ANDBANK RESEARCH

Global Economics & Markets

Alex Fusté
Chief Economist

alex.fuste@andbank.com

+376 881 248

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The next war for the dollar

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Private Bankers

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Cicero once said: "War should be undertaken in such a way as to make it evident that it has no other object than to secure peace" (De Officiis. 01.23.80).

Well. The assessments that major central bankers delight us with today (such as; "devaluation is good for my country and what is good for my economy is good for the world") respond perfectly to the description Cicero made on how war should be treated.

Having accepted the idea that we have witnessed a new norm of monetary aggression (as the Brazilian Minister Mantega said in 2010), after the proliferation of policies of "beggar thy neighbour" via devaluations, it is certainly difficult to know what the fair value of a currency is.

This does not mean we will stop trying to understand what, as ordinary mortals, we often don't understand.

Chapter I. The source of dollars in the system

- When the US incurs a trade deficit (Current Account), they settle their purchases (obligations with foreign firms) in dollars.

- Foreign exporters initially hold those **"earned dollars"** through USD deposits with their local commercial banks. As a result, dollars appear in turn on the balance sheet of the Central Bank as International Reserves or Fx Reserves (see representation). Let's imagine we are talking about an operation of US$100 million.

Foreign Country
Commercial Bank
Balance Sheet

Assets		Liabilities	
Depo with CB.	100	USD depo	100

Foreign Country
CENTRAL BANK
Balance Sheet

Assets		Liabilities	
Fx Reserves	100	Deposit held by private banks (US$)	100

- Thereafter, this Central Bank reinvests its dollars in the Federal Reserve, on whose balance sheet (liabilities) that position will appear under the name of "Selected Foreign Assets held at Federal Reserve banks", and they will be used to buy treasury bonds and to finance the deficit.

Foreign Country
CENTRAL BANK
Balance Sheet

Assets		Liabilities	
Fx Reserves (held at Fed)	100	Deposit held by private banks (US$)	100

US FED
Balance Sheet

Assets		Liabilities	
Tbills	100	Slected Foreign Assets held at Fed	100

Chapter II. But what happens when the dollars that appear in the central banks are not "earned dollars" but "borrowed dollars"

- Imagine now that between the same agents we now add another transaction. On the one hand we had a purely commercial transaction (US deficit for $100 million). But now we know that the exporter has borrowed an additional US$100 million from an individual in the US (see the financial situation of the system in the table)

Foreign Country
Commercial Bank
Balance Sheet

Assets		Liabilities	
Depo with CB.	200	USD depo	200

Foreign Country
CENTRAL BANK
Balance Sheet

Assets		Liabilities	
Fx Reserves	200	Deposit held by private banks (US$)	200

- The dynamics are identical but with this we show that central banks accumulate dollars because local firms have earned them first, but also because the local agents have borrowed them.

- There is no problem with this dependency arrangement, were it not for the small detail that **the dollars borrowed must be returned**, and this is where the data and history give us some very valuable ideas.

Chapter III. When and why do investors borrow dollars?

- **With respect to why:** As in any other currency, when this is perceived to be weak (and, what is even more important, that it will remain weak), there is a strong incentive to borrow in that currency because if it is going to be devalued, you will probably need less local currency to repay the loan.

- **When?:** What happens, often, is that the perception of weakness responds to a monetary policy aimed at weakening the currency (through lower rates). That feeds the incentive to borrow in a currency at a low financial cost and to invest this flow in another asset (in another currency) with higher yields. It is in times of lax monetary policies, therefore, when the currency in question becomes a foreign funding currency.

- In these circumstances the amount of dollars held by central banks do NOT only come from the "earned dollars" (via the USA trade deficit), but also through the "borrowed dollars."

- **What dynamics ensue then?** In this kind of "short selling of the dollar" (borrowing dollars), it is plausible to see an initial depreciation of the North American currency, but the day will come when these short positions need to be covered as these borrowers have to cover their debts. And it is then when the dollar will appreciate more than it lost (due to the amplifying effect of a shortage of reserve currency) and because the intensity of the flow is different when you buy (to repay) than when you borrow.

Chapter IV. Once I know (and isolate) the concepts of "earned dollars" and "borrowed dollars," I know what mistakes I'm making.

- One of the most common mistakes (which we also made initially) when assessing the possible evolution of the currencies against the USD (or, which amounts to the same thing, valuing the dollar itself) is to consider aspects such as divergent monetary policies, divergent cycles, or interest rate differentials. It is a common mistake because we all look to these concepts.

