The dollar problem

by Jay Elwes / MARCH 13, 2014 / LEAVE A COMMENT

Eswar S Prasad is a professor at Cornell University and a Senior Fellow at the Brookings Institution. His latest book, The Dollar Trap, *published by Princeton University Press, explores the global monetary system, and the dominant role played in it by the dollar.*

Prasad explains that the dollar cannot for now escape its role as the global reserve currency, "due to weaknesses in the rest of the world and deep problems in the structure of the global monetary system." There are substantial consequences of this, for the US, other western nations and the developing world.

He spoke to the Prospector about this and other subjects, the full results of which will be published here over the coming days.

Jay Elwes: So the principle theme of the book—there seems to be a certain discomfort with the standing of the dollar. Maybe you could just explain why that is.

Eswar S Prasad: So the global financial crisis had its origins in the United States. The US has built up a huge amount of public debts since the financial crisis and the Federal Reserve has been pumping a lot of dollars into the global financial system. So all of this logically should lead to a decline in the dollar's value as well as its prominence.

But that hasn't happened, in fact quite the reverse. And the reason is simple; it comes down to the supply and demand for safety. The world after the financial crisis sees a lot of financial turmoil and what the world wants when there is turmoil is safe financial assets. That is, assets that are expected to hold at least their principle value and that are liquid, that is, relatively easy to trade.

The demand for safe assets has gone up because the emerging markets want to protect themselves from capital flow volatility. They're now becoming much more open to capital flows, so are exposed to more capital flow volatility. Second, private investors want more safety in times of turmoil. Financial institutions are being asked to hold more safe financial assets so the demand has surged.

But at the same time the supply, partly due to the financial crisis, has shrunk quite significantly. The eurozone is not what we though it was, there are parts of the eurozone that are strong, other parts that are weak. If you take the safe part of the eurozone, the core eurozone economies, those account for only around 40 per cent of government debt issued by the entire eurozone. Japan and Switzerland, traditionally safe haven economies, don't want money coming into their economies because that would drive up the value of their currencies and make their exports less competitive, so they've become net demanders of safe assets rather than suppliers. Private sector securities are not considered safe anymore. They have a surge of demand, a shrinking of supply and who's left? The US. So it's a very discomforting situation because the US in a sense perpetrated a lot of these difficulties in global financial markets and the world is sort of rewarding it by pouring even more money into the US.

JE: But the US, the dollar, still offers security doesn't it? So from that point of view investors are getting what they're paying for.

EP: They're getting very low returns on their US government securities because interest rates in the US are very low. But in addition, behind the dollar strength in times of financial turmoil is this uncomfortable trend that the value of the dollar is falling against the other major currencies. Not against some of the advanced economy currencies, but against emerging market currencies.

So take China for example, the value of the dollar is falling against the renminbi and the value of the dollar is likely to fall in the future which is not such a bad thing because the US is still running a very large trade deficit. Plus it needs to pay off all the obligations it has been building up.

So the world is willing to pay an enormous price for safety, they're willing to accept very low rates of return in US government securities and a decline in the domestic currency value of their US treasury security holdings.

JE: There has to be a global reserve currency. There can be no return to the gold standard. So it seems what you're describing is in many ways an unsatisfactory situation where the dollar has the prominent role. But what's the alternative?

EP: That's a good point. In international finance ultimately everything is relative and this is not really a story about American exceptionalism. But basically what it shows is that the US economy and the set of institutions that the US has put together backing up its currency, are much stronger than any competitors in the rest of the world.

But the US has managed to do something that few other economies have been able to do. Not only does it have economic size, it is still the largest economy in the world, it has very deep liquid financial markets which means it is very easy to trade in those markets and there are a lot of securities that foreign investors can hold. But in addition, foreign investors have a lot of confidence in the US because it has strong institutions. It has an open and transparent democratic government, and one might argue that Washington is stuck in political gridlock right now, but it does have a self-correcting tendency over time. And more importantly there is this institutional system of checks and balances among the legislative branch, the judicial branch and the executive branch.

JE: Maybe too many checks and balances.

EP: Maybe! Second there is the sense that the US's public institutions, especially the Central Bank, that the world trusts. And third, a legal system that gives investors, both domestic and foreign, the sense that they are going to be treated fairly according to the letter of the law. And all of this put together, inspires a lot of confidence among foreign investors, that they wont get snookered.

