What to Make of the Global Dollar Shortage?

The global shortage of dollars has wreaked havoc on emerging market economies, particularly in Latin America. The shortage is a result of dollar flows back into the United States as a result of changes in U.S. corporate tax treatment, deficit spending, and the Federal Reserve's tightening of monetary policy at a time when the major global economies, with the exception of the United States, appear to be sluggish.

But what about China, which is accountable for one-half of the emerging markets' dollar-denominated debt? Chinese officials appear to have been clever at disguising the threat of the global dollar shortage at a time when a lot of Chinese-held dollar-denominated corporate debt will soon mature and will need to be either rolled over or paid off. Some financial strategists suggest Chinese policymakers will have no choice in a world with the dollar still the reserve currency but to continue expanding monetary policy, which could lead to further currency depreciation.

But at a time of huge global trade tensions, would a Chinese turn to further currency depreciation be like throwing a match on the world's stock of political kerosene? Will the trade war ratchet up to a higher level? Or will China figure a way to manage itself out of such a scenario, as it has in the past managed itself out of other predicted policy conundrums? ◆

More than a dozen noted observers offer their views.

SEBASTIAN RITTER

When the winds are strong, even turkeys fly.

DESMOND LACHMAN
Resident Fellow, American Enterprise Institute

According to a Wall Street adage, when the winds are strong, even turkeys fly. This adage might have particular relevance for today's emerging market economic outlook at a time when many years of ultra-easy global liquidity conditions are coming to an end.

During the years when the world's major central banks maintained extraordinarily low interest rates and expanded the combined size of their balance sheets by some US$10 trillion, the emerging market economies had little difficulty in tapping the international capital market. Indeed, emerging market corporates managed to increase their borrowing by some US$15 trillion between 2008 and 2017. And they did so at interest rates that did not nearly compensate investors for the default risk associated with this borrowing.

Equally striking is the fact that last year a country with as checkered a default record as Argentina could issue a 100-year bond on relatively favorable terms. Or that investors eagerly snapped up sovereign bond issues by countries with as dubious economic and political fundamentals as Iraq, Kenya, Mongolia, and Tajikistan.

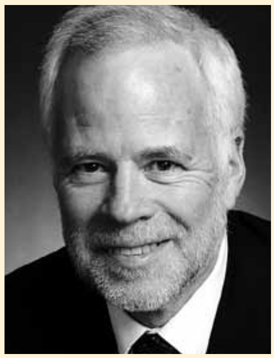
Sadly, for the emerging market economies the strong winds of very easy global liquidity conditions are now rapidly dying down. The Federal Reserve is now well on its way to normalizing interest rates and reducing the size of its balance sheet. At the same time, the European Central Bank has announced that it will stop its quantitative easing program by year-end.

Further clouding the emerging market outlook is the pursuit of an expansive fiscal policy by the Trump Administration at this late stage in the U.S. economic cycle. By putting upward pressure on U.S. interest rates and the U.S. dollar, that fiscal policy reinforces the capital flow reversal from the emerging markets already being induced by the more attractive interest now on offer on U.S. Treasury issues.

The last thing that the emerging market economies now need is a slowing in the Chinese economy and a depreciation of its currency. Not only would that crimp demand for international commodities, which is the lifeblood of many emerging market economies. It would also heighten the risk that China and the United States would drift further towards a full-scale trade war that might derail the global economic recovery.

Yet it is difficult to see how China can succeed in avoiding a slowing in its economy as it tries to address its own domestic credit bubble of epic proportions. And if the Chinese economy does slow, it is all too likely that the Chinese authorities will be tempted to allow their currency to weaken to provide some support to the economy.

The emerging market economies' immediate daunting challenges have clear implications for both the U.S. and the global economic outlook. After all, the emerging market economies now account for over 50 percent of the global economy and are hugely indebted to the global financial system. This has to make one think that the U.S. administration is ignoring at its peril the adverse impact of its budget and America First trade policies on the emerging market economies.



