Daily Note

GLOBAL FRACTURES: DOLLAR HEGEMONY AND NEW RISKS

Shweta Singh

- **Global trade and finance more closely linked than meets the eye**
- **Dollar hegemony means the Fed is the global lender of first resort**
- **Risk triggers increasingly lie outside the banking sector**
- **This Daily Note is the seventh of eight in our "Global Fractures" series**

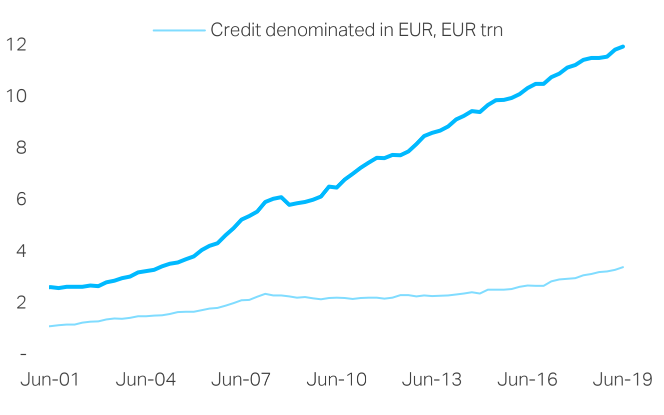
A key theme in our Global Fractures narrative is that globalisation is unwinding. This could lead to a re-ordering of global flows of goods, capital and labour. But the more immediate impact – already evident – is a pullback in global trade and, consequently, manufacturing. Growing protectionism since 2018 has inflicted huge damage on international trade and manufacturing, but the slowdown has been in train since the Global Financial Crisis (GFC).

Trade and manufacturing are closely intertwined with finance, especially bank credit. World trade grew rapidly until the GFC, but there has been a broad retrenchment since then. According to Hyun Song Shin at the BIS, this pattern coincides with the trend in the global flow of bank credit. This is because the brisk growth in trade was driven by a rapid expansion in global value chains (GVCs), which are highly finance-intensive.

Elaborate GVCs need global financing conditions to be very accommodative. Firms participating in GVCs must hold large inventories of intermediate goods and/or accounts

Dollar dominance

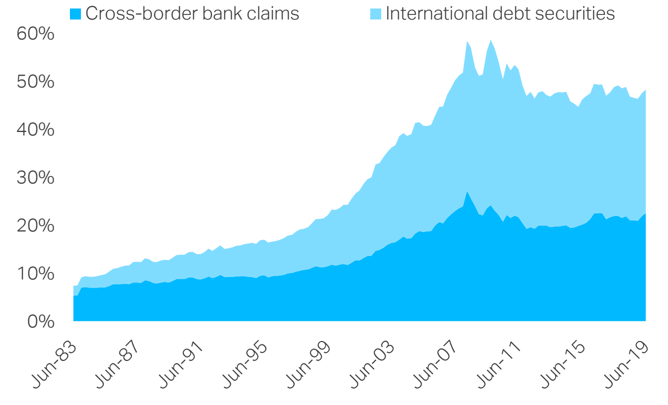
Offshore credit (loans and debt) extended to non-bank borrowers



Source: BIS, Datastream, TS Lombard

International debt issues rise as banks curb credit

% of world GDP



Source: BIS, Datastream, TS Lombard

receivable on their balance sheets. These have to be financed. Not all companies can do so out of their own resources, making them dependent on external financing. The longer and more intricate GVCs become, the greater the financing needs.

The banking system has financed around 35% of global trade, with around 80% of bank trade financing denominated in dollars (see link). Slower bank credit growth since the financial crisis has gummed up GVCs, putting the brakes on trade. Tougher banking regulations introduced following the GFC have crimped lenders' capacity to extend credit. The strength of the dollar since the start of the decade has also squeezed the supply of bank credit. That's because lending in dollars slows when the US currency appreciates and accelerates when the dollar weakens.

Why? The greenback has become a key barometer of global risk appetite owing to its prominence as a funding currency. When dollar debts are not matched by dollar cash flows, as is usually the case, a strong dollar worsens the creditworthiness of borrowers and so makes banks think twice about extending credit. Furthermore, with the global volume of dollar-denominated corporate debt reaching new highs, a more expensive dollar has ramped up debt-servicing costs, making this a source of global financial vulnerability. Emerging markets are particularly exposed because they have borrowed heavily in dollars.

Global supply chains are exposed: a strong dollar generally worsens the balance sheets of non-financial firms that are linked through GVCs, restricting their ability to raise new financing. Foreign currency risks have also risen because cross-border payments and FX transactions associated with sprawling supply chains have become increasingly complex.

An important implication of the dominant role played by the dollar is that the Fed is more than ever the global lender of first resort. The feedback loop whereby the dampening effect of a strong dollar on global demand leads to weaker US domestic demand and corporate earnings has become firmly entrenched. Just as the pressure on emerging markets from a strong dollar has intensified, the share of EMs in US exports and the Fed's trade-weighted dollar index has increased. As a result, the Fed will be called upon more frequently than in the past to put backstops in place to arrest worsening global financing conditions. Take the strains in US money markets in mid-September: these were exacerbated by the trade war, a strong dollar and an inverted yield curve, and they forced the US central bank to expand its balance sheet again.

Another key development in global financing flows is the growing role of capital markets in intermediating international credit (see link). Banks have held back the supply of credit - international credit in particular – because of stricter regulatory requirements and the need to deleverage. With the banking sector better capitalised and better regulated now, risks have migrated to capital markets. Ultra-low interest rates have sparked increased debt issuance across the quality spectrum – one more reason why the stakes are pretty high for central banks to tighten policy.