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# ASIA MACRO INSIGHTS


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## The Iran war and shifts by China are tightening the global supply of dollars

When US interest rates rise, investors tend to focus on what this means for US growth and asset valuations around the world. Less attention is paid to the plumbing of the global dollar system.

Tighter monetary policy by the US Federal Reserve reduces dollar liquidity by design. But the recent increase in the Fed benchmark interest rate comes as two other sources of offshore dollars, which have historically cushioned the rest of the world against Fed tightening, are diminishing: the Gulf and China.

For the Gulf, past oil shocks translated into larger current account surpluses, which were recycled into dollar assets. The Iran war has increased oil prices, which should help generate more dollars. But, alas, the closure of the Strait of Hormuz as well as large disruptions in production and refinery facilities have curtailed exports. This has severely limited the amount of dollars the Gulf is generating.

At the same time, the Gulf states are facing a need to keep more dollars at home to reconstruct damaged infrastructure, increase defence spending and support local economies. Fewer petrodollars are available to assuage the dollar needs of the global economy.

China is the second reason for a shift in dollar liquidity. Its trade surplus is at record levels, which should translate into more dollars being put to work — invested or lent — overseas. The reality is a bit different. The internationalisation of the renminbi is a big priority for Beijing, which is pushing the use of its currency — instead of dollar — for overseas lending and investment.

Chinese banks have expanded their overseas lending denominated in renminbi. It has increased from less than 15 per cent of total overseas lending to more than half in the past four years, according to a Reserve Bank of Australia study. Given the lower interest rates on renminbi debt compared with dollar borrowing, this is supporting appetite for borrowing in reminbi, particularly in the global south. (Continued on next page)

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Furthermore, China's capital outflows tend to be parked in Hong Kong, using the special instruments that Beijing has introduced that support this process, such as the Southbound Bond and Stock Connect. These allow mainland Chinese investors to trade and invest in bonds and equities in Hong Kong.

A clear sign of the excess liquidity parked in the territory is the much lower cost of funding in the Hong Kong dollar versus financing in the dollar. Given the territory's currency is pegged to its US counterpart, the two costs should be close. But the one-month HIBOR rate for interbank lending in Hong Kong dollars is about 2.7 per cent compared with about 3.9 per cent for the dollar-denominated US Secured Overnight Financing Rate (Sofr) over the equivalent time.

One factor in keeping dollar liquidity in Hong Kong stems from the large pool of initial public offerings in the territory's stock market. KPMG has estimated the territory is on track this year to break the 2010 fundraising record of HK$449.5bn ($57bn). Most IPOs are Chinese companies looking for funds for their own uses. Funds raised tend to go back to the mainland or stay in Hong Kong. In other words, less of China's trade surplus is being recycled in New York or London when there were more US listings.

These developments in the Gulf and China look worrisome on the back of tighter monetary policy from the Fed but also larger funding needs from the US Treasury as well as AI hyperscalers.

When offshore dollar liquidity shrinks, the stress can show up in cross-currency swaps, in the funding costs of emerging-market borrowers and in the balance sheets of non-US banks that fund long-term dollar assets with short-term dollar liabilities.

And as the work of Hyun-Song Shin, former head of research of the Bank for International Settlements and now Bank of Korea governor, has shown, dollar funding strains can build offshore, in foreign exchange swap markets and among non-US hedgers, even when US money markets look calm.

The most extreme case of dollar liquidity strains was in the great financial crisis in 2008. But there were also signs of strains in 2020, although the impact was far less acute then thanks to a much speedier response by the Fed, through the extension of US dollar swap lines with major central banks as well as its repo financing facility for foreign official holders of Treasuries.

If strains emerge again, we might need an even bolder and faster Fed, which is by no means guaranteed in the current political environment in the US.

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