Time for China to accept the reality of a somewhat slower growth rate.

BARRY EICHENGREEN
George C. Pardee and Helen N. Pardee Professor of Economics and Political Science, University of California, Berkeley

The editors of *TIE* ask an interesting question, but it is not clear that the implication follows from the premise. While scarce or expensive dollar funding will make it more difficult for Chinese corporates to service and repay their dollar-denominated debts, more expansionary monetary policy in China won't make this task any easier. If anything, the consequent renminbi depreciation will make servicing dollar-denominated debt even more difficult.

It could be that the editors have in mind that difficulties of corporate debt service will mean less investment and weaker economic growth. It is then conceivable that the Chinese authorities, seeking to keep growth near target, will turn to a more expansionary monetary policy designed to boost spending in response. If so, they will then have to find other instruments for dealing with corporate indebtedness, such as stepping up their effort to selectively restructure problem debts. And indeed, a weaker renminbi is all but guaranteed to fuel trade tensions with the United States.

From this I conclude that a more expansionary monetary policy is not the best response on the part of Chinese officialdom. Better would be to accept the reality of a somewhat slower growth rate now that the growth of global trade is slowing and the United States has become a more problematic partner.

The lack of safe assets, not short-term U.S. macro policies, is causing capital outflows from emerging markets.

ADAM S. POSEN
President, Peterson Institute for International Economics

Repeatedly, since the start of the financial crisis, observers have mistaken real phenomena for monetary mischief. Talk about a global dollar shortage is another instance of this error. There is a shortage of safe assets in the world, given real dangers—inflation and instability in Latin America, inability of the euro or the yuan to take on a global role, and most of all low returns on many forms of investment due to slow productivity growth. The world has had multiple reserve currencies and thus a variety of places in which to put savings for safety at other times in history. It is the lack of those alternatives, not the short-term U.S. macro policies, however irresponsible on the fiscal front, which are causing capital outflows from emerging markets to the United States.

Even the fiscal binge of the Trump Administration and Congressional Republicans isn't causing a dollar shortage. By creating more U.S. government debt through deficit spending, they are creating more safe assets for people to hold, and to borrow against. By expanding the U.S. current account deficit at a time when a few economies are slowing down, the United States is being accommodative of emerging market growth. By having the dollar appreciate when the United States is relatively if unsustainability outperforming, the United States is rebalancing growth back to other economies. There are problems with races to the bottom in corporate tax rates and loopholes, as well as obviously with trade war, but again, those are changes to the real return on assets and to volatility. It isn't about currency shortage.

As for China, a market-driven depreciation of the yuan versus the dollar is natural and to be expected when there are tariffs being put on Chinese exports by the Trump Administration. Trump may still try to claim a currency war, even when the Chinese government is not manipulating (and if anything intervening to keep on capital controls and limit currency decline), but he will fail in waging one. The tariffs and fiscal deficits, along with creating uncertainty more broadly, all create upward pressure on the dollar.

The Chinese government can cope by using their ample fiscal space for domestic stabilization whenever they are ready to do so. If they mess up their situation by easing domestic credit standards and creation instead, as they seem to be doing, that will have nothing to do with dollar shortage either.

SDR bonds and an SDR payments system would make the international monetary system more symmetric.

JOSEPH E. GAGNON
Senior Fellow, Peterson Institute for International Economics

The U.S. dollar plays a dominant role in international trade and finance owing to the large size of the U.S. economy and historical inertia. This outcome is not ideal for either the United States, which runs a trade deficit to supply its currency, or the rest of the world. The current concern about a dollar shortage highlights the costs. No single country has the capacity or motivation to be the sole supplier of global safe assets. A better alternative would be to elevate the role of the special drawing right issued by the International Monetary Fund.

The goal is not to replace national currencies with the SDR. The International Monetary Fund does not have the power to operate as a true central bank and the global economy is not (and may never be) ready for a single currency. Nevertheless, the SDR can be at the heart of a strategy to create more symmetry in the international monetary system, to supply a large quantity of relatively stable safe assets, and to create a more neutral standard for invoicing and payments.

