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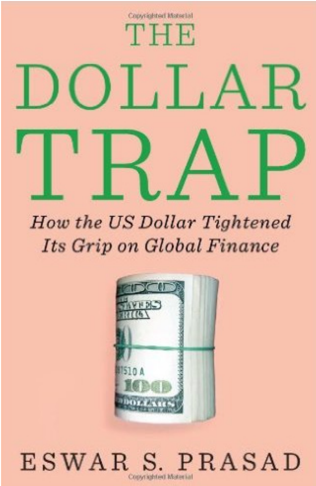

BOOK REVIEW

The Dollar Trap: How the US Dollar Tightened Its Grip on Global Finance

by Eswar S. Prasad

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Book Review

Which are the factors due to which the dollar's role as a unit of account and medium of trade might erode over time? What will be the impact of the present global financial crisis and technological developments on the dollar? What roles do foreign investors play in the consumption pattern of U.S. government and households? How does the conflict and/or cooperation amongst the different economies affect the global configuration of reserve currencies? What does current account deficit precisely mean? What is the relationship between the value of the dollar and the bond market? What opportunities do the currencies offer to the retail and institutional investors? Are the exports and/or imports from/of a country linked to the value of the country's currency in any way? Is inflation really a cause of worry or is deflation a cause of greater worry? How are the interest rates (levied by the apex bank of the country) related to the economic growth of the country? The global markets have been sinking because of the fears of the financial meltdown in Greece and China. On the twenty-fourth of August, two thousand and fifteen the sensex crashed by 1,625 points which was termed as the biggest single-day loss from close to close, and seven lakh crore investor wealth was wiped out. Are these financial crashes related to each other? How are government debts related to the slowdown of the nation's economy? Do exporters generate more jobs than importers? What is Ithaca Hours?* As of date, some of the currencies which are highly traded are: the U.S. Dollar, the European Euro (heralded by many as the Dollar's nemesis), the Japanese Yen, the British Pound, the Swiss Franc, the Canadian Dollar, the Australian/New Zealand Dollar, and the South African Rand. Which currency is likely to gain a dominant position in the days to come? The tome under review contains the answers to the aforesaid questions and is a must-read during these times of financial turmoil which threaten to transform the financial world-map beyond recognition.

The work under review has been effectively divided into four parts. The first part contains two chapters which set the tone of the book. The second part contains four chapters devoted to international capital movements and debt dynamics. The third part contains five chapters which are a critique of competitive devaluation and the fourth part contains four chapters dissecting the competition between the currencies of a few powerful economies.

The United States was supposed to be the epicenter of the financial earthquake of 2007 – 08. The erudite financial

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analysts such as Jim Rogers (co-founder of Quantum Fund), Paul Krugman (of Princeton University), Kenneth Rogoff (of Harvard University) and their likes had sounded warning bells pertaining to the coup de grace for the dollar. On August 05, 2011, Standard and Poor downgraded US's sovereign long-term credit rating from AAA to AA+. But, surprisingly, the dollar became stronger (from coup de grace it became many moments of grace). The first chapter dwells on the ground realities which led to the strengthening of the dollar. It also explains how the financial crises in a few countries in the Euro zone affected the dollar. The second chapter explains how the dollar gained a central role in the world economy and how the global financial crises are fortifying the dollar's dominant position.

The third chapter builds up on the works of Robert E. Lucas Jr. – Nobel Laureate (economics) known for his seminal research papers. It contains the answer to Lucas's disconcerting question: *"Why Doesn't Capital Flow from Rich to Poor Countries?"* It is a chapter in which capital flows theory meets harsh realities. The chapter contains references to a groundbreaking, eye-opening research conducted by Eswar S. Prasad, Raghuram Rajan (the current and 23rd Governor of the Reserve Bank of India) and Arvind Subramanian in 2006. The fourth chapter delves deep into external assets and external liabilities (of/for a nation). The chapter also explains three types of capital: foreign direct investment, portfolio equity, and debt (portfolio debt + other investment). The fifth chapter focuses on the advantages and disadvantages of appreciation in the value of the domestic currency. The sixth chapter dwells on the debt dynamics of major economies such as U.S., Japan and China.

The seventh chapter is a treatise on quantitative easing techniques and the financial policies such as pumping money into the economy, keeping interest rates low, not permitting the currency to appreciate, which have been adopted by powers such as Brazil, China, U.S., Korea, and Germany. The eighth chapter examines the role of IMF, WTO and the need of an institution (or a set of institutions working together) which can prevent the future currency wars. The ninth chapter is a beautiful exposition of the rhetoric of a few of world leaders whose stated vision was to rejuvenate the world economy. It provides a framework which helps in comprehending the reasons for the difference between an ideal world economy and the actual world economy. The tenth chapter is a dissertation on capital controls. The eleventh chapter is a disquisition on liquidity swap arrangement. The twelfth and the thirteenth chapters are devoted to the question: for how long will the dollar retain its dominant role? The thirteenth chapter dwells on a revolutionary question: should the world have a single global currency or a world currency? The chapter also dwells on a new currency which has taken the world by storm – the Bitcoin.

The fourteenth chapter sheds light on the possible consequences of the conceivable actions that can be taken by debt-market investors. The chapter also contains a comprehensive description of steps taken by China and Japan from circa 2008 which might alter the financial topography of the entire world. The fifteenth chapter examines the effects of changes (increase or decrease) in the value of the dollar and how those changes might influence U.S. and the rest of the world.

The book contains short but meaningful descriptions of terms like current account deficit, "Lawson doctrine", exchange rate, reserve currency, "Dutch Disease" effect, and fiat money.

A sound knowledge of currency markets, overvaluation of currency, under-valuation of currency, currency swaps, reasons for depreciation of currencies against the dollar, open capital account, Special Drawing Rights (SDRs), Treasury bond markets, Chicago Board Options Exchange Market Volatility Index (VIX), Great Depression of the 1930s, Chile's crash (1982), Japan's Long Recession in the 1990s, the sterling crisis (1992), the Mexican Tequila crisis (1994), the Asian and Russian financial crises (1997 – 98), collapse of the firm Lehman Brothers (2008) would be of great help in understanding the work under review.

The crash in crude oil prices has spelt huge fiscal deficits for several countries including Saudi Arabia (world's second largest oil producer). Interestingly, many of the oil-producing countries are unwilling to cut their oil outputs. These steps will have far-reaching effects, which can be gauged by a careful reading of the work under review.

The book also provides a subaltern view of the looming financial crises which are systemic in nature, it will help in understanding the recent bloodbath on the bourses, the reasons because of which global investors are frightened, the root causes of financial tyranny by select nations, it dwells on the lack of effective regulations which has led to financial cataclysms, the interplay between domestic inflation, asset markets, cross-border capital flows, foreign exchange markets, literacy rates, political risks, corruption, dilapidated infrastructure and international debts. It lays bare the deep problems entwined in the structure of the global monetary system. The book is an outcome of painstaking research and will definitely help the reader in understanding and perhaps predicting the new financial geography.

*Ithaca Hours is a community currency introduced in 1991 by a community activist by the name of Paul Glover.

About the Reviewer

Wallace Jacob is an M. Phil. in Management. He is presently working as a Senior Assistant Professor at Tolani Maritime Institute, Pune, where he teaches Principles of Management and Project Management. He is the author of the much acclaimed book The Unfathomable World of Amazing Numbers and the co-author of Puzzles - Exercises for Your Brain.