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# THE DOLLAR'S ROLE IN THE
# INTERNATIONAL MONETARY SYSTEM

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P R O C E E D I N G S

MR. WESSEL: I think I'll get started while the mics are going so we don't waste your time. Thank you all for coming. I'm David Wessel. I'm new here at Brookings; I'm the Director of the new Hutchins Center on Fiscal and Monetary Policy. And it's really a pleasure to be here at this event celebrating Eswar Prasad's new book, the Dollar Trap.

One of the cool things about being a journalist which I was until about two weeks ago is that you get the paperback version in advance, the galleys. So you get to read it before other people do and I was -- I immediately recommended it to all my colleagues because in addition to being wise it explains things very clearly. And it's sometimes hard to explain to people the international financial system even in a complicated way. It's really to explain it clearly. Eswar told me that that's one of the benefits of teaching undergraduates.

The big question of course that the book deals with is given that the United States seems determined to demonstrate that we don't know how to run a financial system, we have a democracy that's dysfunctional and we're living beyond our means, why in god's name does the rest of the world have so much appetite for US dollars? And that seems to be like a good question and hopefully you'll get an answer today.

So Eswar will start. Eswar is of course -- is here at Brookings as well as at Cornell University. And we're very lucky to have three panelists here, Charles Collyns, formerly of the U.S. Treasury and the IMF who is now Managing Director and Chief Economist of the Institute for International Finance which is a collection of global financial institutions, Luis Moreno, who is the President of the Inter-American Development Bank and former

Ambassador from Columbia to the United States, and then Jose De Gregorio, a professor at the University of Chile who is -- was the former Central Banker of Chile who very nicely agreed to come at the last minute because -- how do you say her name? Sri --

MR. MORENO: Sri Mulyani.

MR. DE GREGORIO: Sri Mulyani.

MR. WESSEL: -- Mulyani from the World Bank is unfortunately suffering from that cold that's going around Washington.

So the order of business is very simple. Eswar will speak for about 10 minutes. Each of my discussants will speak for about 8 minutes, we'll have a little interchange and then we'll have time for questions. I would as always ask you to put your cell phones on silent or vibrate so we're not interrupted.

And with that, Eswar, take it away.

MR. PRASAD: Thank you, David. It's wonderful to have you as a colleague rather than on the other side of the fence. And it's a great honor to be part of such a distinguished panel.

Consider this, the U.S. was at the center of the global financial crisis and since the crisis the Federal Reserve has unleashed vast torrents of U.S. dollars into the global financial system. The amount of net U.S. public debt, that is excluding the amount of debt that is held by the Social Security Trust Funds and the Federal Reserve, has risen by about $5.5 trillion dollars between 2007 and 2013.

And who's been buying up a lot of this debt? It turns out that about $3.3 trillion or about 60 percent of this new debt was in fact acquired by international investors. And although the U.S. has been at the center of many of these troubles and despite all the easy money policies, in fact on a trade rated basis the dollar is pretty much where it is today as it was right before the financial crisis.

Now consider this, in October of 2013 there was a small probability -- admittedly a small one, but when Ted Cruz was commandeering the Senate floor and especially when he got to the part where he was reading aloud "Green Eggs and Ham", there was a non zero probability that the U.S. might actually default on its debt, perhaps for a short period, perhaps as a technical default.

Anytime a country has faced such a prospect of default on its debt what has happened in the past, money has flown from the country, the currency is depreciated and yields on the bonds have risen. What happened in the U.S.? From early September until mid-October 10 year bond yields actually fell by about 30 basis points. The U.S. dollar stayed flat.

Now these are not isolated episodes. It turns out that ever since the financial crisis time and again anytime there is financial turmoil anywhere in the world including in the U.S. itself money tends to come to the U.S. in search of a safe haven.

So what is going on here? Why is it that the world seems to be so enamored of the dollar? Now in economics when I teach my undergraduates it always helps to come back to supply and demand. And that's a large part of the story. If one thinks about what happened after the financial crisis, the demand for financial safe assets has increased a lot.

What are financial safe assets? These are typically assets that are considered to be relatively safe in terms of their principal and that are fairly liquid, that is easy to trade. And typically government bonds of the major advanced economies that are traded in hard currencies tend to be viewed as financial safe assets.

So what happened after the financial crisis of course is that many emerging markets that had viewed themselves as having large amount of financial protection in terms of foreign currency reserves suddenly started feeling that maybe they should have even more. And of course this goes back to the post Asian financial crisis period after which many emerging markets, especially those in Asia, decided they wanted much more self insurance or protection from volatile capital flows.

So since 2000 emerging markets as a group have accumulated about $6.5 trillion dollars worth of foreign exchange reserves. About half of that is China, the rest is the rest of the world, the rest of the emerging markets. And reserve accumulation has continued of pace since the financial crisis.

So emerging markets want more protection because they're financial accounts are more open and they're much more susceptible to volatile capital flows.

In addition private investors want a lot more protection, especially in times of global financial turmoil. But while the demand has been rising the supply has if anything been shrinking. Private sector securities by and large are not seen as safe anymore. If you think about the Euro zone the safe part of the Eurozone is really much smaller than the entire Eurozone debt.

And countries like Japan and Switzerland traditionally seen as safe havens are in fact themselves accumulating reserves because they don't want their currencies to appreciate. So rather than supplying safe assets to the world on net they are demanding safe assets.

So by default the main provider of financial safe assets, especially thanks to all the public debt that is being issued here is the U.S.

Now there are a variety of paradoxes here if you start looking into this more carefully. First of all one of the reasons why emerging markets see much more capital flow volatility is they might argue the actions of the Fed. When the Fed unleashes loose money policies money flows to the emerging markets. When there is a hint of a taper then emerging markets find money flowing. But all of this causes emerging markets to want more protection. And where do they come for protection, to the U.S.

If you think about the dollar over the long term it is quite likely -- and economists think it should happen -- that the dollar will decline in value because this is necessary for the U.S. trade deficit to decline. In fact even though the dollar has remained literally flat in the period since the financial crisis, in the decade prior the dollar was in fact depreciating by about one percent a year.

And if financial markets stabilize this is likely to happen again. So we're faced with the situation for the -- where the rest of the world is willing to pay an enormous amount for its protection. Not only are they willing to accept very low yields on U.S. treasury securities but they're willing to accept the prospect of a declining value in terms of the domestic currency of their U.S. treasury security holdings.

Now thinking about the dollar's role it's important to distinguish among the different types of roles it plays in international finance. I have little doubt that the dollar's roles as a medium of exchange and as a unit of account will decline. Countries like China, Japan and Korea now have currency packs that allow them to trade in each of those currencies directly without using the dollar as a vehicle currency.

Commodities like oil have traditionally been priced and traded exclusively in dollars. There's no good reason for that to happen. And if you start thinking about electronic currencies such as the bitcoin I don't think they're necessarily the wave of the future but they do point to one aspect of the wave of the future which is that trading costs and currencies are going to decline and there is no real need for a -- for the dollar to remain the dominant unit of account of medium of exchange.

But it's as a store of value that the dollar remains pretty dominant. Now why, as David pointed out, should the world trust a country where the politics seems to be messed up, where the debt levels are rising, where monetary policy seems to be running on fumes?

And here I argue that in addition to problems with the international monetary system, which I will come to in a second, the U.S. has put together a magic combination which is going to be very difficult for any other country to match. It's not just size, it's not just depth and liquidity of financial markets but also a very robust set of public institutions and political institutions including a trusted central bank and also an open and democratic system of government.

