The Telegraph

Global dollar shock threatens fresh financial storm, warns watchdog

The soaring Trump dollar is turning into a financial earthquake

By Ambrose Evans-Pritchard
16 NOVEMBER 2016 • 11:10AM

The soaring US dollar is causing mounting strains for the global financial system and ultimately threatens to set off a full-blown banking crisis in emerging markets, the world's top's economic watchdog has warned.

"We have all the symptoms of a dollar shortage," said Hyun Song Shin, chief economist at the Bank for International Settlements.

The warning came as the closely-watched dollar index (DXY) appeared close to breaking through key resistance levels to a 14-year high, a move likely to trigger a stampede into the US currency as hedge funds and momentum traders join the chase.

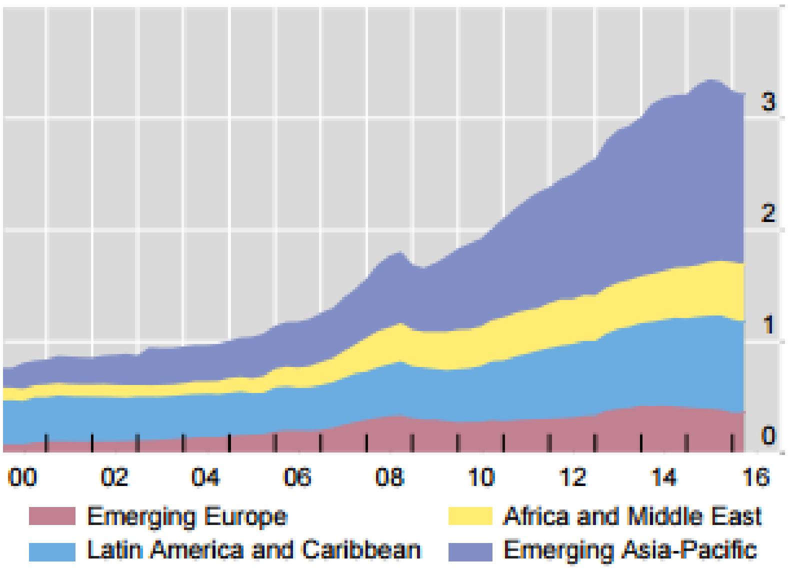
The danger is that the powerful and immediate effects of financial tightening will "swamp" any trade benefits for the rest of the world from Donald Trump's stimulus plans and a stronger dollar, even for countries that export heavily to the US. "It may not be very good news for anyone," Mr Shin told a specialist forum at the London School of Economics.

The warning about the strength of the dollar came at an LSE event CREDIT: ALAMY

The BIS estimates that dollar debt outside US jurisdiction - and therefore lacking a direct lender of last resort - has risen five-fold to $10 trillion over the past 15 years.

It has spiked to $3.3 trillion in emerging markets. This is chiefly due to the leakage of cheap dollar funding from the US while quantitative easing was in full flow. The debts will have to be rolled over in a stronger currency and at a much higher rates.

What is less understood is that the surging dollar automatically squeezes the balance sheet of banks in Europe and Japan through the complex structure of swap contracts. “The dollar is everywhere,” said Mr Shin.



US dollar lending to emerging markets exploded during the QE era - it now has to be repaid CREDIT: BIS

These banks carry out much of their global lending in dollars and therefore have huge dollar liabilities that have to be hedged. This creates a brutal snap-back mechanism if the US currency suddenly spikes.

The BIS said in a working paper that the old rules of global finance have broken down and the dollar now acts as a barometer of risk appetite, and specifically as a “proxy for the shadow price of bank leverage".

The currency has been rising relentlessly since Mr Trump’s election as markets undergo a tectonic shift, switching from deflation worries to a radically different bet on global reflation.

Mr Trump’s wish-list of tax cuts, infrastructure spending and military rearmament amounts to fiscal stimulus of over 5pc of GDP. This is an even bigger blitz than ‘Reaganomics’ in the early 1980s, an expansionary policy that led to ballooning budget deficits and forced the US Federal Reserve to keep monetary policy on a tight leash.

The consequence of this "loose fiscal/tight money" mix was an explosive rise in the dollar as the US sucked in capital from the rest of the world, with grim consequences for dollar debtors in Latin America.

A variant of this was repeated under the "Clinton dollar" in the late 1990s, which led to the East Asian Crisis and again shook Brazil and Argentina to their foundations.

“The question is: are we in the foothills of something like the 1980s, or will it fizzle out?” said Mr Shin