- However, over time (and through mistakes), one realizes that all this may be secondary, since what really matters is knowing what approximate dollar amount borrowed remains to be returned and at what speed it will have to be returned.

- How could we know this? With all the above in mind, we now know the series of dependencies unleashed, but to isolate concepts – and reach a magnitude about what I still don't know – I must find an expression with which to translate these dependencies. This is it:

US Current Account Deficit = [Foreign Assets held at the Fed] - [Dollars borrowed by Non-US entities]

Dollars earned! It is difficult for us to know whether central banks reinvest everything in the Fed, and what part of its USD reserves come from trade with the US (or what share comes through redenomination)

- Or in other words:

Dollars borrowed by Non-US entities = [Foreign Assets held at the Fed] – [US Current Account Deficit]

Chapter V. Finally. A first approximation of the figure.

- According to the BIS Working Paper *"Global dollar credit: links to US monetary policy ",* written by analysts Robert N. McCauley, P.McGuire and V.Shusko, in January 2015; we can draw the following conclusions:

1. Since the beginning of the ZIRP policy in the US, credit in USD granted to non-financial companies outside the US **increased from US $6trn to $9trn** . (In 2000, this figure stood at US$ 2trn).

2. This dynamic has not been seen so far in other major currencies such as the Euro or the Yen. In the case of the Euro, the total amount lent to foreign non-financial companies (outside the euro area) currently stands at US $2.5trn. For the Yen, the figure is much more modest (US$0.6trn).

3. The most active countries in this operation during this period were: China, India and Brazil (the three total US$1.5trn), being precisely those markets that offer a higher interest rate differential.

4. The Emerging Market economies have accumulated US $4.5trn of the US $9trn in live dollar loans to non-financial companies.

5. In conclusion, the authors confirm that there has been a "great leap" in the total amount of dollars borrowed outside the US in recent years and that, therefore, as of January 2015, there are still a lot of foreigners (not North Americans) that still owe an unprecedented amount of dollars. A currency for which demand is also expected to be unprecedented.

Chapter VI. The Implications

1. Contrary to popular belief, the world is more closely connected than ever to the monetary policy pursued by the Fed.

2. Why? Of those $9trn, about $5trn will be directly affected by small changes in the monetary policy of the Fed. Given the large amount of dollars we're talking about, that could determine the degree of global recovery/recession.

3. The volume of borrowed dollars (measured by the spread between the balance of official assets held at the Fed and the accumulated balance of US trade deficits) would be 3-4 times higher today than that observed in the 1980-1985 periods (crisis in Latin America) or that observed in 1997-2000 (Asian + Russian Crisis), according to analyst Charles Gave.

4. Nobody knows if this situation may again lead to a new crisis in emerging countries. I just hope that the lower public debt in these countries compared with other periods compensates for the large volume of private credit in dollars and it is all just a simple (but intense) appreciation of the dollar.

5. According to the BIS, many of these private loans in dollars have not been channelled into real activity, but have been used in "carry trade" activity, and they fear that a significant share of debt has not been captured in national debt statistics…

6. ... This implies that (1) when the time comes to repay this amount of dollars (something which always tends to normalize), we will probably see a lot of pressure on the international reserves of the Central Banks. (2) The authorities may be confused with the modest numbers of local loans, and may erroneously keep rates low (generating possible local bubbles in the future).

7. **Has the appreciation of the dollar now been exhausted?**
   - Recent **appreciation of the dollar** undoubtedly responds to the demand for this currency to repay part of the loans granted in dollars abroad (in light of the first fears of tightening at the Fed).
   - However, if we look at the numbers in detail, we see that **it is legitimate to think of a further appreciation of the dollar**: Between July 2014 and January 2015, the balance of borrowed dollars abroad has fallen slightly to US$9trn at present (global reserves have fallen by US$0.3trn according to JPM: "A rare decline in overall Fx), and yet the demand for dollars to settle a very limited amount of currency loans took the currency from 1.39 to 1.21.
   - **The obvious question:** What will be required to settle the outstanding amount of nearly US$9trn ? A tremendous demand for dollars, in my humble opinion (US$9trn to be precise). And given the relative scarcity of dollars worldwide (USD flow relative to the overall trade volume at a 15 year low), you can imagine the consequences.
   - **When?** When the market really believes in the Fed rate hikes. So, borrowers will be forced to unwind their positions. Something that will be accentuated if the assets in which they invest continue to converge in yields.

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