Why is this important? I mentioned that of the $10 trillion dollars of net debt that the U.S. has foreign investors hold about $5.5 trillion. Now the other $4.5 trillion is held domestically and who holds treasury securities? It does show to be largely pensioners, who happen to live a large number of them in swing states like Florida, it's insurance funds, it's state and local governments. And these are all politically very powerful.

So from the foreign investor's point of view looking into the U.S. it seems like a rational proposition to say that the U.S. would never use a strategy of using default to reduce the real value of its debt because there would be enormous political consequences to pay.

If one thinks about a currency like the renminbi as an alternative, I have no doubt that the renminbi is gaining traction. Indeed it is. Not just as an international currency but also as a reserve currency. Some central banks including those of -- Jose, is the Chilean Central Bank -- are already holding a small proportion of their international reserves in renminbi. But is it likely that the renminbi and China will be seen as a safe haven?

Again my sense is that given the nature of political and legal institutions there, foreign investors are unlikely to trust China as a safe haven. Indeed all the evidence suggests that the Chinese themselves don't trust China. So it's hard to see international investors in China as a safe haven.

So I have no doubt the renminbi is going to become a viable, important reserve currency but it's not going to threaten the dollar's role.

So where does this leave us in terms of how things should be fixed in the international monetary system and whether this is good. If we were to get away from this I think we would really need to fix two things in the international monetary system. One, we need to think about the fact that a large number of economy is not just advance economies but also emerging market economies that are relying on monetary policy as the first and last line of defense.

If you think about the U.S. we have it exactly backwards on fiscal policy with a lot of short term fiscal contraction when the recovery is still not in good shape and very little action in terms of dealing with long term fiscal problems. If one looks at an emerging market economy like India, the Reserve Bank of India, the central bank there is being asked to support growth, maintain low inflation, maintain the value of the currency and do much more.

And of course other advanced economy central banks like the BOJ, the ECB and many others are all essentially the main drivers of policy within their countries. And monetary policy has spillovers and these spillovers are very large in a financially integrated world economy and these are likely to increase.

So with these spillovers and with financial consequences of these monetary policy actions I think we will see emerging markets looking for more protection. An alternative to the sort of protection emerging markets need might be rather than them relying on self insurance through reserve accumulation perhaps to have some sort of global insurance scheme of the sort I have laid out in my book where essentially countries could basically pay an insurance premium and be insured in terms of liquidity (inaudible) rather than have to build up their own insurance.

So ultimately if we were going to fix the situation what we would need is what I think of as institutional reforms both at the international level and at the domestic level to get away from the situation.

But given the reality that we face right now if we want to think about what is ideal, let's face it, if we were starting off with a blank slate we would probably never design a system that looks like this with a small group of reserve currencies and one of them being dominant. And not only allowing that country to run profligate policies but some might argue even essentially forcing that country to run profligate policies although that's not necessarily a view I ascribe to. But it certainly allowed the U.S. to be much more profligate in its fiscal policies, in its consumer spending and perhaps also given it much more leeway in its monetary policies.

So we need to fix institutional aspects both at the international and domestic levels. But given where they are perhaps it's not such a bad thing to have one currency, one central bank that everybody in the world trusts and that one can think about as a go to measure when the chips really are down.

So the world for now is stuck in the dollar trap, but perhaps it could be a lot worse. Thank you.

MR. WESSEL: Thank you. Charles?

MR. COLLYNS: Thanks. Well, I certainly appreciate the opportunity to participate in this panel. And, Eswar, it's a great book; I really enjoyed reading it. It's clear, it's informative, it's really a history of the economic debates that we've had over the past few years since the crisis. And as I was saying to you earlier it's nice having spent a lot of time in the last few years in the bunkers of the Treasury and elsewhere, dotting the "i's" and fighting over the commas to sort of find out what the big picture was that we were all trying to find our place in.

So it's really a very good book and I highly recommend it you all to read.

Also I certainly agree with your main conclusion that the dollar is here to stay for the foreseeable future as the dominant reserve currency despite what happened in the global financial crisis. However my -- I think my take would be somewhat more positive than yours. I mean you -- the title of your book is "The Dollar Trap".

MR. WESSEL: Well, he wants to sell books.

MR. COLLYNS: He wants to sell books. (Laughter) I think it -- as you were talking you were leaning a little bit more to a more positive view. And certainly it's a positive view that I would take. And certainly the global financial crisis was a huge black mark. But on the other hand the response to the crisis I think was very aggressive of the United States and I think underpins the trust that the global investors have in the dollar as a suitable location for investment and underpins the trust in the global financial system that is centered on the dollar.

You mentioned the Fed and certainly the Fed has played a prime role here not just in providing, you know, a whole series of instruments to provide monetary support to the U.S. economy but also -- and this is a point you make in your book -- in preserving global liquidity at very difficult times by being prepared to provide backup liquidity support. And not just to its advanced economy partners but also to a number of emerging economies.

And also, you know, Washington did its job in a number of areas. Banks are recapitalized, bank regulations were rewritten, fiscal support was provided when fiscal support was needed. It was -- it's been slowly withdrawn since then. Maybe -- we can certainly discuss the pace and -- at which the withdrawal took place, but at this point the trajectory of U.S. fiscal policy is not profligate. We -- there's very good reason to believe that the debt-to-GDP ratio is going to be stabilized in the next few years under current policy. There's certainly a lot more that could be done.

I don't want to oversell my case. The U.S. economy has long terms problems that need to be fixed and the political process is certainly noisy and sometimes very scary.

It's also disappointing, I have to say, that Congress was unable to provide -- find a way to fund the increase in the U.S. contribution to the IMF; not able to put the IMF quota increase in the recent (inaudible) legislation. And I think, you know, steps like that do tend to undermine the confidence in -- that the U.S. can play a responsible role in the international monetary system.

But nevertheless taking everything together I would still argue that the aftermath of the crisis has underpinned the overall confidence that the dollar provides a suitable anchor for the international financial system.

A couple of points that you make in your book, I think you have a nice discussion about currency wars. I think that's a topic that must -- both Mr. Moreno and

Mr. De Gregorio will be interested in. You have a very neutral view on currency wars; you give both sides of the story very nicely. I would, however, completely put myself on the side of the Fed in the sense that yes, it's true in a narrow sense that currency wars is a zero sum game;, that one country's depreciation is another country's currency appreciation, but I think if you look more broadly the actions that the Fed took to provide monetary support to the U.S. prevented a much deeper global recession than would have been the case otherwise.

And the Fed is clearly aware of its broader responsibilities. Now to be sure these steps -- the successive sequences of quantitative easing and now the reversal does create volatility in the market potentially and headaches for central bankers and policy makers in emerging economies. But I think the alternative were to be much worse. And there are instruments that the countries can use and countries that have had flexible exchange rates and quite well balanced monetary fiscal policies and good regulations have generally been able to manage through quite well.

Chile I think is a good example of a country that's -- that is -- has worked through this with good success. But it's the countries that whether it be issues in terms of unbalanced policies, too large fiscal deficits or insistence on rigid exchange rates that have had the biggest problems.

In terms of your liquidity insurance facility I think that's an interesting idea. I -- I'm kind of skeptical it would actually work very well. I think the main reason for the accumulation of reserves in recent years is not so much a country's desire to accumulate liquidity back -- although certainly the countries have been happy to have liquidity back -- but the real reason they're intervening is to prevent the appreciation of currencies and loss of competitiveness. And I don't think creating liquidity back is always going to change that motivation.

