Stock markets hold steady but global dollar shortage looms

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Some temporary relative calm returned to financial markets yesterday on the back of moves by the US Federal Reserve, the European Central Bank (ECB) and other central banks to cut interest rates and purchase hundreds of billions of dollars of financial assets to try and prevent a credit freeze.

Stock prices rallied slightly in the US and Europe, the yield on government bonds fell and oil prices moved up after hitting their lowest levels in 17 years on Wednesday.

The moves by the central banks came in response to extraordinary developments in the financial markets which passed into what could be characterised as a through-the-looking-glass world in which everything was reversed.

Under normal circumstances, during a market sell off the price of government bonds rises and the yield (or interest rate) falls as investors seek more secure assets. But this week bonds were sold off in a grab for cash causing interest rates to rise.

This was in conflict with the aim of the Fed to try and lower them. It led to a tightening of credit markets amid indications they might totally freeze as happened during the crisis of 2008.

Consequently the Fed resumed quantitative easing, to the tune of at least $700 billion as well as opening its financial spigot to the commercial paper market for short-term debt and pouring trillions of dollars into the overnight repo market.

The ECB announced it would purchase €750 billion worth of government and corporate bonds at an emergency meeting held on Wednesday evening after the measures it announced from the regular meeting of the governing council last week proved completely inadequate to stem the turmoil.

The Bank of England has pledged to provide an unlimited intervention into the commercial paper market.

Yesterday the Reserve Bank of Australia joined in the central bank action, cutting its interest rate to 0.25 percent and, for the first time in history, launching a program to purchase government bonds.

The move came after signs of a growing crisis in Australian financial markets reflecting the same reversal of normality seen elsewhere.

Following the massive fall in the Australian stock market—it is down by 30 percent—bond yields could have been expected to fall. Such is the rush for cash, however, that they rose by as much as 1.28 percentage points, the biggest one-day move on record.

The Australian dollar has taken a hammering in international currency markets and is now at an 18-year low of $US0.57. At one stage it dropped by 2.5 cents in just one hour in contrast with what takes place in so-called “normal” circumstances when currency movements are a small fraction of that amount.

Announcing the decision to purchase government bonds—at this stage only in secondary markets rather than directly from the government—RBA governor Philip Lowe took a step along the road being taken by his international counterparts.

This is a process in which, through their interventions via asset purchases, this arm of the state becomes the price-setter for interest rates in bond markets.

In a major speech yesterday, Lowe said the practice of the central bank over recent decades had been to target the cash rate. This was now being extended. The RBA would intervene through regular auctions in the bond market to ensure that the yield on three-year Australian government securities was 0.25 percent, the same as the bank’s cash rate.

The rapid plunge of the Australian dollar, one of the world's most frequently traded currencies, is symptomatic of a broader process—the scramble for US dollars in all international markets.

Here, as well, a through-the-looking-glass process is at work. Under other conditions, the slashing of interest rates by the Fed would lead to a decline in the value of the US currency. But instead it has been rising, provoking fears of a crisis in emerging markets and for governments and corporations with large amounts of dollar-denominated debt.

Yesterday, the *Financial Times* (FT) reported: "Currency traders across Asia invoked the spectre of the 2008 financial crisis… as acute corporate balance-sheet stress, cash repatriation by global investors, disruption to trade and hidden losses by imploding hedge funds led to a rush on the dollar."

The head of foreign currency trading at JPMorgan in London, Paul Meggyesi, told the FT: "When you have the most unexpected recession we've seen in modern times, a lot of people are caught in dollar-funding issues. This crisis is affecting every sector and every country in a synchronised way."

George Saravelos, head of foreign currency research at Deutsche Bank, noted that banks are also hoarding dollars because of concerns over corporate defaults. This has led to a rise in the cost of dollar funding.

"We underestimated how acute dollar-funding pressures would become. We worry that fixing this dollar shortage may become more difficult than policymakers think," Saravelos said.

Govinda Finn, an economist at Aberdeen Standard Investments told the *Wall Street Journal* that the global scramble for cash and US dollars was causing disruptions in many markets, describing the dollar shortage as "the biggest fire for now."

"In the past it was relatively easy to buy dollars outside the US, but the cost is getting higher," Finn said.

The relative ease of dollar purchases under the Fed's low-interest rate regime and the quantitative easing program after the 2008 crisis led to an expansion of dollar-denominated debt. The level of such debt has doubled since 2008 to $12 trillion.

Now it is getting much harder to repay because of the fall in all national currencies relative to the dollar, raising the possibility of major corporate defaults that would have a cascading effect through the global financial system.

In its emergency measures announced earlier this week, the Fed took account of the prospect of dollar shortages by reactivating swap lines through which the US currency is made available to other banks—a facility invoked in the 2008 crisis. The swap lines were initially only provided to the ECB and the central banks of Canada, England, Japan and the Swiss National Bank.

The Fed has since extended them to nine other countries, including Australia, Brazil and South Korea, allowing them to tap into a total of $450 billion. In a statement on its latest moves, the Fed said they were "designed to help lessen strains in global US dollar funding markets."

Notably, however, China, the world's second largest economy and its major manufacturing centre is not on the list.

If China faces a dollar shortage it will be forced to start selling off its holdings of US Treasuries—a move that would lead to a spike in interest rates.

Concerns have been expressed that many so-called emerging market economies will also need dollars but may not receive them because of the nationalist "America First" agenda of the Trump administration.