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Prasad, E. S. (2014). The dollar trap: how the US dollar tightened its grip on global finance, Princeton University Press, 2014, 432 pages, US$ 35,00.

The Great Financial Crisis of 2008 (GFC) raised concerns about the imminent demise of the US dollar as the world's leading reserve currency, a status it enjoyed at least since the end of WW II. Yet paradoxically, neither the almost collapse of the US financial system nor political gridlock over the state budget and ensuing downgrading of US sovereign debt could damage trust in the US dollar, as falling interest rates on the latter and recurring appreciation vis-á-vis other currencies during such crisis times revealed. Eswar Prasad's The Dollar Trap sets out to solve this conundrum by explaining the idiosyncratic role of the US dollar within the contemporary global financial system, its flawed governance and consequential geopolitical currency rivalries.

He commences by refuting conventional theory about international capital flows according to which capital should flow from low-interest environments in the Global North towards the Global South and crises precipitate capital outflows with concomitant currency depreciation and rising interest rates. In fact, however, the opposite is happening, which is due to investors around the globe seeking to safeguard their money in times of upheavals in safe assets characterised by high quality (low default risk), stability (preserving principal) and above all, high liquidity. For a range of historical and structural reasons, US dollar denominated public debt enjoys such a status, contrary to their counterparts in other countries and private assets, which investors shun since the GFC and the Euro Crisis, respectively. This shortfall of safe assets in the aftermath of the GFC caused US sovereign debt to become even more entrenched in the global financial system because constant demand led to rising prices and declining interest on US government bonds with concomitant dollar appreciation during crises, thus strengthening the role of US dollar. Hence, the dollar's stability becomes a self-fulfilling prophecy: As long as investors keep demanding dollar denominated safe assets, they keep the markets liquid and thereby uphold trust and in turn enticing more investors to store their savings in dollars.

This “self-reinforcing” circle is amplified by the fact that the current international monetary system lacks strong and coordinated governance. Instead, its institutions such as the IMF or the BIS are weak and inadequate to meet the challenges several countries – in particular in the Global South – face in the wake of increasingly volatile global capital flows. To this day, there does not exist a reliable source of emergency dollar funding without political conditionalities. Therefore, they rely on self-help in the form of reserve accumulation to fend off exchange rate risks, speculative attacks, and spill-overs of monetary policy by the Federal Reserve that can cause instability in their domestic financial systems. A recent example of this has been post-GFC expansionary monetary policy such as Quantitative Easing in core countries which devaluated their currencies compared with those of the periphery. In reaction, emerging market central banks intervened in their respective foreign exchange market in order to stave off currency appreciation that would otherwise undermine their export-led growth model. Interestingly, this neo-mercantilist strategy has also been adopted to an even larger extent by advanced export-oriented economies like Germany, Japan, and China. Since the accumulated dollar reserves from these interventions are preponderantly reinvested in US government bonds, their role as a reserve asset as well as the dollar's exchange rate is further underpinned. Consequently, these currency wars rather strengthen than weaken the US dollar.

After elucidating the reasons for prevalent dollar hegemony, Prasad turns towards its potential competitors, first and foremost China's renminbi. Being the biggest economy in the world and accounting for an increasing share of international trade, the People's Republic of China openly announced its intention to internationalise its currency. However, reserve currency status in international trade alone does not suffice to take over the US dollar's role as the world's reserve store of value, rather, deep, and globally integrated financial markets – especially bond markets – are needed to attract global savings. But access to the Chinese financial system remains relatively restricted due to capital controls and other regulatory constraints. In addition, safe asset status also depends on confidence in the political, public, and legal institutions of the issuing sovereign, which is not given in the Chinese context.
Hence, with respect to the future of the US dollar in international finance, Prasad states that it will remain the world's preferred store of value, although it is likely to demise as a medium of exchange in world trade due to technological innovation and the rise of intra-regional trade agreements such as EU, MERCOSUR, or ASEAN. However, he also emphasises that this equilibrium is fragile and not optimal, for those export-surplus economies funding the US' trade deficits are concerned about facilitating profligacy for the latter, while countries from the Global South continue to face the detrimental side-effects of US monetary policy against the backdrop of de-regulated globalised financial markets.

In conclusion, it can be said that The Dollar Trap succeeds in convincingly providing an answer to the paradox posed initially. It also provides a strong argument against conventional mainstream economics' theory of international capital flows and the role of the IMF in governing the global monetary system, which is all the more interesting since Prasad himself served for the at the fund's China division. However, beyond the economic mainstream to which he himself also belongs his book adds little new to the already known. Basically, his book reiterates and once again illustrates Keynes' concept of liquidity preferences and its portfolio choice theory, which entails the idea of a liquidity premium to explain the deviation of certain asset values and interest rates from its perceived 'pure economic' fundamentals. A more internal critique of his argument is that he overlooks the role of the shadow banking system in constituting demand for safe assets as collateral to facilitate repo-transactions and create liquidity. This also applies to the US banking system in general, whose role in money and credit creation is crucial for the relative supply and demand of reserves and Treasury bills and thus also safe assets.