I also doubt that the Fed would be prepared to participate in the sort of the mechanism that you described which doesn't give much room for discretion and judgment. I think the Fed will want to maintain judgment about who its counterparties are going to be.

Looking ahead I agree with you that the dollar is here to stay for the foreseeable future. I think over time as China becomes bigger, as it opens its capital account, moves to a more flexible exchange rate, as the Europeans develop their institutions I think we'll be shifting gradually towards possibly a more multi polar system. I suspect that will be driven more by the market and less by policy design.

And if we end up in this multi polar system it's not clear to me that it's necessarily going to be a better system than the system that we have at this point. So we may look back in the future with some nostalgia at the time when we had a dollar trap. Thanks.

MR. WESSEL: Thank you. Mr. Moreno?

MR. MORENO: Well, thank you. Thank you very much, David. And it's quite an honor to be here at Brookings and in the company of Charles and Jose De Gregorio who is a very distinguished central banker in Latin American. And being a non economist I'm probably going to wing some ideas here but first I'd like to begin where Charles began.

This is a really interesting book and for a non economist and somebody who wants to get kind of the lay of the land of what's happened in these discussions that we read in the last few years, it's a fascinating book and it's actually a very good read. And so many, many congratulations. I think we all -- as David said part of our role here it to help sell the book so this is why we're here.

One of the things that is very interesting and it goes to Charles' point on the whole question of the currency wars and kind of the conflict that the U.S. had with respect to a country that had current account surpluses both on the ups and downs. And the other issue which I think -- Charles also alluded to this whole idea of the multilateral oversight of global imbalances by the IMF and I totally agree with what Charles was saying is how important it is -- you know, I do believe that the Fund especially for countries that are not systemic risks plays a hugely important role and having the Fund recapitalize and moving forward in that reform agenda, it's very critical for a lot of countries.

I think one of the great things that the Fed did during the crisis where really monetary policy was the center of everything was how quickly it was able to get some of these lines to countries that are systemically risky. Like in our region like was both the case of Mexico and Brazil. This immediately -- and only what they did as well as what we did in development banks -- helped mitigate a lot of the effects.

And also -- I know Jose will build on this more -- but the -- he can give you more insight. He recently wrote a book which I recommend to all of you, why this time not all these crisis did not happen in Latin America but more importantly how Latin America managed it very successfully. That is something that we must always remember. So that's the first point I wanted to make.

The other is something that the Professor -- President just mentioned which is just the -- kind of like the great paradox exists of how as he described it, here is the global financial crisis, the epicenter is the United States and how the dollar become stronger. And I think he has a pretty good analysis on kind of the unstable shortcomings and the equilibriums of the current international monetary system. And this is something that I think will only be solved by a lot of work in the -- in G20 and others. And I think you actually have some very good insights in the book.

I do believe as you were saying that he dollar will continue to be a dominant currency. As you correctly say I think it -- more than anything else for a store of value, probably a straight flows change as units of account as you have bitcoins and whatever developments take place, probably that's going to change. And it's fascinating when I see it from my perspective at the institution like the IDB how there's a tremendous interest of countries like China, but not only China, other countries like Brazil and others to begin to think of ways of trading across our own currencies.

But that won't happen, as Charles was saying. I think this has a market drive component and that has to do a lot of how our trade flows begin to change. In our region I think a lot has to do with how value changes are composed, how we grow the trading integrations across the south. And that -- there is a lot to be done there and I think that at the end will probably be as a unit of account, kind of the changes that you will see in the -- at least the dollar participation as we know it today.

But as you remind us, Eswar, everything is relative. Mostly for lack of a better alternative I think we all agree that the fact remains that the financial losses that are denominated in U.S. dollars, especially in U.S. government securities, are still the preferred destination for investors. You know, I -- you go -- any person who saves any money -- Latin America for many, many years and for that matter emerging markets typically likes the dollar. And that's not changing very quickly.

The other part that you talk about the dollar trap is kind of that unstable character of the current equilibrium and the risk of the global economy. I think this is really the heart of the -- of the discussions

And let me just turn to some of the things that you mentioned regarding the accumulations of reserves because it's fascinating when you look at the large numbers of how even today's 60 plus percent of the dollar there are many currencies are held by foreigners outside of the United States. And the reality is it's an insurance policy. And I think you cannot talk about the dollar and not relate something that you also related in the book which is the quality of U.S. institutions. And, you know, at the end of the day institutions are central to everything. They're central to development. But they're central -- they're fundamental for confidence.

And I think this is the part of the breadth and depth of the U.S. financial system that trades in the dollar and we're not -- and I think this is a very important consideration. Let me just give you as an example, Latin America today has international reserves that represent about 10 percent of GDP. This is the average of all the countries. That's -- of those about 70 percent are invested in dollars denominated financial assets. And that's the insurance policy which you were referring which probably is -- represents about half a percentage point of GDP.

And so the question to Charles, is this a reasonable price to pay as an insurance policy? And, you know, that basically depends on the damage which you would -- you are protecting yourself against. And, you know, we saw in Latin America the sudden stops. And the risk of those sudden stops, you know, in historical terms they represent about 2 basis points of GDP and the historical average is probably about 1 percent, 1.7, 1.8 percent of GDP.

So -- not to mention the direct correlation that would exist in terms of currency depreciation which can be as high as 10 percent. So you look at that, you know, it makes sense to pay that policy. You just -- from the -- from that perspective.

In the -- one of the other fascinating things Charles alluded to was this whole question of the currency wars. Because one of the outcomes of that -- I remember a President of Columbia who is -- was before a Finance Minister telling me can you believe I had this mission from the IMF and they're telling me all this controls I should put to prevent appreciation of the dollar -- of our currency rather.

So all of the sudden this set of tools came into being and they began to be accepted basically to prevent the rapid appreciation of the currencies. And now of course as we see the tapering you see of course the other side of the equation of how quickly that tapering goes, the impacts on interest rates. And so this is very much a part of this question at the end what really countries wanted was a closer coordination to understand and to be able to message the markets all in a unified way.

So I think that's another part of the international discussion that I think is missing that is fundamental and I think we'll see much more of it. But again I think it's a fascinating book, it's an easy read and I think we will be talking about this for many, many years to come because I think the dollar probably will remain to be a very important currency and unless you see government driven kind of mechanisms -- but I believe that mostly on trade related matters is where you're going to start seeing the changes.

Again, thank you very much.

MR. WESSEL: Mr. De Gregorio -- and I hope if not in your initial remarks we can get to what you think about the capital controls that Mr. Moreno refers to that the IMF seems now to consider a better idea than it used to consider. (Laughter)

MR. DE GREGORIO: Okay. Thank you very much. Thanks for the invitation. As a former governor of a central bank, and it will be always a central bank here I have to recognize that -- I'll be very transparent, I was invited last night. (Laughter) Which is pretty bad for my ego, you know. (Laughter) But I have excuse to say that the organizers knew that I was around very recently. So that's -- I won't ask them why they didn't invite me. (Laughter)

But this also has an advantage because I didn't have time to read the book. (Laughter) Last night I read a summary of the book. I have talked a lot to Eswar about this idea so I know and I got excited with the discussion.

MR. WESSEL: You can still say it looks good.

MR. DE GREGORIO: Yeah, it looks very good. (Laughter) Yeah. I will read it on my way back by the same. So I don't have to refer exactly to the book but I want to make three points and at the end I'll talk about this one.

First I want to talk about the importance of all this discussion about whether the dollar, the euro, is a threat or the renminbi. Which we have every -- from several years and they sometimes spike and resurge and then a bit more on the issue of reserves and emerging markets demanding a lot of dollars and finally on currency wars, currency manipulations, currency suicide and all of the things.