Toward that end, the International Monetary Fund should take three related actions: First, create synthetic SDR bonds of various maturities backed by sovereign bonds denominated in the currencies of the SDR basket. The potential volume of these safe assets would be far larger than the market for U.S. Treasury bonds. Second, set up a payments system based on such bonds or their analogs in bank deposits to settle claims denominated in SDR. Third, expand the SDR basket to include the currencies of all countries that have sound macroeconomic policies and whose financial markets meet minimum standards of openness and supervision. Although desirable, the third step is not essential to the success of the first two.

The first two steps might, in principle at least, be undertaken independently by financial institutions. However, they will almost surely not occur without explicit IMF approval and support. The weight of precedent is heavy and the markets of the established key currencies have an enormous advantage in liquidity and transactions costs. Only the International Monetary Fund, with the support of its members, can lead the world to a better outcome. Indeed, the Fund and its members are obliged by Article VIII of the IMF Articles of Agreement to make "the special drawing right [SDR] the principal reserve asset in the international monetary system."

SDR bonds and an SDR payments system would make the international monetary system more symmetric. They would provide investors with a liquid market for a safe asset that has the potential to exceed the size of any one country's sovereign bonds. They would enable trade to be invoiced and settled in a more stable unit of account.

A global dollar shortage could yet prove a very serious problem.

WILLIAM R. WHITE

Former Chairman, Economic and Development Review Committee, OECD, and former Economic Adviser, Bank for International Settlements

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 2009. Given that the system as a whole is vulnerable, what "triggers" a crisis is almost irrelevant.

Nevertheless, grounds for belief do exist that a sharply stronger dollar could be troublesome. Bank for International Settlements statistics indicate that, between end 2007 and 2017, dollar-denominated debt issued by non-U.S. residents rose to $11.4 trillion, with emerging market debt doubling to $3.6 trillion. Moreover, these figures do not include off-balance-sheet borrowing. 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 U.S economy show particular vigor, both the dollar and interest rates might be expected to rise. Against such a positive global backdrop, richly valued asset prices might still be thought sustainable. 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 U.S. rate increases would be moderated while 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": continuing market anomalies (such as violation of covered interest parity), flash crashes, declines in market liquidity, more indexing and passive investing, and the continued reliance of banks in many countries on wholesale dollar funding. Given that there are also "unknown unknowns," a repeat of 2009 market conditions cannot be ruled out.

The scramble for dollars in 2009, 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.

There is no generalized global dollar shortage. The situation in the emerging market economies is more mixed.

STEVEN B. KAMIN
Director, Division of International Finance, Federal Reserve Board

In the aftermath of the Second World War, the phrase "dollar shortage" referred to the difficulties faced by Europeans in acquiring the hard currency to pay for the imports of capital equipment and other materials needed to rebuild their economies. In today's environment of floating exchange rates and free capital flows, the original meaning of "dollar shortage" no longer makes much sense, but the phrase still persists, as evidenced by the more than 100,000 results indicated when I Googled it. Although there was no consensus as to what the phrase meant, broadly speaking, "dollar shortage" seemed to refer to a situation where dollar credit becomes very costly and/or difficult to acquire.

By that definition, I would argue that there is no generalized global dollar shortage. At about 2 percent, the federal funds rate is still very low, even after seven hikes since December 2015. Ten-year U.S. Treasury yields remain under 3 percent at present, again well below historical averages, despite solid U.S. economic growth and the expectation of substantial fiscal deficits. And dollar funding in overseas markets remains cheap, with the three-month LIBOR running below 2.5 percent, and the FX currency swap basis—the premium paid to fund in dollars through the FX swap market—currently very narrow.