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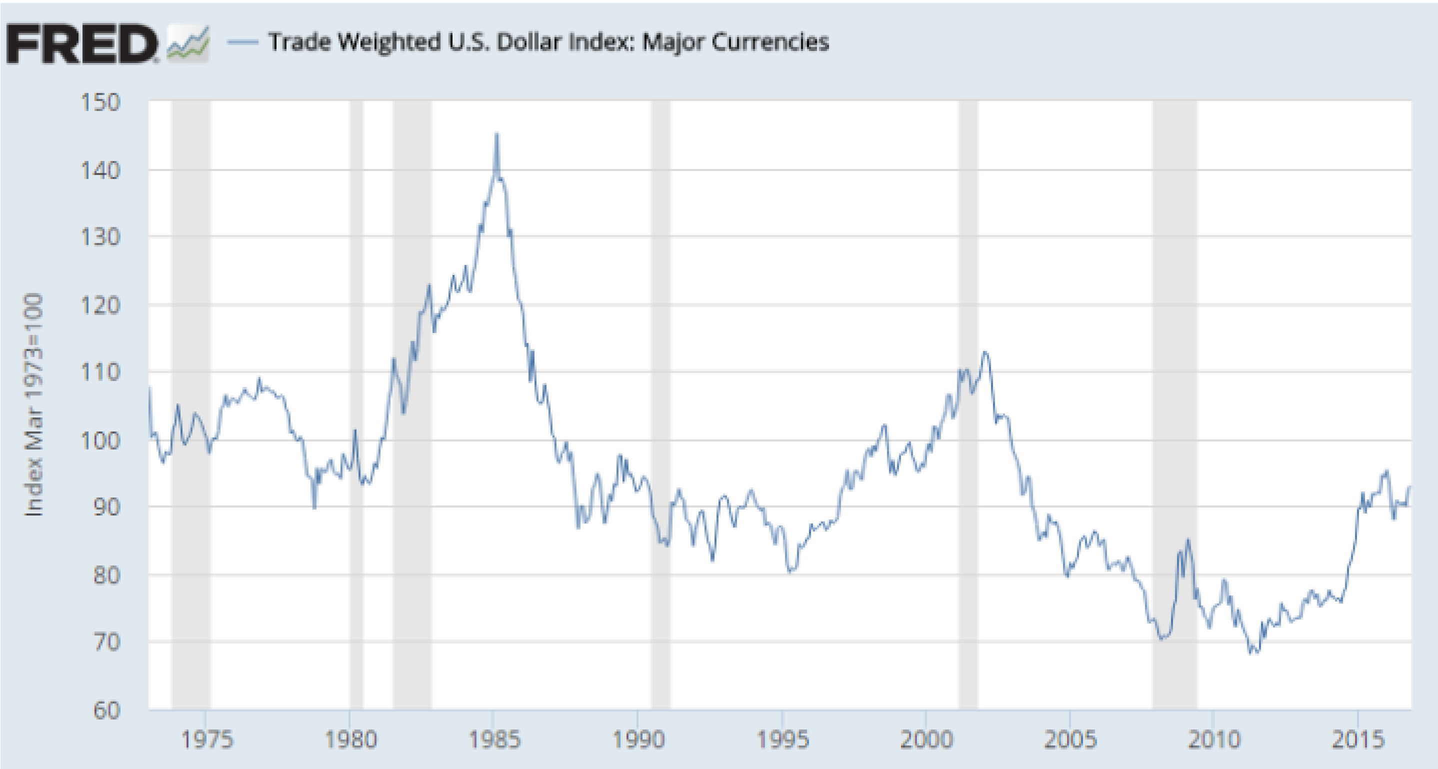

The dollar rally has been powerful but it could go a lot further, based on the early 1980s and late 1990s CREDIT: ST LOUIS FED

The great unknown is what will happen to China, where corporate debt has mushroomed to 145pc of GDP. Fitch Ratings says bad debts in the banking system are 10 times higher than officially admitted and warns that rescue costs could reach a third of GDP.

The yuan has dropped to an eight-year low of 6.87 to the US dollar this week on the offshore market in Hong Kong. While the recent slide is mostly a “passive” effect of the rising dollar index, it has psychological effects and could easily become self-fulfilling.

The South China Morning Post reports that even ordinary white-collar workers in cities such as Shanghai are going to great lengths to funnel their savings out of the country, convinced that a serious devaluation is becoming unstoppable. Those who have used up their legal $50,000 allowance this year are likely to "front-load" next year’s quota as soon as they can in January.

White-collar workers in cities such as Shanghai are sending savings out of China because of fears the yuan is overvalued against the dollar CREDIT: ALY SONG/REUTERS

The strains in emerging markets do not yet match the drastic sell-off seen during the "taper tantrum" in 2013 but they are severe, and the dollar rally may still be in its infancy.

Spiralling US bond yields since the Trump shock have lifted borrowing costs in lockstep across much of the world, sending tremors through Malaysia, Vietnam, Indonesia, South Africa, Turkey, Brazil and Colombia, as well as Mexico.

This interest rate effect is compounded by threats of US tariffs and fears that globalisation is starting to unravel, undermining the core development model of emerging markets. Mexico is expected to raise rates on Wednesday to defend the peso, which has fallen 11pc. A string states are having to tighten monetary policy to stem capital outflows.

“It is classic ‘risk-off’. The countries with the biggest current account deficits are being hit hardest, though not only them,” said Neil Shearing from Capital Economics. The broad MSCI index of emerging market equities has dropped 7pc since the US election.

Marc Chandler from Brown Brothers Harriman said the pain is not yet enough to cause the Fed to dial back its expected rate rise in December. “The trade-weighted broad dollar index is in the middle of its range over the post-Bretton Woods era,” he said.

Mr Chandler forecasts that the dollar will scream higher, rising another 20pc against the euro before it is all over.

At some point the strong dollar must short-circuit. Emerging markets now make up half the world economy. This is much higher than in any previous episodes of a dollar squeeze. The days when the US and Europe could shrug off trouble in the developing world are long past.

The core problem is that international trade has become genuinely multi-polar and global, but the financial system has become more dollar-dependent than at any time in history - and more indebted. The world is therefore acutely leveraged to the effects of the US monetary cycle.

"It is our currency but your problem" were the immortal words of the Nixon Administration in 1971. Mr Trump may have outdone them.