So regarding the -- and this say right on the book, it's very nice how the book sets the issue about the dollar. They said it's a currency and as a currency it's a unit of account, it's a unit of exchange and it's a store of value. Who cares about whether it's a unit of account? With the calculator today we can choose different unit of accounts and have it converted very easily. The same as a medium of exchange. We can even pick another medium, so it's not a big deal. There is always this -- all discussion that I always have been confused about in which currency are set prices.

In here prices are set -- relative prices. That's what we learned from economics. And then how you measure them is just a convention but it's a -- so but important thing -- and it's that a -- and what the book stresses is that the U.S. dollar as a store of value.

Now where this is important for emerging markets is -- for emerging markets it's an (inaudible) value. Where we have to use the dollar (inaudible) will depend on the world economy. I think that much more important is for the U.S. because the U.S. collects seigniorage from the rest of the world by issuing dollars. Okay. And it has -- also the U.S. takes (inaudible) and everybody holds dollars and hold U.S. securities which is a -- actually brings a lot of benefits.

Now we in emerging market in Chile we don't plan to have the peso as the unit -- as the store of value. The world -- so we just take whatever it is. Now it's not that way.

So then comes the second issue if it's a store of value. And most countries accumulate reserves in U.S. dollars for several reasons. First, it's not that we want U.S. dollars it's that you demand U.S. government securities. And that's great important. Why? The first reason I think that it's the most unlikely country to default. So that's again from the point of view of the four risk. I think it's usually taken as a no default security.

And consequently it's a very good hitch, it is a very good hitch because precisely as it was emphasized in the discussion when there is turmoil in the world they -- the dollar strengthened and it's precisely when we hold dollars, okay. And we will worry about the world economy. World economy kind of is weakened and it goes to adjustment. And from the world side we are having the currency that -- the security that help us to hitch against those bad state of the nature. And also the dollar -- and when they say dollar depreciation in the world because there is some weakness, what tends to happen is that the reality price of commodities goes up.

So again at times of strong world economy perhaps we have low relative prices and that's where we demand dollars and we prefer to have that hitch because the value of our assets will correlate negatively with the state our business site.

And now that's -- we can do a lot of mulls and ask finance people to compute the -- the optimal thing I want to say is -- but also it has a huge liquidity premium. That is a tendency for very few currencies. And I think that at the end when you have one currency it has a premium that currency and you want to hold that currency because you know that it is extremely liquid and you can -- and that's quite important.

I have to tell you that -- I -- this is -- what we did in the central bank when we were calculating the ultimate composition of reserves, and this is something that is probably in the Central Bank of Chile, we basically hold peso, dollars, euros -- that's usually like a third euro -- and it's almost half dollars, 30 percent euros, maybe up to 40 percent and 10 percent with a lot of foreign currencies and we were getting rid of yen. But at the beginning you say yen, dollar, euro, but at the end the yen doesn't help you to hitch too much your balance sheet at the central bank.

So that -- so it's a store of value. And then it comes to all -- this is a schedule which is quite interesting, it's a store of value in a moment in which countries are demanding a lot of reserves. So when emerging market have accumulated so much reserve there's a lot of pressures on buying U.S. securities.

Now why count these accumulated reserves -- and this is important of the future of the dollar -- why count these accumulated reserves? Because -- two reasons. One is the insurance reason. This is the typical reason we say well we have --

want to have a lot of reserve because there may come a sudden stop. The other reason -- and just -- they put it as -- I think that (inaudible) and it's quite important is for competitiveness reason. This is American (inaudible) reason.

Now what is interesting is that (inaudible) this country that had huge windfall gains were the ones that most accumulated reserves in the world which is an indication that reserves were accumulated because of competitiveness reasons. And I can -- we can tell a lot of stories, but I was sitting with many central bankers accumulating reserves and you mention insurance but you say, well, but your currency's very strong so we want to accumulate reserves.

So reserves are a way to intervene in the market and to have a -- and to avoid an extreme (inaudible) which is fine. And I think that's fine; it's a very sensible policy. Whether it works or not -- it's transitory fix are small -- but this has been quite important. And this is important because the thing that's quite striking is that in emerging market the use of reserves, the intervention during the global financial crisis, the worst crisis since the Great Depression was less than during the Asian crisis.

During the Asian crisis there was much more fear floating, there was much more concern about currencies weakening than during the global financial crisis. Average of 20 percent which is still not a match. During the Asian crisis you -- many countries averaged 20 percent of reserve they use, during the global financial crisis 10 percent as (inaudible) countries. Some other countries very little. So that shows that you have a lot of reserve, excessive reserves and you don't want to use them because you have accumulated them to have -- to attempt to have a weak currency. And that does work.

And then there are many issues about accumulation of reserves but that also shows that perhaps we may see if there is a turmoil, if tapering causes some turmoil in emerging market countries that are not able to absorb a lot of depreciation perhaps may have to start using some reserves. So that's -- and they have a lot so we may see some reduction in some reserves in some few countries and especially some big countries that are not able or well prepared to accumulate reserves to absorb a large depreciation.

Let me now mention and close with this discussion of currency wars, currency manipulation, IMF capital controls. This is -- the world is kind very schizophrenic. I don't know, I'm economist but it's -- first, in the major markets at the beginning of last year there was talk about currency war and that the U.S. was pumping dollars all around the world to weaken the currency and this was very bad for us and we have to fight this currency war.

And then in May the U.S. announced that they could start tapering, could start tapering, very gradual and currencies move along, there was a lot of turmoil and the emerging markets came and said please stop. (Laughter) We were joking. No. (Laughter) We were joking about currency war but don't go to the other extreme. (Laughter) So please taper the tapering.

On the other hand we had Bretton Woods not so long ago. Then we had -- and we are learning. We grew up starting -- whether you use the interest rate to do monetary policy, whether you use money, whether you use the exchange rate and whether you want to do capital controls of some form, to arrange our things to avoid a recession and to -- because you cannot tolerate all the volatility and then they call you a currency manipulator because you are doing things that quite fine. Whether your country -- if you want to have an exchange rate bank it's like having an interest rate. There's no religion to say that you have to choose the interest rate or you have to choose the exchange rate.

I like floating. I'm absolutely in favor of floating and think that capital controls are not that effective and we shouldn't rely or try to rely on capital controls. But this is a decision that sovereign countries make. It's not -- so it's not that we will impose a rule for the world, I think it's very bad to have a fixating rate for emerging market. It's a huge mistake but they still want to have it because they are not able to float or if they want at least to have some smoothing of the currency fluctuations, that's fine, that's fine. It shouldn't be a big global concern.

This is like Switzerland. The Swiss they realize that this is -- I like this story because we thought to do it in Chile. We did some quantitative easing but the crisis was very short so we start raising rates rapidly. But what the Swiss National Bank has been doing they say we will do QE but instead of buying T Bills and finance the U.S. we will buy euros which is fine. There is no difference between one security and the other security.

And why? Because our objective will be not to push loan rates to one and a half percent but to push the Swiss franc down. It's completely fine, it's completely fine. It thinks that's the same. The world economy -- I think that what they need is to have a safe financial system, some micro government policies, low inflation and growth. They're the best.

And I said when there was this currency war story, I said the best for the -- for emerging market is that the U.S. start growing again. That's the best for their currencies and that's the best for the world. And not how exactly they do because I think that what they were doing was fine. So I'm kind of -- I think that we tend to blame too much the problems and our local problems on the foreign authorities rather than on our own problems.