While dollar credit remains inexpensive and readily accessible for highly creditworthy borrowers in the advanced economies, the situation in the emerging market economies is more mixed. Certainly, borrowing conditions remain favorable for more highly rated emerging market economies, especially in East Asia. However, financial pressures have indeed intensified in many other emerging markets: since the beginning of May, aggregate EMBI+ spreads have risen almost 50 basis points, outflows from emerging market-dedicated investment funds (excluding intra-China flows) have totaled about $30 billion, and EME stock indexes are down. These downdrafts have been less pronounced than during earlier episodes of financial stress, such as the 2013 "taper tantrum" or the worries about China in 2015–2016, so I would not characterize them as "wreaking havoc" on emerging market economies. But they nevertheless pose challenges for stability and growth in the most affected economies.

What accounts for these stresses? Rising dollar interest rates are likely putting some pressure on EME borrowers, although these rates started rising well before this year's bout of emerging market stresses. Moreover, as I noted above, dollar interest rates remain historically low even after these increases. Certainly, some of the pressures evident in emerging markets also owe to heightened market focus on elevated debt levels, fiscal and other structural vulnerabilities, trade policy developments, and political uncertainties.

Because of the size of the Chinese economy, Chinese borrowers account for a sizeable share of EME dollar-denominated debt (though one-half may be an overestimate). However, dollar debt accounts for a relatively small share of China's overall debt, and China's financial system is at least partially buffered from the rest of the world through its capital controls. Accordingly, China's main economic challenge is largely domestic: reining in corporate leverage while maintaining economic growth.

China is not strained by foreign debt.

CHEN ZHAO
Chief Strategist, Alpine Macro

There is no question that downward pressure on the renminbi has intensified lately. Many blame the renewed RMB weakness on trade tensions with America. I am not so sure. China's total exports to the United States account for 3.5 percent of its GDP. In a highly unlikely event that these exports are halved by higher tariffs, the net impact on the Chinese economy is still very manageable. In my view, the weakening RMB is caused by many more factors than concerns over a trade war.

The Chinese government has been trying to deleverage the economy ever since the economy accelerated in early 2016. The central government has been actively reducing fiscal stimulus, while the People's Bank of China has tightened credit policy aggressively. Meanwhile, the RMB rose more than 8 percent in trade-weighted terms between mid-2017 and June of this year, compounding the effect of policy tightening. All of this has begun to inflict damage on the economy, weakening growth sharply in recent months.

Beijing is making a policy mistake similar to what happened in 2015, when authorities mistakenly tightened credit supply and fiscal policy in the wake of a much strengthened RMB. This policy combination put the Chinese economy in a severe slump, only to be arrested by an aggressive policy reversal in 2016.

Today, Chinese authorities are facing unprecedented challenges, both domestically and externally. Some say that, by allowing the RMB to drop, it could offset the expected higher tariffs on Chinese imports. But this could be a dangerous policy. A falling currency and weakening investor confidence could become self-feeding, leading to a panic that is beyond government's control. In addition, competitive devaluation could invite even more forceful retaliation from the United States, with consequences much more damaging and less predicable.

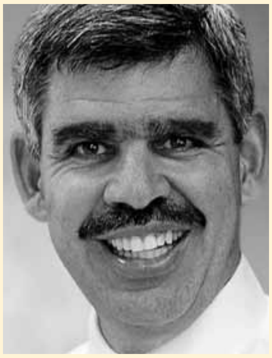
What should China do? In my view, the policy remedy to the current situation is the same as it was in 2016. At the moment, there is enormous confusion about the government's game plan—if there is one—to deal with a slowing economy and trade frictions with the United States. As a result, anxiety about RMB depreciation is growing among Chinese citizens.

The Chinese government needs to stabilize market expectations quickly and decisively.

First, the government needs to articulate its game plan promptly and clearly on how it intends to deal with renewed economic weakness and trade frictions with the United States. Second, Beijing needs to reverse its current policy of deleveraging, and re-apply monetary and fiscal stimulus quickly to support aggregate demand, particularly if there is a sharp fall in exports to the United States as a result of higher tariffs. Finally, China needs to cut taxes and accelerate reforms to stabilize and attract foreign capital flows.