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In a crisis, only one thing will do

by Jay Elwes / MARCH 14, 2014 / 1 COMMENT

Eswar S Prasad is a professor at Cornell University and a Senior Fellow at the Brookings Institution. His latest book, The Dollar Trap*, published by Princeton University Press, explores the global monetary system, and the dominant role played in it by the dollar.*

Prasad explains that the dollar cannot for now escape its role as the global reserve currency, "due to weaknesses in the rest of the world and deep problems in the structure of the global monetary system." There are substantial consequences of this, for the US, other western nations and the developing world.

He spoke to the Prospector about this and other subjects, the full results of which will be published here over the coming days.

Jay Elwes: On the subject of quantitative easing—the Fed has engineered a very extraordinary situation with its asset purchase programme. But there are now politicians in the United States, like Rand Paul, who think that the Fed is debasing the currency and that the Federal Reserve should be abolished. That is a minority view but still one that is being voiced by a senior and very prominent US politician. What effect has quantitative easing had on the standing of the dollar and how easy do you think it will be to unwind QE?

Eswar Prasad: In a normal world, what the Fed did and what the US government has done with its issuance of massive amounts of public debt should definitely have driven down the dollar's value and its prominence. But what we've seen is that at times of crisis, the world looks for dollars. The dollar still remains very important, and if anything, the Fed's actions have entrenched the dollar's role.

Why is this? In the US, as in many other economies, the problem was that monetary policy is being relied upon to do the work of all the other policies that are not pulling in the right direction. Fiscal policy should be supporting the recovery—it's not, its being pulled back. There are structural reforms the US needs to undertake to help long-term productivity. Those are not being undertaken. So monetary policy is the only tool that's working.

Now monetary policy has spill-overs. Last year when the Fed had engineered quantitative easing and even before that, that was leading to a flow of capital to emerging markets. The notion of the Fed pulling back on those operations has led to capital flowing out. So, the Fed is creating more turmoil in international financial markets creating more capital flow volatility and the paradox is that to protect themselves from this volatility, what are emerging markets doing? And what are they likely to continue to be doing? Building up reserves. And when they build up a lot of reserves, where can they go? Back to the US dollar.

So it's a remarkable paradox again that actions by the US that create financial turmoil also pull more countries into the grip of the dollar. So when there is financial turmoil, anywhere in the world, in emerging markets in the eurozone, or—and this is the paradox—in the US itself, money comes to the US in search of protection.

So can the Fed pull back its quantitative easing operations? My sense is that the Fed can pull this off, but expectations and financial markets are very difficult to predict and they could come unhinged. But the difficulty here again in thinking about a scenario where you have panic in these markets leading to a plunge in the dollar, is that if you have panic in US government bond markets you'll have panic in all US financial markets. If you have panic in all US financial markets that will very quickly infect world financial markets and when there is turmoil everywhere what do people want? Safety. And where do you go for safety? Back to the US dollar.

JE: That's a very satisfying equilibrium state you've just described, one that cannot necessarily be relied upon here in the UK, where we also have a asset purchase programme—of £375bn. How do you see the British QE experiment? How does it compare with the US?

EP: In the UK again, I think that there are other policies that could have helped. In the UK, in particular, I don't think it has been monetary policy that has been carrying the same burden itself. Other policies have been somewhat more supportive.

But it is true that in the UK as well there is some degree of leakage. But again, given the size of the UK financial markets, I think the spill-over effects have not been that large, unlike in the case of the US where the sheer

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absolute scale of the problem has been much greater. The UK economy does in some ways seem to have repaired itself, and the economy is registering good growth considering. So I think that even if one does not attribute this to the quantitative easing policies of The Bank of England, I think it had at least some positive effects.

Now whether the risks are going to manifest themselves as the BoE tries to pull back is still an open question because what is certainly true in the UK and the US, and many other advanced economies, is that even though the effects on the real economy might not be obvious, the effects on financial markets have certainly been very clear and if the pull back of quantitative easing in the UK and the US and so on, leads to financial markets being deflated and that in turn affects aggregate demand then we could end up in a situation where, so to speak, the artificial propping up of financial markets will end up badly which in turn will affect aggregate demand. My sense is that the BoE can manage this fairly well, although, it doesn't have as much room for manoeuvre as the US because the US still remains very special in many ways.