And I think that basically we have to deal with what the world is going on. The world needs an adjustment. The world adjusted quite reasonable after the crisis. Emerging markets were the one that grew at the beginning of the crisis because advanced economies did extremely bad. They did worse than Latin America in our worst time which is really a record how they -- they did pretty bad. And then now the -- that emerging market has grow along they may be close to -- now they have more long term challenges.

Now advanced economies, especially the U.S. are picking up and that's -- I think is perfect. That's how the world should go. We need the rules. This is not a world without rules. But I said rules are strong, good micro, free trade and those basic things and the rest I think we have to look at how we do our policies rather than to blame our neighbors. Thank you.

MR. WESSEL: Let me ask you, you used a term that's -- actually Eswar quotes here in the book but I want you to explain what you mean. What is currency suicide?

MR. DE GREGORIO: No --

MR. WESSEL: And who's practicing it? (Laughter)

MR. DE GREGORIO: We practice this. It's to sell. (Laughter) But they say -- this is what -- this is sort of what's happening in Chile in the '90s and it's my view in Brazil before the crisis. It's when we have -- when we claim low war interest rate and imbalances in the reservoir for the strength of our currency. And we use capital controls, we intervene, but at the end in those period Chile and Brazil had two digit interest rate differential, almost 10-12 percent point interest differential with the U.S.

So if you don't have pressures in your currency when you are -- when you have an interest rate differential of 10 percent point there's no way. So that's -- it's not a currency war, it's closer to a currency suicide.

MR. WESSEL: Charles, Mr. De Gregorio suggests basically that the whole concept of currency manipulation is wrong; that countries should be able to set their own exchange rates and if they want to base their monetary policy on exchange rate target rather than an interest rate what business is it of the United States. So that's not exactly the way the treasury has looked at. What's the other side of that?

MR. COLLYNS: I think it's -- that's fine if you're a relatively small economy that doesn't have systemic consequences and Chile would be in that category. There are a number of other countries that have chosen to pick their exchange rate or to intervene heavily in the exchange rates where it does seem quite sensible given the state of their financial system and their economic capacity. It's hard to run a flexible exchange rate.

However, when an economy becomes large it becomes systemic. And a country like China is now the world's second largest economy, the world's largest exporter and have an international monetary system in which most of the major economies floats but one economy picks the rate or heavily intervenes to manage the rate, it makes it -- means that the exchange rate mechanism in the global economy no longer can play a useful buffering role to deal with external shocks or to adjust to longer term shifts that are necessary.

So for me then the fact is the biggest flaw in the current international monetary system is you have this asymmetry. And one of the consequences of that for example is that the global imbalances that were present at the time of the global financial crisis and to some degree contributed to the crisis have been reduced but reduced in a very inefficient way. Basically by demand compression by the deficit countries while the surplus countries like China and some others continued to in fact emphasize the need for strong export performance.

What would be much better would have been if the Chinese had let the exchange rate move more quickly while taking actions to rotate demand within their own economy to boost domestic demand through consumption, raise China's demand for global goods. And I think that would have meant that the aftermath of the crisis would have been somewhat better. We wouldn't have gone through quite such a long period of slow growth than we have in fact been faced with.

MR. DE GREGORIO: That's a very important point and I have to say that for small countries who cares. And that's the advantage of being small. So for big countries there may be some spillovers. So but the issue is -- would be that we have to really have a good sense of how large are the spillovers. And my impression is that what I have seen in the literature they are not that big the spillovers.

Now I would think this is the excuse because I received the book last night I can't say whatever and I say well, I didn't thought. This is a -- perhaps a very extreme conceptual and perhaps silly comment but who is the big -- the biggest currency manipulators in the world is Germany because they joined currency with very weak countries. And Germany -- which they should have had the most appreciated currency -- today they don't have it because they have bed with southern Europe. So where we draw the line? That's a -- where we draw the line is that -- because Germany they have a huge surplus.

MR. COLLYNS: Right.

MR. DE GREGORIO: And they have gained a lot of competitiveness because they choose 15 years ago to pick to very low priority countries and --

MR. COLLYNS: You make a good point. I mean there is a big issue with German policies. It's hard to call it a currency manipulator since it's a member of a currency and it does not intervene in exchange markets. But as you say it only benefits from the weakness of the euro which reflects the behavior of the other countries rather than itself. It is an issue and indeed U.S. Treasury has not hesitated to raise concerns about Germany's continued reliance on exports and Germany's unwillingness to take steps to boost domestic demand.

So it is a global problem for these two large systemic current account surplus problem countries. That requires different solutions I think in the two countries. I think in China it would be easy to deal with it through the exchange mechanism. In Germany it's more to do with reforms.

MR. WESSEL: Eswar, so let's talk a little bit about China. Put yourself in the position of the Chinese; and I know you talk to them quite a bit. How do they look at the world and why do they think it's in their interest to have $4 trillion dollars of reserves which seems to me -- I don't know what the right insurance level is but it's not $4 trillion. And wouldn't they want the RMB to be a reserve currency, they don't want it? What do they see as their interest and do they have a clear way to get there?

MR. PRASAD: China has about $3.6 trillion dollars worth of foreign exchange reserves, a lot of held in the U.S. And this is clearly not ideal from China's point of view because they are taking risks and in fact I do go over a lot of discussion in the book about how politically this is not working out well for the Chinese because domestically there are lots of pressures, lots of questions about whether this is going to end well.

There's a nice expression from one of the Q & A posted on the website of the administration that manages the currency, somebody asked will the value for reserves disappear like a cooked duck flying away, which seemed like a very apt metaphor apparently in China. The Chinese I think are going beyond this insurance strategy clearly and it's largely driven by a market list approach. Now they're tied into this very difficult situation where they are trying to rebalance the economy. And right now the issue is not so much about rebalancing away from exports as it is away from investment because in fact the current account surplus in China has fallen from about 10 percent at its peak in 2007 to about 2 percent right now although the trade deficit is beginning to back up.

So they're trying to do a lot domestically and they don't want additional turmoil coming from what they see as an important nominal anchor which is the currency. Now simultaneously they're trying to make the currency an international currency and it's curious to be trying to do this when the currency is not convertible, when they don't have a flexible exchange rate. And China has always managed to move by its own playbook and they're doing the same thing here.

They are in fact selectively opening up the economy to both capital inflows and outflows and trying to get the RMB, the renminbi, to play a much more important role internationally. And the remarkable thing is how much traction this has got. There are about six central banks that have already indicated, including the Chilean Central Bank, that they are or plan to hold renminbi as part of their reserve portfolios. There are about 21 central banks that have signed bilateral currency swap lines with the

Chinese Central Bank. The renminbi is now the currency in which about 10 percent of China's trade is denominated and China accounts for about 10 to 11 percent of world trade. So it's really getting traction.

But again my view is that this is not because people believe that China is going to ultimately have the dominant reserve currency in the world but because China is a big large economy, the biggest contributor to world growth and everybody wants to be friends with China. So it's a very low cost bet to become friends with China by singing currency swaps, by using renminbi and thereby at least a little be moving away from the dollar.

Now it think the Chinese strategy about capital account liberalization is really to some extent domestically driven because if they can get the domestic constituencies to sign onto this notion that a great currency should have -- a great country should have a great currency to match it forces them to think about what they need to do domestically in order to make capital account liberalization work smoothly and to make it safe. And that trade (inaudible) is exactly the set of is exactly the set of reforms that China needs, better financial markets, better regulatory systems and perhaps better institutions.