In short, China's economic policy must be geared toward reversing falling growth expectations, which is the key to stabilizing the currency market. There are signs that Beijing is beginning to implement some pro-growth reforms, and the People's Bank of China has begun to lower reserve requirements to provide liquidity support. However, the government needs to ease monetary and fiscal policy much more forcefully to shore up economic growth. I am hopeful that the Chinese government will eventually get the policy right, and stabilize the currency market before the year's end.

Finally, I am not concerned at all about China's foreign debt situation. The country has been a creditor nation for a long time and its accumulated foreign currency assets far exceed its foreign liabilities. China's total foreign-currency debt is about US$1.8 trillion, which is about 13 percent of GDP. Of course, with the dollar and interest rates going up, some private borrowers may feel the pinch. However, the economy as a whole is not strained by foreign debt, unlike debtor countries such as Brazil and South Africa.



For emerging economies, neither depreciations nor reserve depletions offer sustainable solutions.

MOHAMED A. EL-ERIAN

Chief Economic Advisor, Allianz; Chair, President Obama's Global Development Council; and author,* The Only Game in Town: Central Banks, Instability, and Avoiding the Next Collapse *(Random House, 2016)

The growing indications of an emerging dollar funding shortage are part of a broader phenomenon that will become more important. It is the leading element of tighter financial conditions that many countries will need to navigate through as global liquidity recedes; and it is one that will make pre-existing domestic fragilities more urgent to address and more threatening.

Higher policy rates by the Federal Reserve, a gradual contraction in the central bank's balance sheet, and larger debt issuance by the U.S. government are the primary drivers of tighter dollar funding conditions. They come after a prolonged period of ample liquidity that has encouraged pockets of over-indebtedness and excessive risk taking. Already, it has pressured the currency markets and the international reserve holdings of some emerging economies.

For emerging economies (including China), neither depreciations nor reserve depletions offer sustainable solutions for a global liquidity environment that will become even more challenging as the European Central Bank and the Bank of Japan eventually join the Fed in normalizing monetary policy. Countries need to move decisively and rapidly to reduce funding pressures associated with maturity and currency mismatches. They also need to press forward with structural reforms that enhance the productive flexibility of their economies.

While in the midst of escalating trade tensions with the United States, China is better placed than many other emerging economies in this regard. It has already embarked on a gradual reorientation of its economy aimed at maintaining solid growth and increasing domestic resilience. Its private sector has become much more agile and internationally competitive. And it benefits from large reserve holdings that minimize the impact of the inevitable potholes along the way, as well as a relatively closed capital account that reduces the risk of forced deleveraging.

Having said that, even for China, some of the required policy advances are not easy to realize quickly. This is, of course, a much bigger issue for other emerging economies whose initial conditions are weaker and where prior policy measures have been long delayed or only partially implemented. As such, as global liquidity recedes, a growing number of countries will look to the multilateral organizations, and not just for financial support. Timely analyses, including in the sharing of best policy practices, and the enhancement of national policy coordination will need to play an important role.

Despite the circumstances, maybe the dollar won't rise so much.

JIM O'NEILL

Former Commercial Secretary to the Treasury, United Kingdom, and former Chairman, Asset Management, Goldman Sachs International

Some part of me thinks this topic is up there with a lot of popular myths in finance. Another part of me thinks that, at times when the U.S. central bank is tightening monetary policy, the fact that the U.S. dollar is so dominant still in the world is neither good for the rest of the world, including emerging markets, nor, due to the degree of integration and U.S. global outreach, in the slightest bit good for the United States.

Let me explain both. For large parts of my career in finance, I spent a lot of time trying to be a guru of the foreign exchange market. Indeed, I became a partner at Goldman Sachs as chief currency economist. I knew even by then that the Andy Warhol principle held true in foreign exchange: everyone can seem like a genius for fifteen minutes. But I also realized that it is the world's biggest fruit and vegetable store, and it is usually the market that knows more than anyone in it.