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Terence Hale **March 15, 2014**

Hi,
In a crisis, only one thing will do, yes call for help and watch from a safe distance. The quantitative theory infers if you have a stack on money (moneten, doe, bucks; for comprehension of the Americans) you can influence the price level. It consists of five factors, proportionality, neutrality, theory of prices, role of money and exogeneity. Negative changes are usually called crises and in economics this when central banks don't know what to do. There are many solution, do nothing as the European central bank or exogeneity which involves controlling the money supply, now so good, when all this do's not work you have two options, fiddle the books or quantitative easing. Quantitative easing is when a central bank stacks money by the back door to the economy by buying financial assets from commercial banks and other private institutions. The method once a method of the last resort has now become a fashionable method of choice. It has certain draw backs, it doesn't work.

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QE, the renminbi and Scotland

by Jay Elwes / MARCH 17, 2014 / LEAVE A COMMENT

Eswar S Prasad is a professor at Cornell University and a Senior Fellow at the Brookings Institution. His latest book, The Dollar Trap*, published by Princeton University Press, explores the global monetary system, and the dominant role played in it by the dollar.*

Prasad explains that the dollar cannot for now escape its role as the global reserve currency, "due to weaknesses in the rest of the world and deep problems in the structure of the global monetary system." There are substantial consequences of this, for the US, other western nations and the developing world.

He spoke to the Prospector about this and other subjects, the full results of which will be published here over the coming days.

Jay Elwes: Do you think that quantitative easing in the US and the UK, has been pro-cyclical—that it has amplified movements in markets and prices that would have taken place nonetheless?

Eswar Prasad: Not quite, because these economies are still well below potential output, especially in the US given where the labour market is right now. There is clearly a lot of room for the economy to expand and do better so in that sense the policy has certainly been counter-cyclical in the sense of trying to mitigate the weaknesses in the economy.

If the economy does recover very strongly and the Fed does not pull back quickly enough it could turn pro-cyclical but I don't think there is any risk of that at least as yet in the US. The UK does seem to be a little further along in terms of the repair, but my sense is that in the UK too there is a significant output gap that it is likely to mean that we are not able to talk about pro-cyclical monetary policy.

JE: On the question of the renminbi. There was excitement last year when George Osborne secured certain arrangements with the Chinese government for allowing renminbi-denominated deals to go on in the City. Might the renminbi challenge the dollar as the desirable global currency?

EP: So China is an economic powerhouse and a trading powerhouse, everyone wants to be friends with China. So I think the sense that this is a big economic power that has a currency which is becoming more prominent internationally will certainly lead to more central banks signing local currency swap lines with China, perhaps even holding some renminbi as part of their foreign exchange reserve portfolios. If China goes forward with its economic reforms, which allows the country to continue on its growth trajectory—although perhaps at a slightly lower growth rate than in the previous decade—if China moves on with financial market reforms that allow its financial markets to become deeper, broader, give foreign investors more renminbi assets to hold, if China continues towards its move to opening of the capital account, then the renminbi becomes a reliable reserve currency.

So there are many "ifs" here. My sense is that over the next decade or so, the renminbi will become a viable reserve currency. It will erode—but will it challenge the dollar's dominance? For that, one would have to think about the renminbi becoming a safe-haven currency. And for that you need a lot more than economic size and financial markets, you kneed people to trust you and that sense of trust will require very significant political, institutional and legal reforms. I don't think that any of these are on the cards.

But there is an important point raised by your question, because the dollar right now is the dominant currency as a unit of account, as a medium of exchange and as a store of value. Let's take the unit of account function, so if you think about commodities like oil, they're all priced and denominated and settled exclusively in dollars, that's because the dollar is the cheapest currency to trade, it's a very liquid currency. As other financial markets become more developed, as the cost of transacting in other countries falls there is no good reason why the dollar should remain dominant in that role.

As a medium of exchange, it's likely to become less important. China is now signing bilateral currency pacts with many of its trading partners, with Indonesia, with Korea, with Japan, with Russia. So they can settle trade transactions in each other's currencies, they don't need the dollar to intermediate those transactions. So in those two functions, it isn't happening yet, but over time I can see the dollar playing a less important role.

