What to Make of the Global Dollar Shortage?

By William White

Ultra-easy global monetary conditions over the last decade have actually deepened pre-crisis problems. Global debt ratios have risen sharply. Moreover, in a globalized world economy, problems that materialized anywhere could soon spread everywhere - as in 2008. Given that the system as a whole is vulnerable, what “triggers” a crisis is almost irrelevant.

Nevertheless, grounds for believing that a sharply stronger dollar could be troublesome do exist. BIS statistics indicate that, between end 2007 and 2017, dollar denominated debt issued by non-US-residents (non-banks) rose to $11.4 trillion, with emerging market debt doubling to $3.6 trillion. Moreover, these figures do not include off-balance-sheet borrowing through FX swaps which is probably even greater. The primary worry is that a stronger dollar would make such loans harder to service, leading in turn to concerns over the solvency of borrowers and then of lenders worldwide.

A variety of developments might support dollar strength. Should the US economy show particular vigour, both the dollar and risk-free interest rates might be expected to rise. Against such a positive global backdrop, richly valued asset prices might still be thought sustainable. However, another possibility is a bout of “risk-off” in global financial markets, say due to geopolitical concerns. In this case, the dollar would also rise but US risk-free rates might decline even though risk spreads of all sorts would trend higher. This latter case seems both more likely and more dangerous.

In both scenarios, overshooting in the dollar and other financial markets is a serious risk. Due to unprecedented central bank policies, the process of “price discovery” has been severely curtailed for years. It would be naive to assume that, once reintroduced, it would work perfectly from the start. New developments in financial markets have also, historically, been a source of contagion. The combination of large scale bond sales by emerging market corporates and purchases by asset management companies constitute just such a development. To these concerns about “known unknowns”, we must add worries about “known knowns” indicating poorly functioning markets. We have recently observed continuing market anomalies (e.g. violation of covered interest parity), flash crashes, bouts of reduced market liquidity, more indexing and passive investing, and the continued reliance of banks in many countries on wholesale dollar funding. Given that there could also be “unknown unknowns”, a repeat of 2008 market conditions cannot be ruled out.

The scramble for dollars in 2008 and after, particularly by European banks, was materially eased by swap lines between the Federal Reserve and the central banks of major, advanced economies. The continued adequacy of such measures is questionable. No such lines have been negotiated with emerging market countries, likely the first to be attacked. Further, the Dodd-Frank Act now constrains the Fed’s flexibility as Lender-of-Last Resort, even for American banks. Finally, would Congress and the Trump administration willingly accept lending trillions of dollars to unreliable foreigners in an “America first” world? Since the funding difficulties of banks could lead to insolvency, and since preparations for such events also remain inadequate, a global dollar shortage could yet prove a very serious problem.