Given that, since 1982 when I first entered professional finance the value of the dollar was considerably stronger against most other major currencies than it is today, and perhaps actually stronger than it is against a number of so-called emerging market currencies, I am not sure how this equates to a supposed dollar shortage. Indeed, as *TIE*'s editor himself knows, after the 1985 Plaza Accord, many countries spent a lot of time, until the dollar's reversal ten years later, trying to stop its decline. A dollar excess was the issue in most countries' minds.

Now, to the opposite, what has repeatedly seemed clear, each time the Fed starts to tighten, whatever the difference of the era, it usually ends up causing considerable external challenges, especially for many so-called emerging markets. Think of the Tequila crisis in 1994, the Asian crisis in 1997, and of course, some of the issues that are appearing on today's agenda. Indeed, as it relates to the topic of China and the yuan, I recall well the crucial role that then-U.S. Treasury Secretary Bob Rubin played in late 1997 when he decided to reverse official policy by intervening to support the yen. He feared that if the yen continued weakening, then China would exacerbate the Asian crisis by devaluing the yuan. It was a masterstroke, and worked, and indirectly the Chinese played a big role in helping bring that crisis to an end.

So what about now? Clearly if the Fed carries on or accelerates its tightening, then in all likelihood the dollar will rise in value for some time further, and put pressure on the renminbi to depreciate against the dollar. Given that the Chinese have decided to allow the renminbi's value to be more freely determined by market circumstances, it would be surprising if the dollar rises against major currencies such as the yen and euro, that the renminbi would not join the decline. It is also quite feasible that this could result in problems for excessively U.S. dollar-denominated debt-financed Chinese companies (as it will for many others in the emerging world). But surely this is why it is important that as we creep through time, the yuan and other currencies increase their importance in global finance, as it isn't really clear to me as to why this is beneficial to anyone including the United States. If Fed tightening causes a significant tightening of U.S. financial conditions including a broad rise of the dollar, then it would add to the risk of a U.S. recession, and certainly pour cold water on any hopes the U.S. administration will improve its external trade position permanently.

But if I remember the Andy Warhol principle, perhaps it might just turn out to be the case that neither will the dollar rise so much, and indeed, perhaps if China ends up shifting to its own version of a more expansionary fiscal policy, then in fact it might fall, especially if European economic growth were to simultaneously pick up.

A stronger dollar and reduced export opportunities create a problem for dollar-denominated Chinese debtors.

BERNARD CONNOLLY
Founder, Connolly Insight, LP

Why might here be a dollar shortage? U.S. tax changes may have led to "forced" repatriation of dollar profits. But, all other things equal, that should make dollars available for other agents to deploy abroad, with no obvious reason why the net effect would be a dollar shortage in China. Short-term U.S. growth expectations may have increased relative to expectations elsewhere, creating a demand for dollars and pushing U.S. yields up. That, too, has ambiguous effects on China, increasing the debt-service/refinancing burden for dollar-denominated borrowers but increasing U.S. import demand for Chinese output.

The third possibility is that Fed asset sales are, independently of growth prospects, reducing the net supply of dollars. That is clearly the worst case for Chinese borrowers. However, U.S. long yields have fallen in recent months—yet the dollar has strengthened, probably indicating increased rest-of-the-world risk premiums resulting from trade tensions and a rather general belief, justified or not, that the United States would "win" a trade war.

To the extent that is so, the combined impact of a stronger dollar and reduced opportunities for exporting to the United States creates a potentially serious problem for dollar-denominated Chinese debtors. Rolling over or paying off dollar borrowing at a more unfavorable exchange rate yet with worsened export prospects, must, at best, reduce the funds available for Chinese firms to support output and investment and could well lead to major financial difficulties at worst.

With the Chinese economy already slowing, a negative factor of this sort is likely to elicit a policy response. But any such response is unlikely to come from the U.S. side unless problems in China, and in the emerging market world, first threaten to affect growth or financial stability in the United States.