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But as a store of value, I see few competitors to the dollar and certainly not the renminbi, unless again they undertake very significant reforms.

JE: You were talking about China developing new relationships with its regional neighbours. We in Britain have our own question about currency unions with regional neighbours. The big monetary and political story is the question of Scotland and the pound. Do you think Scotland would be able to have anything like the global economic standing that it enjoys if it were to lose Sterling?

EP: Having an independent currency would certainly give [Scotland] another shock absorption mechanism. But my sense is that they have benefited enormously from the very close integration with the rest of the United Kingdom. So it's not obvious to me that this is going to be a big net plus for Scotland to break away from the currency union. It will create some degree of instability.

Now if Scotland can move forward very quickly with setting up its own institution mechanisms and make them distinct from those of the UK it could work, but setting up institutions that work well, that are credible takes a long time and I'm not sure that Scotland is quite there yet in terms of being able to run its own ship effectively from the United Kingdom.

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Gloom, doom—or boom?

by Jay Elwes / MARCH 21, 2014 / 1 COMMENT

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Jay Elwes: We've been talking to a lot of economists and reading with great interest the thoughts of, for example, Larry Summers and Robert Gordon—who I spoke to last week—and Thomas Piketty, all of whom are gloomy and worry that economic growth will necessarily return to levels enjoyed in the past. Are you optimistic for growth in developed economies, or do you share their gloom?

Eswar Prasad: The US in particular is a fundamentally very resilient and dynamic economy, so I think the US will pull it together. But what causes a lot of concern really is the lack of political will in many of the advanced economies in particular to undertake the hard reforms that are needed. There is this reliance on monetary policy as a simple and easy tool for getting away from doing what really needs to be done.

So if you take the US for instance, there are good grounds for pessimism because on fiscal policy for instance, ideally fiscal policy should support the economic recovery for now and we should be dealing with the longer-term fiscal problems. But the US is getting it backward, pulling back on fiscal policy and not dealing with the longer-term fiscal problems, and the pulling back in the short term is having a very negative effect on expenditures like education, infrastructure and so forth that are very important for long-term productivity. And if you don't have productivity growth that is certainly going to be difficult.

Now it's been argued that there are regulatory burdens and so on that are holding back US growth. But my sense is that while those uncertainties are important the government plays an enabling role and given how much of a paring back there has been in government expenditures on these productive areas, my sense is that the government is not playing that enabling a role anymore. But again, I remain reasonably confident that the US can return to reasonable growth rates of at least 2.5 to 3 per cent. If nothing else to catch up for what has been lost over the last few years.

The labour market is very troubling, the fact that despite where we are in the economic cycle the labour market continues to perform very poorly certainly gives grounds for the secular stagnation story that Larry Summers has been talking about both in the economy and in the labour market in particular.

As I look around the rest of the advanced economic world, the UK is doing quite well. But in countries like Japan I don't see the political will to put in place the tough reforms that are needed, so it's still only one of Prime Minister Abe's three arrows that is really being fired, and keeps continually being fired, the other two are not working well at all.

The eurozone has begun the process of repairs, and some progress has been made and some significant progress has been made on some of the periphery economies. But I don't think that's enough to ensure the competitiveness of those countries in the eurozone so I think this part of the advanced economic world will remain under serious tensions for a while and across all these economies the common theme again, is the excessive reliance on monetary policy without other policies pitching in.

JE: Do you worry about deflation as a global economic phenomenon?

EP: I think that, given how aggressively central banks are moving towards ensuring that that outcome is avoided and given how much fiat money they have actually provided, one has the sense of optimism that that will be avoided. But unless aggregate demand picks up in these economies, unless consumers and investors show some degree of confidence, that isn't going to translate into a boost in aggregate demand which in turn could lead to deflationary pressures continuing.

In the emerging markets I think we are beginning to see a significant slowdown in growth and that adds to these concerns because the emerging markets have accounted for the bulk of growth since the financial crisis and if those economies start slowing down and if they too start relying on external demand then we could be back to the old scenario before the financial crisis where much of the world was riding on the US coat tails, and to some extent on the Chinese coat tails.

