

US Dollar

## Risk of dollar shortage hits investors' radar

Further monetary tightening from the Fed may unsettle emerging markets used to abundant dollars



The Federal Reserve's plans to shrink its balance sheet are likely to impact upon emerging markets © FT montage: Bloomberg

YESTERDAY by: **Jennifer Hughes** in Hong Kong

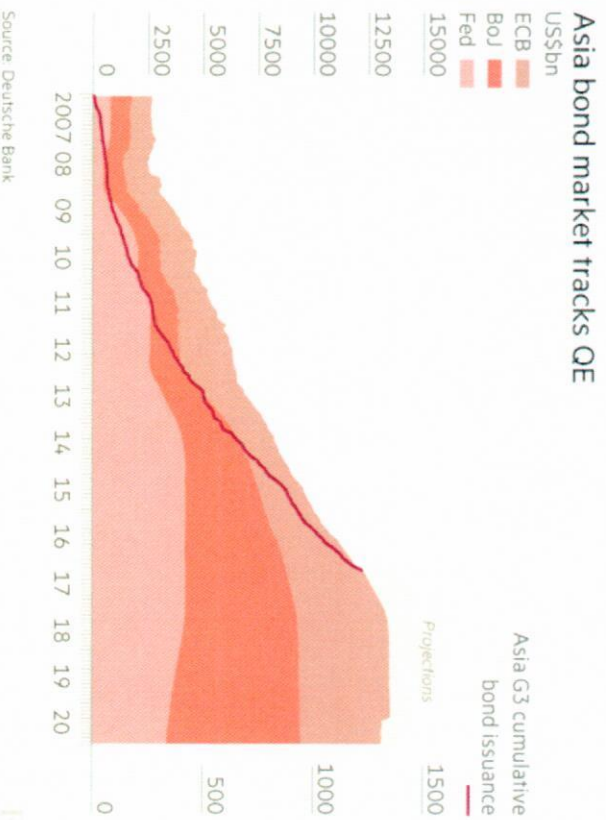
When two big international organisations highlight the same issue, investors should pay attention. When the issue is the risk of a scarcity of dollars outside the US, then arguably everyone should take note.

The International Monetary Fund ([https://www.ft.com/topics/organisations/International\\_Monetary\\_Fund](https://www.ft.com/topics/organisations/International_Monetary_Fund)) and the Bank for International Settlements ([https://www.ft.com/topics/organisations/Bank\\_for\\_International\\_Settlements](https://www.ft.com/topics/organisations/Bank_for_International_Settlements)) both pointed to the potential danger in

their most recent reports. Bank analysts and investors, too, are beginning to discuss the implications of fewer dollars, particularly for emerging markets, as the Federal Reserve opens the door to further unwinding the multi-trillion stimulus programme put in place after the financial crisis.

Fewer dollars would raise the cost of obtaining the currency from the pools that have developed outside the US since the Fed began flooding markets with money via quantitative easing in 2008.

That deluge of cash lifted asset prices and pushed down borrowing costs globally. It has also helped spur growth of new markets, such as an international dollar-denominated bond market in Asia (<https://www.ft.com/content/bfoeffe2-18fa-11e7-9c35-0dd2cb31823a>), where borrowing has reached record levels this year.



Source: Deutsche Bank

Before QE, almost all would-be dollar borrowers needed to pitch to US fund



managers. More recently, those same funds have instead set up local offices to allow them access to deals outside the US.

The recent discussion about dollar availability has arisen as Fed officials begin discussing shrinking the [central bank's \\$4.5tn balance sheet](https://www.ft.com/content/99734cd6-2cf1-11e7-9555-23ef563ecf9a) (<https://www.ft.com/content/99734cd6-2cf1-11e7-9555-23ef563ecf9a>), possibly starting later this year.

Once the Fed slows its purchases of Treasuries and other securities, the dollars effectively pumped out around the world through those deals will start to disappear.

“Quantitative tightening will be an interesting topic,” says James Montier of GMO, the asset manager. “US monetary policy has been incredibly easy post-financial crisis. If the US is entering a phase of more broader-based tightening, the rest of the world will be forced to import it — and that will be an interesting experiment for people who’ve had the best part of a decade on easy money.”

