The Future of the U.S. Dollar and Implications for the Korean Economy - Eswar Prasad

Years after the disastrous global financial crisis, the U.S. dollar has ironically become more dominant in international finance. With China rising in the global economy, many have questioned whether or not the renminbi will rival, or even threaten, the dominance of U.S currency. At the World Knowledge Forum 2015, held at the Shilla Hotel in Seoul on October 20th, Professor Eswar Prasad of Cornell University shared his knowledge and insight on the power of the U.S dollar and the Chinese renminbi, as well as the implications that the currencies hold for international finance as a whole, especially on the Korean economy.

Following the aftermath of the financial crisis, it was only logical to expect that the U.S. dollar would erode its value and power. However, the outcome was an unexpected one, even for Dr. Prasad, who researched the phenomenon extensively for his award-winning book, "The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance."

According to Dr. Prasad, the story is filled with many interesting twists and turns.

"Typically, when a country is in trouble… investors tend to run away from that country's debt and from that country's currency. But in this case, quite the opposite happened," he said.

The U.S. dollar did not decline after the financial crisis, as many expected. In fact, it strengthened.

"This is the great paradox. If there is trouble in the U.S. itself, money comes to the U.S. looking for safety," said Dr. Prasad. For investors, safety is of the utmost importance, especially when there is turmoil. "Why is it that foreign investors have this almost child-like faith in the U.S?" he asked.

He believes the first reason lies in the nature of U.S. institutions.

"The remarkable thing is that the U.S. [has] a system of checks and balances, and [has] a self-correcting mechanism. Over time, the U.S., through some blundering process, gets the right thing done," he explained. It's this kind of system that builds trust for investors.

The second reason is the legal framework.

"The U.S., by law, cannot treat different holders of its debt differently. So everybody… has to be treated equally," Dr. Prasad said.

Furthermore, there are not many countries in the world like the U.S. in the sense that the government can go to court.

"Sometimes, in fact, reasonably often," he mused, "[The government] loses, because [it] has to play by exactly the same rules that everybody else has to play by."

The third aspect involves the public institutions that are regarded as trustworthy by the rest of the world.

"If you take a look at this 'magic sauce' that the U.S. has put together," he said, "it's not just economic size, it's not just very deep and liquid financial markets, but also this combination of institutions and open and transparent, democratic system of government." He believes that these factors are what keeps the investors coming to the U.S., and what paradoxically strengthened the dollar after the financial crisis.

Regarding the Chinese renminbi, Dr. Prasad does not believe that it will take over the U.S. dollar as the dominant currency. He acknowledged that China is definitely becoming more powerful and putting in place effective economic and financial market reforms to potentially become a reserve currency.

“But I don’t think it will ascend to the status of a safe haven currency unless China is willing to undertake not just economic and other market-oriented reforms, but a much broader set of institutional and legal reforms,” he said. “And I don’t think that is going to happen.”

According to Dr. Prasad, China is currently lacking the firmness and stabilities of the American institutions and framework.

“My prediction is that [the renminbi] will erode, but not seriously displace the U.S. dollar’s dominance in international finance.”

He emphasized that he is not trying to tell a story about U.S. exceptionalism.

“My point is that in international finance, everything is relative. And relatively speaking, the U.S. economy is still in the best shape given all the other advanced economies.”

However, he said this does not necessarily mean that the global financial system is working well.

“In fact… this points to fundamental weaknesses in the international monetary system,” he said. “There aren’t any good alternatives to the U.S. Dollar... there is so much demand for safety, that emerging market economies feel that they have to protect themselves from all of this volatility.”

This weakness also points to the flaws in financial structures of individual economies, according to Dr. Prasad. So, what about Korea, which is a country caught between the U.S. and China?

“I think the harsh reality for many emerging economies, especially those in the Asian region, is that this is going to be a period of enormous volatility in currencies as well as capital flows,” he said.

Despite the uncertainty, there is still optimism for Korea.

“Fortunately for Korea, I think this economy is in much better shape than many other neighbors to deal with these forces,” Dr. Prasad said. The country still has flexibility in its monetary and fiscal policies.

He believes that the current situation, with one dominant currency, is not such a bad thing.

“Think of a scenario [where there are] multiple currencies also playing a role similar to the U.S. dollar,” said Dr. Prasad. He speculated that it would be beneficial for the U.S. economy, as well as the global one, as it would require more discipline and policies. “But if we had another financial crisis,” he said, “then [in that scenario], things would have been a lot worse.”

“It’s not great to end... on this somewhat pessimistic note of, ‘It could have been worse,’” he mused. “But I think that’s the reality that we face today.”

Reporter: Selina Lee