And if those two economies are not able to pull their weight then they could drag everybody down with them. So I think it is an ever-present concern but my sense is that in the advanced economies, at least in the US and the UK in particular, will be able to avoid these risks. Japan I worry about a lot more as the policies in place are certainly not credible in generating more aggregate demand. The eurozone again remains a concern because they seem to have gotten out of the hole they were in, but other than Germany it is hard to see significant strength in the other economies. In those economies not contracting already seems to be a victory every time so it's not a good position to be in.

JE: You mention the problem of demand—do you make the link between weakness of demand and inequality? Because that's one of the big political and economic questions here and certainly in the United States.

EP: That's not something I have done any research on myself, but it's certainly a plausible argument that the rise in inequality has contributed to the weak demand because it is certainly true that those at the lower end of the economic distributions tend to have a higher propensity to consume. And if you shift a lot of income away from there towards the upper parts of the income distribution where saving rates are typically higher, that alone mathematically would lead to a reduction in aggregate demand. But this is again not an area I have looked at closely myself. I find it to be a plausible connection. But I don't have a good sense of quantitatively how important it is.

JE: Is it an idea that you think has political traction in the United States?

EP: I think the concerns about inequality and especially what they imply for the labour market are certainly very much part of the political dialogue in the United States. There is of course enormous dissension about what the policy implications of that are—whether the government should actually step in, with policies like raising the minimum wage, and providing other sort of protection to workers, what the re-distributive role of the government should be. And there I think we are not going to see significant progress simply because the political dissensions are too great and all these programs to have the government play a role in reducing inequality require money and the money is not there.

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Terence Hale **March 22, 2014**

Hi,
Gloom, doom—or boom? With the Transatlantic Free Trade Area deal America hopes to solve some of it ill's. What's disturbing these negotiations are secret and from a European perspective a danger. The American objective is to side step EU laws in the interest of America companies particularly in agriculture which would result within a decade EU agriculture succumbing to pesticide resistant weeds as in many parts of America. The EU must open up these negotiation in the interest of Europe as a whole.

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Replacing the dollar

by Jay Elwes / MARCH 27, 2014 / LEAVE A COMMENT

Eswar S Prasad is a professor at Cornell University and a Senior Fellow at the Brookings Institution. His latest book, The Dollar Trap*, published by Princeton University Press, explores the global monetary system, and the dominant role played in it by the dollar.*

Prasad explains that the dollar cannot for now escape its role as the global reserve currency, "due to weaknesses in the rest of the world and deep problems in the structure of the global monetary system." There are substantial consequences of this, for the US, other western nations and the developing world.

He spoke to the Prospector about this and other subjects. This is the fifth and final part of that interview.

Jay Elwes: In your book you say the dollar's reserve status brings potential instability, but that strikes me as a comment not necessarily specific to the dollar. If we were to fast forward twenty years and the renminbi was the unit of account, then presumably these instabilities would still arise. So it seems that these points about the dollar could equally be applied elsewhere.

Eswar Prasad: So if there was one dominant reserve currency, then the prospect of instability is somewhat greater because then the world does not exert enough discipline on that one currency. If you had say, the US dollar, the euro and the renminbi, as potential competitors roughly equally weighted then none of these economies individually would be able to run extravagant policies because then people would shift away to the other currencies. So my sense is that having a uni-polar system certainly doesn't help, but one could also make the reverse argument.

If we were starting with a blank slate we probably wouldn't develop a system where one currency is so dominant. But given where we are right now in terms of financial development and also financial market imperfections around the world, a bad mix of policies and so on, maybe it's not such a bad thing to have one central bank that the world trusts, one currency that the world is willing to accept in essentially unlimited quantities—because if you think about the financial crisis the demand worldwide was for dollars and if you didn't have one institution or one currency that the world trusted perhaps it could have been a lot worse.

JE: Is there still an appetite on the part of China for treasuries?

EP: China would desperately like to diversify away from treasuries but as many of the quotes from Chinese officials in my book indicate they have no other place to hide. When an economy is accumulating say half a trillion dollars worth of reserves every year, as happened in 2013, there aren't markets that are big enough, deep enough, liquid enough to go to. So while the Chinese are trying at the margin to diversify, to find real assets, they're trying to move into a little bit of gold and other currencies, the reality is there isn't enough of those other assets or instruments out there. So ultimately they have to turn back to US dollars for the vast majority of their holdings. In that sense their currency policy, that is, not letting their currency depreciate and intervening heavily in foreign exchange markets ties them even more to the US dollar.