In particular, the politics of a Fed response along the lines of the 2008–2009 massive increase in central bank swap lines would seem close to impossible where China is concerned. From an economy-wide Chinese point of view, generalized dollar strength has increased the command of China's dollar reserves over rest-of-the-world (non-U.S.) resources. Some liquidation of reserves (which may already have been happening in a stealthy way) could make dollars available to Chinese firms if the authorities decided to bail out over-borrowed firms.

The alternative would be to loosen Chinese monetary policy, producing yuan depreciation and aiding the Chinese economy in general at the refinancing expense of dollar-indebted firms. That might, if China were a small economy, be the better alternative, especially as the Chinese authorities have been attempting to encourage or enforce deleveraging. But in terms of real-world China-U.S. relations, such a move, or threatened move, would be less likely to push the Fed into making dollar swap lines available to the People's Bank of China than to intensify the trade conflict. It might thus not be the route chosen by the Chinese authorities.

Thus one more unsustainable structure—to add to U.S. asset valuations, the euro area, and indeed the European Union itself—may yet again be propped up by the authorities for a bit longer.

This looks more like the typical discomfort from a restrictive monetary policy cycle, rather than systemic disruption.

RICHARD JERRAM
Chief Economist, Bank of Singapore

At the heart of any question about the implications of a global dollar shortage, tightening U.S. monetary policy, or China's stance towards its exchange rate is the degree of vulnerability of emerging markets. Are we at risk of a repeat of the taper tantrum of 2013, the Asian

Financial Crisis of 1997–1998, or one of the many Latin American debt crises?

We can answer the question objectively or subjectively. Hard data shows that very few emerging markets have a problematic current account deficit that needs funding. Argentina and Turkey stand out and are accompanied by a handful of smaller countries, but we find that emerging markets representing only about 4 percent of the world economy have a deficit over the 3 percent of GDP that is usually seen as problematic. Similarly, it is hard to find many examples of countries with badly misaligned exchange rates, low foreign exchange reserves, or high levels of short-term debt.

More subjectively, policy management has improved. Looking across Asia, we see more independent central banks, with clearer policy targets, better fiscal management, and use of macro-prudential policies to choke off real estate speculation. Myriad reforms on the micro level are captured in higher scores in rankings from the World Bank or the World Economic Forum. This improves the investment environment, including foreign direct investment, which provides a more stable source of capital.

Inevitably there will be some problems after nearly a decade of ultra-low interest rates. Imprudent management of some companies and countries will be exposed as interest rates rise, especially as we suspect that the Federal Reserve will have to tighten far more than the market currently expects in order to cool down the overheating U.S. economy. However, this looks more likely to be the typical discomfort that comes from a restrictive monetary policy cycle, rather than systemic disruption that follows the build-up of serious global imbalances.

It's not clear why the Chinese would depreciate their currency.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

What dollar shortage? Any creditworthy borrower can get hold of U.S. dollars, it just costs a little more [than a year ago]. The Federal Funds rate has gone up by 50 basis points since early 2018, and rates on longer-maturity dollar loans have typically gone up by even less.

It is true that the U.S. dollar costs more measured in most other currencies, but again the increases have been modest apart from currencies of a few emerging markets, and those major depreciations have been governed by local developments (such as in Argentina, Turkey, and Venezuela), not by developments in the American economy. Put another way, borrowing in dollars commands more local currency than last year.

What about dollar-denominated Chinese corporate debt? It depends on why it was acquired, and on what terms. Much Chinese foreign currency-denominated corporate debt was acquired to purchase foreign assets, which purchases have been abundant in recent years, especially 2016. The assets have to be evaluated along with the debt. Measured in Chinese currency (renminbi), the assets presumably have also risen in value, unless they were unwise investments. If the debt carried floating interest rates, servicing costs will also have gone up, both because of higher interest rates and because of higher exchange rates (measured in renminbi).

