

The New York Times | <http://nyti.ms/1di6i8e>

THE OPINION PAGES | OP-ED CONTRIBUTOR

Why the Dollar Endures

By **ESWAR S. PRASAD** MARCH 21, 2014

ITHACA, N.Y. — Why hasn't the dollar plunged?

Since the 2007-8 global financial crisis, the public debt of the United States government has soared to \$17.4 trillion, roughly equivalent to America's annual gross domestic product. The Federal Reserve has pumped more than \$1 trillion into the economy in an attempt to spur lending — and, in effect, weaken the dollar. Uncle Sam's credit rating was downgraded, for the first time ever, in 2011. Round after round of fighting over the debt ceiling led to a government shutdown last October. Bitter gridlock has made it difficult for America to get its fiscal house in order.

All of these circumstances would predict, under normal economic theory, a decline in both the value and the importance of the dollar.

Strangely, this hasn't occurred — instead, quite the opposite. Since the crisis, the dollar has more than held its own against other major currencies, like the euro, the Japanese yen, the British pound and the Swiss franc.

Over the last decade, experts have variously warned that the euro — or even the Chinese renminbi — might threaten the dominance of the dollar; almost no one seriously says that anymore.

Most international trade and financial deals are still transacted in dollars. Central banks around the world hold nearly two-thirds of their foreign-currency reserves in dollar-denominated assets, mostly Treasury securities. To understand the dollar's endurance, it's necessary to distinguish the different roles the currency plays in global finance.

The dollar's roles as a unit of account (for denominating transactions across countries) and medium of exchange (for settling payments on those transactions)

are likely to wane. Developments in financial markets and in technology are making it easier to conduct cross-border transactions using other pairs of currencies. China, South Korea and Japan have signed agreements that will allow them to trade with one another using their own currencies.

Oil and other commodities have for a long time been priced and traded almost exclusively in dollars because it was by far the most widely traded currency, but this is unlikely to persist. Technological advances will make it cheaper to settle commodity transactions using other currencies.

However, the dollar's position as the predominant store of value in the world is secure. The demand for American investments, especially Treasury securities, is not just a short-term, panic-driven phenomenon. Since the crisis, the long-term demand for safe and liquid financial assets — mostly advanced-economy government bonds — has gone up, while the supply has shrunk.

There are three principal reasons why investors continue to turn mainly to the dollar for safety: First, emerging market economies such as Brazil and India, and even richer countries like South Korea, have a stronger incentive than ever to accumulate vast stores of foreign currency reserves. This protects their currencies from speculative attacks and insulates their economies from volatile capital flows. Governments are now trying to restore reserves that they used during the crisis to shore up their currencies and banks.

Second, regulatory reforms agreed to by the major advanced and emerging-market economies have increased the demand for safe assets among financial institutions. New regulations require the biggest American and European banks to hold larger buffers of liquid and safe assets. Since the implosion of the market for mortgage-backed securities, private-sector investments are hardly seen as safe anymore. The market for gold is too small and volatile for it to be a realistic alternative.

Third, the supply of safe assets has shrunk. Bonds issued by most euro-zone countries look shaky in the aftermath of the euro-zone debt crisis, especially since many of these countries face weak growth prospects. Countries like Japan and Switzerland have taken steps to weaken their currencies (thereby shoring up their exports) and are intervening in foreign exchange markets to prevent their currencies from appreciating in value. Thus they are adding to the demand for safe assets.

The centrality of the dollar in global finance is frustrating to many foreign governments, but there is little they can do about it. Countries like China and Japan, each of which hold well over \$1 trillion in Treasury securities (let alone other dollar-denominated assets), have nowhere else to turn.

The dollar — which decisively surpassed the British pound sterling as the world's main reserve currency by the 1950s — will remain dominant for a long time to come, mostly for want of a better alternative. This turns out to be a mixed blessing, both for the United States and for the rest of the world.

The dollar's dominance lets America borrow cheaply from the rest of the world to help finance its consumer spending and budget deficits. Foreign investors' eagerness to buy Treasury securities has kept American interest rates low, which translates into cheaper mortgages and consumer loans.

But low rates also lessen the pressure on Washington for fiscal discipline. And the recent strength of the dollar against other currencies has held back American exports and job growth.

The value of the dollar was in fact gradually declining against that of other major currencies in the decade before the crisis. This trend is likely to resume once financial markets stabilize.