So I think this notion of making the RMB an international currency may end up being a sort of Trojan horse strategy to achieve what needs to be accomplished domestically. But they still face some enormous challenges and risks.

MR. WESSEL: Mr. Moreno, I wonder if you could look at the world from the point of view of Latin America and is -- do Latin Americans in general -- and I know it's hard to generalize -- is it a good thing for Latin America that the U.S. has a rival in China and maybe someday in Europe if they get their act together? Would Latin America like to be less dependent on the dollar and on the U.S. markets or does it frighten them because no one quite knows what game the Chinese pare playing?

MR. MORENO: Well, I think in the last 20 years like the two big things that happened was China and cellular phones (Laughter) in terms of imparting development in many of our countries. China I think -- and Gregorio knows this much better because for instance about a third of the trade of Chile is with Asia and a good component of that is with China -- the level the reserves that China has makes them a very attractive source of financing for Latin American countries. And, you know, we see it through the bank but more importantly this accumulation of reserves that took place in -- really almost in the last decade -- in Latin America was really part of the super cycle of commodities.

So is China a good source for Latin America? So far it has been but I think -- and more and more, at least what we see in our discussions with the Chinese, they became shareholders of the IDB about five years ago, is they're very interested in finding ways to do financing in renminbi. And a lot of their -- you know, I think pretty much on this Chile has led the way beginning to open up that conversation.

And I think a lot will have to do with these trade flows that we see. They have been -- you know, another store of value for China has been commodities. The huge amounts -- I mean in terms of what they've done for instance through the Chinese Development Bank on oil in some of the larger oil producing countries in Latin America is a good example. They've been financing, you know, close to $50 billion dollars now, a bulk of it really going to Venezuela.

So the short answer is it is not that you choose or not choose this, China has been a good source of growth through basically a commodity producing region that we are.

MR. WESSEL: Eswar, let me ask you one final question before we turn to the audience for questions. You explained very nicely how we ended up in this somewhat unusual equilibrium where everybody is forced to use the dollar as a store of value basically because they have no alternative, and because they want to accumulate reserves there's nowhere else to do it, and we're kind of -- it kind of -- we're in the muddle through stage. But I'm curious what you think could go wrong here. If it doesn't make sense that the world is so dependent on dollars what are the risks that something unpleasant happens and disrupts it? What -- is this a -- if -- is this equilibrium a stable, bad equilibrium or a fragile one?

MR. PRASAD: Okay. Before I answer that I just want to make one question clear. I kind of make I should maintain my purity so it's not good for me to say that I want to sell a product. I'm just trying to sell an idea. If you want to buy the book to get that idea -- (laughter)

But going back to your question, so this is -- this was an interesting part of the evolution of my thinking as I wrote the book because it is useful if you want to appear sage like to say that this is all crazy and that doom is nigh and that this is all going to end very badly. Then you can get taken very seriously. But as I tried to work through scenarios where this equilibrium, the fragile equilibrium as David characterized would come apart it turned out it was not easy to lay out a scenario. One could think -- and I do have a chapter actually are tipping points. One tipping point could be China. So China holds a lot of U.S. treasury securities but there could be political issues that cause China to say I don't care about how much it costs I'm going to take it out on these Yankees.

But that scenario turns out to be very difficult to follow through to its logical quantitative conclusion. Let's say China says okay, I want to take $100 billion dollars out of treasury securities. That would cause panic in not just U.S. but international markets. But where is China going to go with that $100 billion dollars? If you start looking around for markets where China could put $100 billion dollars it's really not there.

In fact the sovereign well fund that China set up initially with a capitalization of about $200 billion and that capitalization has risen to about close to $500 billion, they're finding it very difficult to find good, high quality investments. And even the sovereign well fund turns out a whole part of its portfolio in U.S. treasury securities and other U.S. dollar assets.

Things could go down in U.S. bond markets. It's possible that although inflation expectations despite all that the Fed has been doing remains remarkably thin. But all of a sudden there could be panic and it's very hard to predict what these trigger events might be.

But here is a remarkable thing -- and if you think about panic -- and what better example of the panic than during the financial crisis -- in a time of panic you want to put your money someplace safe. And as a small investor if you have a few hundred, $2,000 dollars and even a couple of billion dollars you can move into alternative markets commodities. But once you start talking about the tens or a hundred of billions of dollars it turns out that given the amount of liquidity that there is in U.S. treasury securities markets there really is no alternative.

So in a sense this equilibrium although it should be fragile by all logic has sort of become self reinforcing from the foundations because given where we are we all have a very strong incentive not to allow things to crash. Now it's true that the dollar is going to decline in value over time but that it turns out is perfectly consistent with the dollar remaining the dominant store of value that everybody turns to.

So again it's a very curious sort of trap that we all walk into and the additional paradox is that anytime the U.S. does anything crazy with its monetary or fiscal policies that's only going to tighten the strength. But as Charles pointed out there is a positive spin too to this, that again given where we are and given the possibility of instabilities if we didn't have a currency in the central bank that everybody trusted and perhaps it could be a lot worse.

MR. WESSEL: Okay. We'll turn to questions now. If you want to buy Eswar's ideas which happen to be encapsulated in a book (laughter) we're going to sell it outside and Eswar is going to be signing things.

There's a woman there. I ask two questions. First -- I have two favors, one, say who you are; wait for the microphone, say who you are and remember that a question generally ends with a question mark. And we have about 20 minutes and a lot of people so please keep that in mind. Ma'am?

SPEAKER: Thank you. Reporter from the Voice America. My first question is for Mr. Collyns and Mr. Moreno. If I didn't get you -- you two sort of think that China's political system is not a problem for China to become -- Chinese renminbi to become a reserve currency and that the Chinese government is now pushing hard to make the RMB to become an international currency. So what is the biggest challenge for that?

My second question is about the U.S. dollars. If everybody trust U.S. dollars and is it possible that because everybody trust it everybody has no alternatives so U.S. -- that would make U.S. or the Feds to behave irresponsible. And because when the Fed has this loose monetary policy and everybody else, I mean China and other countries thought of stuff to blame that -- to -- that the U.S. is behaving irresponsible. So, you're view. Okay. Thank you.

MR. WESSEL: Okay. So the first question -- anybody can take it -- is what would China have to do in its political institutions for it to make itself a real rival to the dollar?

MR. COLLYNS: I didn't refer to political institutions --

MR. WESSEL: Right. I know.

MR. COLLYNS: -- and I would answer the question more in terms of economic institutions.

MR. WESSEL: Fine.

MR. COLLYNS: But I mean I guess Eswar is --

MR. WESSEL: Or any question you want even without asking.

MR. COLLYNS: I mean I think it -- over time China has become the dominant player in global trade. The renminbi will naturally become an increasingly important unit of account and medium of exchange. I mean the real question is when will the renminbi be trusted as a store of value? But the renminbi cannot be a useful store of value until you have access to renminbi assets that yield good returns. And at this point that is generally not the case, there's still heavy capital control on flows into China. Those are slowly being dismantled but the Chinese are being cautious. And they're being understandably cautious because there are still big issues in terms of the domestic financial system and Eswar himself is an expert on this and talked a bit about this earlier.

So the Chinese need to strengthen the regulations of domestic financial system, liberalize the system, remove controls, build up means to control risk in the system so they are able to open the capital account and allow foreign money in and allow more competitive forces to operate. Once that is done then I think the RMB will become a more attractive store of value.

And then you get into the political questions about these -- essentially what we're talking about is the stability of the system under strain and there it's a matter of relativities and how does the Chinese political system look as a source of stability compared to other systems. And that -- I'm not an expert, maybe others would like to take that one on.