If the overseas debt was remitted to China, presumably because of lower interest rates on dollar-denominated debt than those prevailing in China, then one has to recognize that U.S. interest rates have been expected to rise for several years, such that only the detailed timing was not known, and that timing was widely understood to be keyed to developments in the American economy: the stronger the economy, the more rapid the rise in U.S. dollar rates. The two need to be viewed together, not in isolation from one another.

There is no reason on these grounds for the Chinese to expand domestic credit more rapidly. China has ample foreign exchange reserves (around $3 trillion) to cover all foreign currency-denominated liabilities if it chooses to, and it could do so through a variety of potential channels. But why should it? Under the declaratory policy of allowing market forces to play a greater role in the allocation of resources, China should allow each firm to deal with its own outstanding foreign debt.

It is true that the renminbi has depreciated against the U.S. dollar in 2018, but only by 2 percent since the first of the year and 6 percent from its peak in April. So far this mainly reflects the link of the renminbi exchange rate to a basket of currencies, and other currencies in the basket have depreciated against the dollar. If China were to deliberately depreciate the renminbi against the dollar and other currencies, that would certainly aggravate the trade disputes that many countries have against China. But to do so would also make it more difficult for Chinese debtors to service and repay their foreign debt. Again, why should China do that?

The focus should be on U.S. interest rates, the dollar, and credit risk spreads.

WILLIAM R. CLINE
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Invoking a "dollar shortage" to diagnose current global macroeconomic forces is a distraction. There was a dollar shortage in the early postwar period as Europe sought to import capital equipment for reconstruction and needed to build up dollar reserves, while fixed exchange rates hampered external adjustment and private capital flows were controlled. There was a different type of dollar shortage in 2007–2008 as the financial crisis froze access to short-term dollar funding for European banks holding long-term dollar claims. There is not a comparably meaningful dollar shortage now.

If the dollar is in severe and chronic short supply, why is the broad real effective exchange rate as measured by the Federal Reserve no higher now (99.4 in June) than in October 2016 (99.1) before the election of Donald Trump? Although emerging markets have recently been under pressure, for eleven major emerging market economies (Brazil, Chile, Colombia, Mexico, India, Indonesia, Malaysia, Philippines, Thailand, South Africa, and Turkey), the average real depreciation against the dollar since October 2016 is only 3 percent, compared to 17 percent in the corresponding 21-month period following the Taper Tantrum in May 2013. And if there is a dollar shortage now, why wasn't there a dollar glut last year when the Fed index fell from a peak of 103.1 in January to 94.6 in January 2018?

The focus of attention should not be on a structural short supply of dollars, but on how much three key variables will rise: U.S. interest rates, the dollar, and credit risk spreads for emerging market economy sovereigns and corporates in the face of the shift to risk-off international markets. A major change is the pressure imposed by the increase in prospective U.S. fiscal deficits following the end-2017 tax legislation. The Congressional Budget Office forecasts that from 2017 to 2020, the deficit will rise from 3.5 percent of GDP to 4.6 percent, and the ten-year Treasury rate will rise from 2.3 percent to 4.6 percent. Another effect of the tax law has probably been overstated, however. The repatriation of multinationals' profits held abroad is unlikely to cause much upward pressure on the dollar, because Apple and other U.S. multinationals were already holding these assets mainly in dollar investments such as U.S. Treasury obligations and corporate bonds.

Some see the Fed's reversal of quantitative easing as causing a dollar shortage, but this influence is already reflected in the forecasts of higher interest rates. Those who worry that there will be a resulting collapse in money quantity should recognize that there was no huge increase in M2 during quantitative easing because there was a large buildup in banks' excess reserves. As the Fed draws off liquidity by reducing its holdings of Treasury bonds and mortgage-backed assets, banks will tend to provide more liquidity by reducing their excess reserves (which have already fallen since their peak in November 2017).

Yes, China's currency may depreciate relative to the dollar given uncertainty from the trade war, but no objective Treasury report will be able to charge currency manipulation so long as China is selling reserves to keep the renminbi from falling further rather than buying them to prevent appreciation. ◆

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