that was the concern. There was the assumption that when debt was being issued by the Greek government, that was implicitly backed up by the entire Euro Zone, and this is why even though Greece was racking up a large amount of debt even before it became apparent that its fiscal books were being cooked, they had a high level of debt, a very uncompetitive economy.

In a normal world, Greece would've have had to pay a very high premium for government borrowing. But because markets believed that Greece was going to be backed by the Euro Zone, they got away with very cheap financing, and that allowed them to build up bigger and bigger problems till it came to a head.

Forbes: Question on our monetary base, which has grown more than 400% since 2008. Between 1970 and 1982, our base grew about 225%, and we have this wild rise in the consumer price index, huge surge in interest rates. Yet this time, in a shorter period of time we've ascended at almost twice the rate we did at the '70s, yet very different outcomes. Is that because, what?

Prasad: Well, one reason of course is that aggregate demand remains very weak, and the standard monetary mechanism through which you would expect an increase in the money supply given a specific supply of goods and services to lead to inflation has not quite kicked in yet. It is still a bit of a mystery why inflationary expectations in the U.S. remain very, very dim.

I think over time, the Fed has built for itself enough credibility that there is a sense that despite this massive expansion in the monetary base, when inflationary expectations start rising again, as economic conditions normalize, the Fed will be able to pull back on its monetary expansion, and that it will be able to keep inflation under control. Whether this proves to be a realistic assumption is yet to be seen. But markets certainly seem to have enormous faith in the credibility of the Fed.

Forbes: In terms of looking at currencies, which ones strike you as undervalued, overvalued, rightly valued?

Prasad: That's a very hard thing to say, because it's conditional on many statements. If you take China, for instance, China's intervening very heavily in foreign exchange markets, as you can see from its foreign exchange reserve accumulation. But that is conditional on the status of its capital account opening.

If China were to liberalize its capital account today, so that domestic investors could take money out. Right now they don't have too many good options in terms of investing domestically. They're getting very low rates of return on their bank deposits. The stock market is a bit of a casino. So, if they could invest abroad, for diversification reasons, or for yield reasons, you could in the short run even have a depreciating rather than appreciating.

But it is true that in the lower end productivity growth does tend to drive exchange rate movements, especially in the inflation adjusted or real exchange rate. And by that measure, over time by which I mean over the next five to ten years, almost certainly the renminbi will appreciate very significantly as it has been doing.

The Japanese yen, again bounces around a lot for these safe haven reasons. My sense is that the U.S. dollar eventually is going to have to depreciate to some extent, again just given productivity growth in the U.S., relative to the rest of the world. But the U.S. again, seems to be coming back very strongly, and one thing we've learned over the years is never to bet against the U.S.

Forbes: So, a combination of the dollar trap and the fact the U.S. economy seems to be putting the weather aside, showing some more vigorous signs of life. Do you see a rise in interest rates here, or it's just merely the Fed hinting that it was going to wind down quantitative easing enough to have the ten-year go from 1.6% to 3%, now it's back to 7%, give or take? Is that about it?

Prasad: My sense is that, as business and conditions normalize, and as inflationary expectations start kicking back up, which will be a normal thing as the business cycle of recovery continues, the Fed will work to raise short-term rates. But my sense is that, long-term rates even if the Fed continues its taper, are actually going to stay low because the demand for safety, especially from the emerging markets, is going to remain very strong. And in addition, because of regulatory changes, financial institutions are going to be looking for $2 to $3 trillion worth of financial safe assets in the next four to five years, as Basel 3 rules come into play. So, the demand for safe assets is going to, if anything, strengthen. Which I think will keep rates at the long end much lower. So, I think we will go back to a relatively flat yield curve over the next year or two.

Forbes: Thank you very much, Dr. Prasad, and *The Dollar Trap*, which too bad we can't have that with eating; the more you eat, the less weight you have.

But in the real world it seems to work, certainly with currencies, certainly with the dollar. Thank you.

Prasad: Thank you very much.

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