MR. PRASAD: So Charles is correct that first -- the first priority is to have a more convertible currency and China should be able to provide high quality renminbi denominated assets that foreign investors can hold so that it can be seen as a reserve currency that investors have access to. Now even if China's currency does become a reserve currency the question is whether it becomes a safe haven.

And I argue that political institutions and legal framework are very important. I gave you an example already in my original remarks about why politics matters a lot because it gives foreign investors as well the sense that things will not go completely out of whack.

Now this is not really a story about American exceptionalism but the curious thing about the American political system is although it seems to be cramped in political gridlock right now it does have this tendency over time to correct itself. And I think this open democratic process does really help in that context.

And the second issue is the legal framework. Now you may not like the rules in the U.S. but the rules are applied in a fair and consistent manner. And it's very hard to think of many countries in the world where the government goes to Court and very often the government loses. And the government loses because there are rules that are laid out and the Court interprets those rules, again more or less fairly. So when international investors come into this environment they know that again they may not like the rules but they're going to be treated in a fair and consistent way.

So I think this combination of a sound, legal framework and trusted political institutions is really important if you're thinking of ascending not just to a reserve currency status but to becoming an important safe haven.

MR. WESSEL: Mr. De Gregorio, I think I got -- her second question if I got it right is isn't one consequence of the dollar's dominance it allows the U.S. to run irresponsible fiscal policies and sometimes monetary policies? And isn't that a downside of the system?

MR. DE GREGORIO: I'm thinking whether --

MR. WESSEL: It's a yes or no question.

MR. DE GREGORIO: It's not a responsible monetary policy; I think it's been very fine. Sometimes you can -- they can push it a little bit. Irresponsible fiscal policy compared to many European countries is not very responsible so I wouldn't say -- of course you have the benefit but that benefit is -- and the response -- and the world will respond to the -- to your policies. If policies were really responsive and the U.S. go into a solvency crisis of course you would get rid of your securities, but that's not the case.

It's an amazing country because I found it impressive in that they had all this fiscal contraction when the government was coming out of a recession and they could have expanded but they were looking at -- with all the political mess. So I -- and that was pretty bad but it's a -- they were looking at that long term solvency which is long term stability.

MR. WESSEL: Ted Truman in the back there. And then after that the gentleman in the back over there.

MR. TRUMAN: Thank you. Ted Truman, Peterson Institute for International Economics. So my question is -- well, what will -- well, so this is a question about the internationalization of the RMB which fascinates everybody. Let's be quite honest about that. It is a little weird because actually they're doing it backwards. It's usually at -- you denominate your exports and your domestic currency, then denominate the imports. That has something to do with monopsony I think rather than has to do with economics. That's just a comment.

So -- but the question is so why does a country now hold RMB in its reserves? You asserted, Eswar, that Chile does. Jose didn't actually acknowledge that fact. He might or not have. I don't know whether it's a matter of public record not. If it's not a matter of public record I'm sure he will not acknowledge it. But the question is why do you do that when it is -- they're inconvertible, right? So in some sense you would only hold the reserves presumably when you have a promise from the Chinese authorities that you can use them, right? I mean is that the right way to interpret this and is that the right way to do that?

And by the way Mr. Collyns used to do work for their national monetary fund. Strictly speaking if you hold reserves in their -- in RMB you shouldn't count them as part of your reserves. I am confident that every country who holds RMB in their reserves counts it as part of their reserves. They hold the inconvertible assets and various cats and dogs and furnitures and chairs and pictures and things like that in your reserves is a long time practice of central banks.

But so the real question is why -- what is the incentive for Chile, if Chile is doing it, or any country to hold RMB in their reserves given that presumably they're not useful except when the Chinese say that they can use them?

MR. PRASAD: Very good and intriguing question, Ted. In Chile it is a matter of public record. In fact all the countries that are holding the renminbi in their reserve portfolios have stated this publicly and they have agreements with the Chinese government because they need to buy the bonds on the interbank market. So these are all a matter of record.

The Austrian Central Bank, the Australian Central Bank have all indicated that they're holding renminbi. Now why? The amounts are small. In Chile's case it started out at .2 percent when Jose was the governor. It's gone up to about 1.8 percent. Again a matter of public record. And the question is why have a convertible currency and does this even count the reserves?

Now from the point of view of an emerging market as Mr. Moreno pointed out the key issue when you hold reserves is you want protection. You want protection against international investors who aim to threaten your currency, who are going to threaten your balance of payments position. Now I think about this again, I use this bazooka metaphor which is used in a different context in the U.S. You have a big bazooka and if you have a really big bazooka you scare off investors. Who cares whether the bazooka is green or it's a little bit of red on top? And that's the way central banks see it.

Because they have a lot of trade with China and if you go back to the old notion of holding the reserves it was to give you protection against having import compression when your currency came under pressure. So if you're importing a lot from China and China says you hold some of my currency and I'll take care of you. That seems like a very well (inaudible) option.

I think that the reason why many countries have central bank swap arrangements with China again is the same reason. These are very small amounts but being a friend of China I think is going to serve these countries very well in the future. In fact -- I didn't use this in the book but there was one central bank governor who I asked explicitly about this issue and this was his response, that once we have a small arrangement with China we can deal in a much more friendly basis with China and it gives us a way of expanding this when the time arises and when the renminbi eventually becomes a real reserve currency.

So I think at this stage what we are seeing is a play by many central bankers, especially of countries that have very strong trade relations with China trying to build better relationships with China. I don't think they see it as a safe haven currency yet.

MR. WESSEL: There's a question in the back there, the very back.

MR. MC AULIFF: John McAuliff from the Fund for Reconciliation and Development and NGO. This may be petty cash in the realm in which you guys mostly operate but I'll ask it anyway.

MR. WESSEL: Only in our professional lives. (Laughter)

MR. MC AULIFF: Question is what is the impact on the long term credibility of the dollar in international realms when it's used -- currency is used for domestic political reasons, particularly when that political reason has no international support? And I'm speaking specifically of the way the U.S. has tried to prevent Cuba from using dollars internationally and has fined European banks substantial amounts of money for daring to take Cuban dollars. What is -- I mean this is obviously an immovable domestic problem at the moment but the rest of the world thinks we're out our minds. Since -- so how -- what is the impact of us using our power on the rest of the world?

MR. WESSEL: Charles?

MR. COLLYNS: I think it's a good question. I think the implications of that particular example are pretty small. But you can imagine circumstances in which the U.S. could overplay its hand in terms of exploiting its position as a reserve currency and using it for foreign policy reasons that could get countries nervous about continuing to hold large reserves in the U.S. So, you know, I don't see it as a factor in that particular example but I can see scenarios in which that would be a concern.

MR. WESSEL: Was it easier for the U.S. to use financial sanctions against Iran and Syria because they -- denying them access to the dollar based financial system made them vulnerable, right?

MR. COLLYNS: That's right.

MR. WESSEL: Right.

MR. COLLYNS: But if you use that instrument repeatedly then other countries that might think they're in the future go into the Iran and Syria situations --

MR. WESSEL: Right.

MR. COLLYNS: -- may want to get out of the dollars before they get vulnerable to that sort of intervention.

MR. WESSEL: Right. And Eswar would say they'll leave as soon as they find somewhere else to go.

MR. COLLYNS: Right. So that's why in principle it could eventually undermine the interest in countries in having the dollar.

MR. WESSEL: Over here? Is there one on this side? If you raise your hand so the mic can get close to you.

