Economists called it the “dollar trap.”

The world is trapped into buying dollars because the United States market is big, liquid and reliable as a safe haven. And America is trapped in an addiction to cheap credit, with foreign demand for the dollar allowing the nation to spend well beyond its means.

In his latest book, “The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance,” Eswar S. Prasad, the former head of the International Monetary Fund’s China division and now a professor of trade policy at Cornell University, explains how the dollar’s “exorbitant privilege” came into being, why it’s unlikely to face a challenge anytime soon from the euro or China’s renminbi, and why this is so troubling for the future of the global economy.

He answered questions from David Barboza, the Shanghai bureau chief of The New York Times.

Q.

One of the surprising findings of your book is that things didn’t quite work out the way economists like you expected after the global financial crisis begin to hit in late 2008. What happened?

A.

I expected the dollar to weaken because the crisis exposed problems in the U.S. financial system. Moreover, the U.S. racked up a lot of government debt and
the Fed began flooding the global financial system with dollars. The more dollars there are out there, the less value they should have. But the exact opposite happened. The dollar, if anything, gained slightly in value.

Contrary to all expectations, the U.S. dollar’s position as the world’s dominant reserve currency has been strengthened by the crisis. The world became even more dependent on the dollar than it had been before the crisis.

Q.

What made the dollar attractive?

A.

It’s simple: there are no good alternatives to the dollar. Any time you think of the dollar losing its dominance, you have to ask yourself: if not the dollar, then what? And there’s no good answer. Emerging markets need foreign exchange reserves to protect themselves from volatile capital flows. And private investors and financial institutions want safe and liquid assets – assets expected to at least hold their principal value and that are easy to trade. These are typically government bonds.

But the supply of safe assets in the world has shrunk. The euro zone doesn’t look quite as safe anymore. Japan and Switzerland don’t want money flowing into their markets, as that would drive up the value of their currencies and hurt their exports. So that leaves the United States as the main provider of safe financial assets in the form of U.S. Treasury securities.

Q.

What are the implications of this so-called “Dollar Trap”?

A.

The dollar’s prominence is a mixed blessing for the U.S. A strong dollar and low interest rates mean the U.S. gets cheap goods from the rest of the world and cheap financing. But a strong dollar hurts U.S. exports and job growth. A more
fundamental problem is that this reduces U.S. fiscal discipline. Any other country would have to pay a higher price for racking up big deficits.

Emerging market economies find it frustrating that they have to buy U.S. Treasury securities to protect themselves from capital flow volatility that is in part due to U.S. fiscal and monetary policies! They are trying to diversify into other currencies and other assets such as gold and real estate. But the reality is that there are no other financial markets that give them both safety and liquidity to the extent the U.S. can.

Q.

*We know the euro has not challenged the dollar as a reserve currency. What about the prospects for China’s currency, the renminbi, becoming a global reserve currency?*

A.

If China moves ahead with financial market reforms and liberalizes capital flows so foreign investors can acquire RMB-denominated assets, China’s renminbi could become a major reserve currency. But that wouldn’t be enough to make the renminbi a safe haven currency that would challenge the dollar. For that to happen, China would have to undertake significant reforms to its political, institutional and legal frameworks. That is needed for foreign investors to invest with confidence in China’s markets, for safety rather than just high yield.

Q.

*The dollar is being bolstered by purchases made by the central banks of emerging market economies – economies where the average resident has one-sixth, one-seventh or one-eighth the financial resources as those living in advanced economies. Why are relatively poor countries financing the debts of wealthier countries, like the U.S.?*

A.

Emerging markets such as Brazil and India could use money more effectively domestically rather than buying U.S. bonds. But they want to protect themselves
with large stockpiles of reserves. A second motive is to keep their currency from appreciating, which would hurt their exports. That’s why net flows are going uphill, as they say, from poor to rich countries. This began to happen after the Asian Financial Crisis of 1997-98. Memories of that and other painful crises that beset emerging market economies in the 1980s and 1990s are seared into the minds of their policy makers. So emerging markets are eager to increase their “self-insurance” against economic disasters by stockpiling reserves, even knowing the yields of U.S. government bonds are low and the dollar could depreciate over time, eroding the value of their holdings. This is a signal of how much the rest of the world is willing to pay for protection.

Q.

*Isn’t there a better way to manage exchange rates?*

A.

There are costs to managing or manipulating exchange rates. It’s expensive to sterilize as governments have to pay high interest rates on bonds they issue to soak up money they print to cheapen their currencies. And currency intervention creates all sorts of other problems. You end up distorting the financial system and subsidizing exports. What’s needed is a better mix of domestic policies in both advanced and emerging market economies, with less reliance on monetary policy to do all the heavy lifting. We also need international governance reforms that give emerging markets more voting power at institutions like the I.M.F., which is seen as beholden to its advanced economy shareholders and less responsive to the needs of emerging markets. Domestic and international reforms are necessary for a freer, market-oriented exchange rate system to work well.

Q.

*Could we ever see a return to the gold standard?*

A.

One thing we learned from the Great Depression and subsequent crises is that the gold standard severely constrains central banks from providing liquidity. Financial markets often need massive infusions of liquidity or cash, as happened
during the global financial crisis. The gold standard inherently limits liquidity. I don’t think there is any going back. The supply of gold is limited. If you’re anchored to gold, you can’t print money at will. Financial assets that can be created freely turn out to be most useful in a crisis. Without an institution like the Fed that could produce money in unlimited quantities when the crisis hit, we’d be in much worse shape.

Q.

The U.S., like many advanced economies, has an aging population, a declining work force, growing debts and forecasts that suggest the dollar will weaken over time against the currencies of emerging market economies — which could raise interest rates. That would raise the cost of capital for the U.S., dealing a strong blow to the economy. Is this inevitable?

A.

The dollar is likely to depreciate, partly because the U.S. still has a sizable trade deficit. From this perspective, a dollar adjustment would be good for the U.S. and the rest of the world.

But it’s not clear interest rates will rise significantly any time soon. The world still clamors for dollars and there is no sign this will end. The world is so eager for protection against financial market mayhem, and there’s such a dearth of safe assets, so people may be willing to pay a high price for safety. It is plausible that there could come a tipping point when foreign and domestic investors lose confidence in the dollar. But this would create turmoil in financial markets worldwide. And that would cause investors to run for cover—right back into the arms of the dollar! So, till a better alternative comes along, for the foreseeable future the world is stuck in the dollar trap.