JE: Do you think China's urge to diversify out of treasuries is going to encourage them to invest more in other countries?

EP: They've been trying hard—the Chinese central bank like every other central bank cares about three things: safety, liquidity and yield. If you look at the first two criteria—safety and liquidity—there aren't many places to go. So what they've done with part of their reserve portfolio is move it to the Sovereign Wealth Fund, the China Investment Cooperation which now has a market capitalisation of about $500bn compared to the foreign exchange reserves of about $3.8 trillion. Even with this $500bn they've had a great deal of difficulty finding high quality assets and a lot of that money in fact comes into the US into equities, into real estate, and even the Sovereign Wealth Fund itself holds some US Treasury securities because again, it is very difficult to find such a massive amount of investments that you can put any place.

JE: What about Bitcoin?

EP: Two sets of observations. First, things like gold and Bitcoin have a certain allure because of the limited supply and the sense is that if you only ever have 20m Bitcoins that are only ever going to be mined or a finite supply of gold, those should hold their value. But ultimately the market value of gold is well above its intrinsic value. Bitcoin also has value because ultimately people have faith in it. But the crisis has taught us that first of all it is not necessarily assets that are limited in supply that keep their value because the fiat currencies were expanded into essentially infinite quantities and those are what made them more valuable because at a time of crisis you could get more of these into the system. This is why I think that given the nature of financial markets right now going to something like gold or any other restricted supply currency would be foolhardy.

But Bitcoin does presage one very important stage of development, that is, I think a move to electronic currencies and away from paper money. So I don't think we're going to be carrying around paper money for much longer, we're going to be transacting largely through economic mediums and that will also mean, going back to an observation I made earlier, that the unit of account and medium of exchange functions in traditional fiat currencies might be replaced by some extent by these electronic currencies.

Of course if you had an electronic dollar you could still have the dollar maintaining all three functions. But to have a currency, or any asset, that has a store of value function, you still need an institution backing it. So the dollar has behind it The Federal Reserve, which in turn behind it has the US government with its taxing powers. So that is what makes the dollar dominant in its role. So I think again whether Bitcoins survive or not, they do suggest there are going to be important changes in financial markets and money markets. But I don't think we will get away from fiat currencies so that Bitcoin will replace a fiat currency particularly as a store of value.

JE: Were you ever worried during the worst of the crisis, back in September 2008, that the dollar could loose its reserve currency status?

EP: Absolutely, I think in the initial days of the crisis this was a very real possibility and I think that all logic would suggest that what happened after the financial crisis should have led to a decline of the dollar's value and prominence. And this is where my book essentially got its starting point because I was planning to write a very different book on capital flows, which have been going from poor to rich countries, which is a bit of a paradox.

But as I started looking at these things through the lens of the financial crisis I realised there was a much more interesting story to be told. As I sifted through the data I could see that every time you had turmoil potential, even in the US like the Standard and Poor's downgrade of US debt, I don't think it has happened in any other country where a rating agency downgrades a country's debt and bond yields fall, because it created scares in peoples minds and some said "where am I going to put my money? In the US dollar".

And we had it happen again in October 2013, there was a small, very small, but distinct probability that the US may at least technically default on its debt. What happened to the US treasuries in the very short end they did actually rise, but they rose from 0.2 per cent to 0.8 per cent which is nothing, and where did that money from short term treasuries go? It went into longer-term treasuries. So the yield on the ten year bond actually fell by thirty basis points from early September to the middle of October 2013. So again this was treasury bonds of a country that looked like it might default and money came into the US, and this has been a repeated pattern.

So the financial crisis was a very important game changer again driving up the demand and eliminating a lot of the supply, and leaving the US in a really much more strong position.

JE: What would have replaced it?

EP: That's the key issue, I ask this question in my book, if not the dollar then what? And we don't have a persuasive answer to that question and I don't think we will have a persuasive answer to that question any time soon. Yes the renmimbi is going to become more important, yes I think the renmimbi could even account for between 5-10per cent of foreign exchange reserves if they do everything I mentioned that they would have to do.

It could happen in the next 10 to 15 years but just like the euro in its initial stages after its inception it looked like it was on its way to world domination and it flatlined very quickly, and the financial crisis hurt it. So the dollar is certainly going to become somewhat weaker but it will still remain by far the most dominant currency.

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