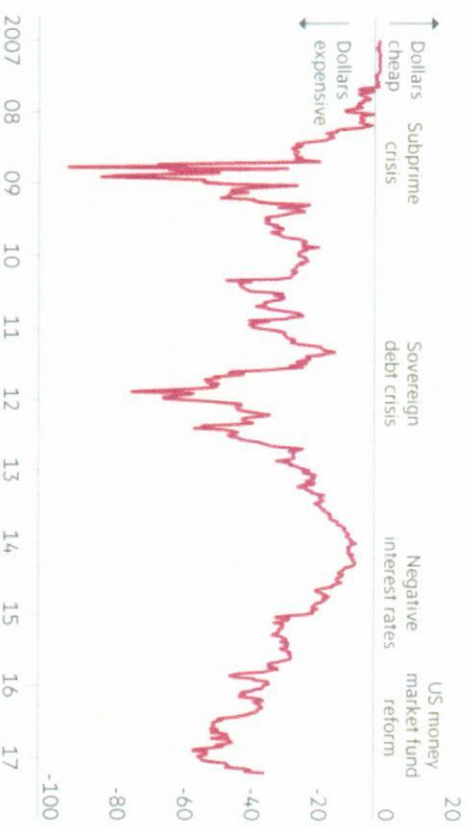
Dollars would also be drawn back to the US under any [tax amnesty](https://www.ft.com/content/a2326068-2919-11e7-9ec8-168383da43b7) (<https://www.ft.com/content/a2326068-2919-11e7-9ec8-168383da43b7>) granted by Washington that allows companies to repatriate hundreds of billions — trillions, according to Treasury secretary Steven Mnuchin — in profits held overseas to avoid paying US-level taxes. Studies suggest the majority of those funds are already held in the US currency.

Despite the post-crisis dollar flood, money market rates suggest greenbacks have been somewhat scarce since the financial crisis.



## Financial crisis raised the cost of dollars

Weighted average of cross-currency swap costs for dollar v euro, yen, sterling and Swiss franc (basis points)



Source: International Monetary Fund

Non-US investors have had to pay a premium to swap their funds into dollars via cross-currency basis swaps.

The cost has varied with market conditions. The most closely watched example is the [dollar-yen basis swap \(https://www.ft.com/content/d6b5a92c-0e15-11e7-b030-768954394623\)](https://www.ft.com/content/d6b5a92c-0e15-11e7-b030-768954394623), where Japanese investors — notably life insurers — are traditionally big buyers of US assets, particularly in the months after their fiscal year ends on March 31.

Facing low-to-negative yields at home, they are expected to buy yet more dollar assets — potentially raising the overall cost of sourcing the US currency in the process for others.

Asia generally is likely to be hit hard by any withdrawal of dollars. Every \$100 increase in the Fed's QE programme sent \$15 to Asia for a cumulative inflow of \$500bn, according to Sameer Goel, head of Asia macro strategy for Deutsche

Bank.

The inflows are linked far more closely with US easing, according to Mr Goel, rather than the QE programmes of the eurozone (<https://www.ft.com/content/735bec0e-2c12-11e7-bc4b-5528796fe35c>) or Japan. Funds flow from those markets to the US — as with Japan's life insurers — and from there to other destinations.

“If the unwind starts as we think in 2018, this will be the first time in many years we will have seen balance sheets going down,” says Mr Goel.

“At its worst, it could be very hard on emerging markets. The depth of those markets is smaller and large numbers heading for the exit could exaggerate the illiquidity and the price moves.”

The problem with quantifying the likely effect of a shrinking dollar pool is that not all market forces point in the same direction.

#### FX markets

**Can Mr Trump talk down the dollar?**  
(<https://www.ft.com/content/16ddd0830-2057-11e7-a454-ab04428977f9>)

Verbal interventions are likely to have limited effect on the currency, but his policies can be influential



One suggestion is that a mood of deregulation in the US could free up US banks to lend more dollars. Basis swaps, for example, used to be treated as a riskless trade since they involved holding very liquid short-term instruments.

Tougher post-crisis regulation resulted in such swaps being treated as a foreign currency exposure and a derivative — raising the costs of executing such trades.

“Regulators weren't making the



distinction between the essentially riskless packaged solution of a basis swap and the underlying components," says Hans Redeker, global head of foreign exchange strategy at Morgan

Stanley.

"If you now believe there is excess capital — our equity analysts think there is perhaps \$120bn — and that the US is deregulating, the result is that US banks will be much more active and will be an important source of dollars."

Much depends, too, on the mood in which tighter US monetary policy is undertaken — be it in the form of interest rate rises or balance sheet reduction.

"If this is happening in a globally confident environment, then that will have an offsetting positive effect on Asia," says Mr Goel. "You could have a situation where fixed income sees big outflows but equities receive money because of that strong outlook."

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