MR. MADRIFF: Nicola Madriff from the Embassy of Switzerland. We've been hearing a lot about trust in the U.S. institutions, especially when it comes to the store of value function of the U.S. dollar. Now in respect to what we've seen in August 2011, last October 2013, isn't the market's behavior of not raising the yields of the treasuries, isn't that at least somewhat irrational to any of you?

MR. PRASAD: It's irrational if you believe that there are alternative financial investments that investors could turn to. But the key issue here is that there is a paucity of financial safe assets at this juncture. And when there is a prospect of further turmoil investors naturally turn to look for more safety.

And this is the ultimate paradox at one level that if there is concern about the safety of the U.S. treasury securities people buy even more of that because they say well, what else am I going to do. And I think this is where the trust comes in because even if one might believe that things might go crazy in Congress and there might be technical default nobody really believes that ultimately the U.S. will not live up to its obligations.

There are in fact a couple of other -- there's one other occasion in the past when the U.S. did actually go into technical default because again Congress arrived at a settlement only at the very last hour. This was in fact about three decades ago. But there were no long -- major long lasting consequences from that because everybody understood it was a technical default.

So this is where ultimately the trust comes. The belief that number one, the U.S. will not walk away from its obligations, and it turns out statutorily that they cannot walk away from obligations selectively in any way. And second, I think the political system and the trust in the Fed is important for international investors and domestic ones to feel that the government won't walk away from its obligations even in real terms. That is through a burst of inflation.

MR. WESSEL: And why isn't Europe more of a challenger? Let's say that after they get through the current crisis they maybe build some institutions, a unified banking system and stuff, they had have some of the political institutions and they have a tradition which is very different from China. Why aren't they more of a threat now?

MR. PRASAD: Europe could be a threat and in fact it seemed like a viable threat in the initial years after the establishment of the euro. A share of the euro in world foreign currency reserves did rise from about 19 percent or so to nearly 27-28 percent. But then it stabilized and in fact it's fallen more recently.

And the problem here is that if you take the extent of the financial markets and amount of liquidity that again they don't quite match those of the U.S. If you add up the corporate bond markets and the government bond markets of the U.S. that capitalization is greater than the capitalization of all euros on bond markets, the bond markets of Japan, the U.K. and Switzerland combined. So size plays a very important role as well. And I think there is a sense that again given that Europe is a union in some ways but not really a political union the fact that the ECB is very well trusted is still not enough for it to be underpinned as the major safe haven.

But clearly the euro with about 25 percent of world reserves is a very trust safe haven currency. And Switzerland with its institutions, again to your own detriment has turned out to be a country that everybody trusts in as well. So trust is not exactly a wonderful thing for the countries that are trusted. In some periods it's good, in some periods it can actually hurt domestic adjustment.

MR. WESSEL: Here in the front.

MR. MOSSETIG: Yeah, Mike Mossetig, PBS online NewsHour. I just wanted to follow up on the question about political pressure because it suddenly reminded me Eisenhower ended the 1956 Suez War by applying financial pressure directly on Britain and France to get out of Sinai. Is there anything analogous to that now? Is it the United States just doesn't have that kind of political power or the financial situation now, the global financial situation so different, or would there be -- is there a possibility that if the United States felt like throwing its weight around that much they would have the financial power to do so?

MR. COLLYNS: I think in 1956 the U.S. was still lending large amount of money to the U.K. and France which is certainly not the case these days. The flows tend to go in reverse direction. And it is generally the case that the U.S. economy is much less dominant in the global economy today than it was 20 to 30 years ago. And that does certainly have consequences for the potential for the U.S. -- as I was saying before -- to use financial instruments for political and foreign affairs purposes.

I think it's very important therefore for the U.S. to use its soft power wisely and to build alliances rather than to play a very unilateral role, which is why instruments like the G20 and the INF become very important. It is why it's important to find ways to give them legitimacy and power because I think that the U.S. by itself is less able to influence the direction of other countries' policies as it used to be.

MR. WESSEL: I just want to add I don't accept the premise that somehow it's wrong for the U.S. to use its financial power for foreign policy goals if the alternative is we drop bombs on them. There is some -- it may be the civilized form of warfare is to shut off their access to the global financial system. It's not obvious to me that that's a bad alternative.

Yes, here. And then Eswar will get the closing words.

MR. MOHAN: I just wanted to ask you --

MR. WESSEL: Tell us who you are.

MR. MOHAN: My name is Govind Mohan; I am from the Embassy of India. What do you think the implication of the premise that you establish in your book which is the continuing supremacy of the dollar is for an international multilateral organization like the IMF? And I ask you this question in the context of the increased role that the Fed played in the aftermath of the crisis in providing easy liquidity to a lot of central banks around the world. You've made a reference to this in your book as well.

Do you think that there is a possibility that the role which legitimately is assigned to the IMF, given the fact that it has lost a lot of its credibility, especially in the aftermath of the quarter reforms not being approved even after three years, is likely to be -- let me say usurped by a more dominant Fed which has more credibility and with the premise of dollar still being the strongest reserve currency in the world?

MR. PRASAD: This is an issue that certainly is reinforcing the current very fragile equilibrium because many emerging markets would like an alternative to the Fed and the Fed did play a very important role during the financial crisis by providing large small plans of credit to the big advanced economy central banks which turned out to use it a lot, but to a very small and selective group of emerging market central banks as well. And as I document in the book there are many central banks that did come to the U.S. and looked for support and they did not get it. Now they would like to be able to turn to an institution like the IMF but the IMF has enormous problems in terms of its governments and in terms of its credibility among emerging market economies.

So from the point of view of emerging market economies -- and this goes back to the point of reserve accumulation -- they see one very powerful institution, the IMF, that they see as largely being in the hock of the advanced economies. They see one very powerful institution, the Federal Reserve, that could bail them out but they cannot count on it because there seem to be political considerations that play into this and they cannot count on it at a time of crisis. So they are left to cope with this themselves. And that exactly reinforces this notion of having to protect themselves.

And right now even countries like India after what we've been through in the last few months, we are trying to build up reserves once again so that it won't have to come to this. And as any central banker including Jose will tell you, it's not just the level of reserves but the direction of change in reserves that matters a great deal. Once you start using up your reserves and markets test you reserves can start disappearing very, very quickly.

So during the worst of the financial crisis not all emerging market countries used up their reserves; China in fact continued accumulating reserves. But of a group of about 14 countries that did use their reserves significantly, those 14 countries including countries like Brazil, India and Russia, they lost about a third of their reserves on average in a period of five to six months. And with central bankers seeing the reserves disappearing that quickly, it is scary.

So I think we are again back to the situation where the advanced economies that are relying largely on monetary policy to get their economies out of where they are, this is creating more turmoil in terms of international financial flows, this is causing the emerging markets to want more insurance. They have no place to go, the turn to the dollar.

MR. WESSEL: Do you want to give us some closing benediction here?

MR. PRASAD: So like I said this is not really a story about American exceptionalism. And one of the curious aspects of what we are seeing right now is that the dollar in its role as a safe haven currency, a reserve currency is actually strengthening while U.S. economic and political influence around the world seems to be getting elevated to some extent.

So ultimately this is a fault not just of the international monetary system but the fact that there aren't other countries and institutions capable of picking up the slack. If Europe could get its act together it could perhaps become once again a viable competitor. If China were to undertake the reforms it needs both economically but also much more broadly in terms of its institutions it could become a viable competitor. But for now we are stuck with the dollar.

MR. WESSEL: The book is for sale but you have to buy in dollars. (Laughter) (Applause)

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I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

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