Economists see this depreciation as desirable and necessary to bring down America's trade deficits. But it means that foreign investors pay a high price when they come to the United States financial markets for safety: They settle for very low yields on Treasury securities while accepting a fall in the value of their holdings as the dollar declines in value relative to their own currencies. This is a price they seem — so far — happy to pay.

Stranger still, when other currencies strengthen against the dollar, American households may have to pay more (for imported goods and for their vacations abroad) but America as a whole makes a profit: Its foreign investments are worth more (in dollars) while the dollar value of its liabilities to the rest of the world is unaffected.

Yet another paradox: In 2008, when the Fed began what would be the first of three rounds of quantitative easing — flooding the financial system with dollars — capital flowed to emerging markets, fueling inflation and asset bubbles. Indications of a gradual end to this policy have sucked money out of those markets in anticipation of rising United States interest rates. So foreign central banks have

been storing money in American assets partly to protect themselves from the spillover effects of American policies themselves.

What accounts for this almost childlike faith in the dollar?

In fairness to the United States, it has a winning combination that no other country comes close to matching: not just a large economy but also deep financial markets, robust public institutions including a trusted central bank, and an effective legal framework.

Why do these institutions matter? With its massive buildup of debt, one scenario for meeting obligations to its creditors is that Washington will tolerate a burst of inflation to bring down the real (inflation-adjusted) value of its debt. Foreign investors, who hold more than half of publicly traded Treasury securities, would suffer disproportionately as they would also be hurt by the dollar depreciation that would almost surely follow.

Aren't foreign investors concerned about this prospect? High inflation would hurt American retirees, pension funds, insurance companies and other politically powerful groups that hold government bonds — making this scenario politically difficult and therefore less likely.

Still, the frustration of the rest of the world at having no significant alternative to dollar-denominated assets is understandable. To fix that, other countries need to improve their own financial systems, making them more stable and capable of providing high-quality financial assets that foreign investors can purchase.

In its early years, the euro appeared to be a viable competitor to the dollar. But Europe's financial markets are less deep and liquid than America's. Moreover, the euro-zone debt crisis revealed that the European Union is only partway toward becoming a true economic union. To punch at its true weight, the euro zone needs to unify its fiscal, banking and regulatory systems.

There has been a great deal of hyperbole about China's currency, the renminbi. China's economy could soon equal America's in size. With better financial markets and freer movements of capital across its borders, the renminbi will become a reserve currency in due course — but not the dominant one. With its present political and legal frameworks, it is hard to see investors seeing China as a safe haven for their money.

To reduce emerging markets' demand for safe assets, there is a crying need for a global insurance scheme to protect countries from panic-driven "runs" on their

currencies. The only existing option is the International Monetary Fund, which bails out countries in distress, but often requires them to undertake painful (but necessary) reforms. This is politically unpalatable, leaving policy makers in these countries to self-insure by building up reserves — and intensifying their dependence on the dollar.

The world needs a system like the Federal Deposit Insurance Corporation, which protects American banks against runs. Countries would pay a premium — depending on how much insurance they wanted and how sound their fiscal, monetary and other policies were. Countries with large budget or trade deficits would pay higher premiums.

In the event of a liquidity crunch, countries would get a short-term line of credit they could draw upon up to the amount of insurance purchased and with no reform conditions attached to this credit. A neutral institution like the Bank for International Settlements, an association of central banks based in Basel, Switzerland, could easily manage such a scheme. Of course the stumbling block is that this scheme calls for international cooperation on basic rules and premiums.

For now, the world is stuck with the dollar-centric global financial system, because the alternative would be chaos.

This is not the system one would design if starting with a blank slate. An ideal system should feature multiple major currencies, with no dominant one. Perhaps even the notion of reserve currencies as safe harbors from financial turmoil would be irrelevant if big economies, and emerging markets, had sound financial systems and good economic policies.

The dollar's continued prominence is ultimately less a parable about American exceptionalism than about weaknesses in the rest of the world and deep problems in the structure of the global monetary system. In international finance, it turns out, everything is relative.

Eswar S. Prasad is a professor in the Dyson School at Cornell University, a senior fellow at the Brookings Institution and a former head of the International Monetary Fund's China division. He is the author, most recently, of "The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance."

A version of this op-ed appears in print on March 22, 2014, in The International New York Times.