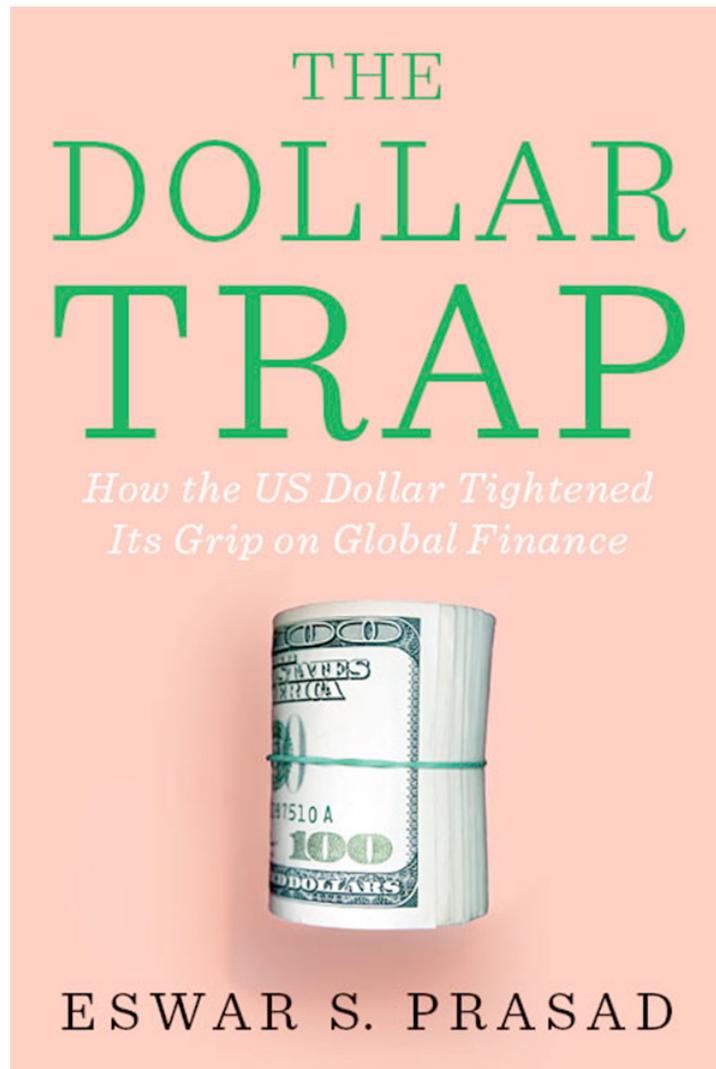


The Dollar Trap

— By *P.P. Ramachandran*, July 13, 2014 12:05 am



This is a painstakingly researched book and throws a flood of light on the omnipotence of the dollar

Eswar Prasad examines how the Dollar came to have a central role in the world economy and demonstrates that it will remain the cornerstone of global finance for the foreseeable future.

The Dollar Trap
Eswar Prasad
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Eswar Prasad was Head of the China Division in the IMF and is presently a Professor in Cornell University and the Brookings Institution. He had served in the Advisory Committee to the Indian Finance Minister. He has made impressive contributions to respected economic journals.

The book under review rejects the idea that the dollar is no longer a global currency and contends that it continues to be relevant in the

aftermath of the global crisis after 2008 and the emergence of new markets. Prasad points out the paradox of the dollar gaining in strength with each financial crisis as also how capital flows from richer to poorer countries. What exactly is the future of the dollar and its impact on the global economy forms the gravamen of this significant book.

The world economy is in a fragile equilibrium. Although we can hardly think of a scenario that could cause it to happen, it is quite likely that we are on a sand pile that is just a few grains from collapse. According to the author "The equilibrium in which the dollar remains the dominant global currency is sub-optimal but stable and self-reinforcing."

The US dollar reigned supreme in global finance for most of the twentieth century. In recent years its position has become shaky. A major challenge was the creation of the "Euro" in 1989 and currently a rising competitor is the Chinese "Renminbi".

The global financial crisis which has its epicentre in the US has led to speculation in the dollar's looming displacement as the world's leading currency. The Federal Reserve has attempted to prop up the economy by injecting massive amounts of money into the US financial system. The political dysfunctioning in the US has affected effective policy-making.

The author observes that the dollar's position as the foremost store of value is more secure. Financial assets denominated in US dollars are still the preferred destination for investors.

Prasad devotes one chapter to explain the origins and resilience of the dollar's status as the principal reserve currency. Unlike the theoretical presumption capital has flown from poorer to richer nations. There is a careful analysis of the direction, composition and volatility of capital flows. The global financial crisis shattered conventional views about the level of reserves that is adequate to protect an economy from the consequences of volatile capital flows.

One Section of the book deals with the existing frameworks for international financial diplomacy, using a variety of sources. It is revealed that while global co-ordination of some economic policies are desirable in principle, efforts made in this direction have not been crowned with success. We are provided a review of the safety nets that offer protection from crisis. Instances of extreme volatility have led the IMF to create new lending programs which function like insurance schemes.

The prospects of the dollar are considered in the final part of the book. The chances of the Renminbi replacing the Dollar are clinically analysed. China is the second largest economy of the world and could be world's largest in the next decade.

The Chinese government is taking aggressive steps to promote the international use of their currency. It could become a viable reserve currency. However, the limited financial market development and structure of political and legal institutions in China make it unlikely that their currency will become a major reserve asset.

The author has arrived at a judgement that the dollar will continue to reign as the leading reserve currency in the near future. The dollar-centric equilibrium seems to be unstable with big risks for the entire global economy. The fear of its decline and the resultant devastation itself lends a measure of equilibrium to the dollar.

This is a painstakingly researched book and throws a flood of light on the omnipotence of the dollar and deserves to be read by economists, planners, financiers and students of banking and finance.

P.P. Ramachandran

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