Markets
Odd Lots

Transcript: Hyun Song Shin Explains Why This Dollar Shock Is So Unique

A dollar shock and commodity shock at the same time.

Hyun Song Shin, economic adviser at the Bank of International Settlements. *Photographer: Taylor Glascock/Bloomberg*

By Tracy Alloway and Joe Weisenthal
November 2, 2022 at 9:19 AM EDT

It's no secret that a strong US dollar causes the rest of the world pain, but the impact of this year's rally is shaping up to be a bit different than previous episodes of dollar strength. Hyun Song Shin is the Economic Adviser and Head of Research for the Bank for International Settlements, which has just published a bulletin outlining why this particular dollar cycle is so unique. Shin has also done a ton of previous academic research on this exact topic – examining what happens to global trade and business investment when the dollar hits its highs. In this conversation, we talk to him about the impact of the dollar rally, what could stop it and what policymakers around the world can do to cope. This transcript has been lightly edited for clarity.

Key insights from the pod:
How does this dollar rally compare to previous cycles? -- 3:09
The different roles played by the dollar – 5:45
How the dollar's relationship with commodities has changed – 11:07
What a strong dollar and higher commodities prices mean – 13:55
How tighter financial conditions play out – 16:37
Are we going to see lots of currency intervention? – 19:13
Why dollar dominance persists – 21:45
Why advanced economies are more impacted now – 27:11
When a strong dollar might be problematic for the US – 21:50
On what could stop the dollar rally this time? – 36:17

Tracy Alloway: (00:10)
Hello and welcome to another episode of the *Odd Lots* podcast. I'm Tracy Alloway.

Joe Weisenthal: (00:14)
And I'm Joe Weisenthal.

Tracy: (00:16)
Joe, have you looked at\ a chart of the dollar recently?

Joe: (00:20)
It's the only chart I look at.

Tracy: (00:22)
Well, if you were going to choose one Desert Island chart right now, the dollar is a pretty good candidate.

Joe: (00:27)

Yeah. That's why I'm only sort of half joking when I say it's the only chart that I look at because, you know, the strong dollar has become the sort of central market story right now. And then everything else sort of trades off of, is the dollar weak or strong? I think we went a couple days where we were like paying attention to the British pound, but now that kind of seems to be over. It’s really all about the dollar and it's coming off a little bit from its highs, but it's still very high.

Tracy: (00:54)
Yeah, I was going to say, you know, the last time we had an episode specifically devoted to the dollar, I think was in the summer and we were kind of joking about top ticking it. We didn't though. We definitely didn't, because it just kept going and I think it reached, you know, a record high in September and now as you mentioned, it's come down a little bit, but still incredibly strong and it's having a massive impact on not only markets, but real economies around the world.

Joe: (01:19)
Right. That really is the key thing. And you know, it's a theme that we've talked about for years, even before the pandemic or you know, even during periods when the dollar is kind of weak or much lower than it is, dollar cycles are really important both for markets and the real economy.

Tracy: (01:35)
Yeah. And even though people write quite a bit about dollar cycles, I feel like they still don't get enough attention paid to them. Weirdly, it's like one of those things that I don't know, people talk a lot about them, but we should definitely talk even more.

Joe: (01:47)
And when people, or at least you and I, but when people think about these dollar cycles and the effect they have globally, I feel like there's always one name that comes up first.

Tracy: (01:56)
Yes. So on that note, we really do have the perfect guest to discuss this, someone who's been on the podcast before talking about what the strong dollar means for the global economy. Someone who's done a lot of academic research on this topic. And to this day, whenever you and I write about a strong dollar, we always make sure to reference his previous papers. So I'm very pleased to say we are going to be speaking with Hyun Song Shin. He is of course the Economic Advisor and Head of Research at the Bank for International Settlements. And the BIS has just published a bulletin all about the FX market with a big portion of it devoted to what's going on with the US currency. So really the perfect person.

Joe: (02:37)
Let’s do it.

Tracy: (02:38)
All right. Hyun, thank you so much for coming back on Odd Lots.

Hyun Song Shin: (02:41)
Thanks Tracy, thanks for inviting me back.

Tracy: (02:44)
So, you know, I mentioned in our intro the chart of the dollar looks like if you look at the Bloomberg Dollar Index, for instance, it seems to be at a record. Can you maybe give us some context about what we're seeing with the US currency now? How unusual is this particular moment in history? And you know, Joe mentioned that there have been strong dollar cycles previously, how is this one similar or different?

Hyun: (03:09)
Yeah, Tracy, that's a great question to kick off with. You know, maybe I can go back in time a bit and give you the broad sweep here. I mean, if we look back to the past 50 years or so, maybe even the past 40 years, the era of floating exchange rates, the chart for the dollar looks a bit like a 'W.' We have a peak in the early eighties. In fact it peaked in January of 1985 and then it peaked again in the early 2000s. And I'll give you some numbers shortly, and it's very high currently.

So just to give you some magnitude, I think it's worth having some of these numbers in our minds as we talk about this. The BIS publishers a long series on exchange rates. It's the BIS series on real effective exchange rates, so it's a weighted average across all the major bilateral exchange rates with respect to a particular currency. And then we adjust for inflation, relative inflation as well.

If we go back 50 years and just look at the average of the real effective exchange rate for the dollar, the average is around, it's just over 110. And in '85 it reached, 145, just over 145. That gives you a sort of sense of how strong the dollar was back in '85. In 2002, it peaked around 124 and currently it broke through 140. So we are sort of, you know, we're not quite there, in terms of the 1985 level, but we are reasonably close.

And to give you a sense of the troughs, there were periods of a weaker dollar as well. The first trough, you know, the first trough in the 'W' as it were, that comes in the early nineties, it reached the low nineties. And then just after the global financial crisis, it again reached the low nineties then. So there have been some wiggles in the last five or six years, but I think it's, you know, useful to have this kind of broad historical sweep as well.

Joe: (05:16)
There's that famous phrase, and I guess it was a former Treasury [Secretary], I just had to Google it, that former Treasury Secretary John Connolly stated, 'The dollar is our currency, but it's your problem.' 'Our currency, your problem,' is this phrase that gets repeated a lot. And I feel like when I

think about, well, how is it your problem? How is it everyone else's problem? How do you summarize the strain that it places on the global economy when the dollar moves up this rapidly?

Hyun: (05:45)
What we can do, Joe, is to highlight some of the roles played by the dollar. I mean, it is the premier international currency and it is the premier currency in pretty much all respects. So it is the invoicing currency of choice in international trade. It is therefore the trade financing currency as well quite naturally because if you're invoicing in a particular currency, then the the trade financing will also be in that currency as well. But more broadly, it is a currency that figures very highly in reserve holdings, but in particular in capital markets and cross-border banking as well. So it's the, if you like, the funding currency for global banking and capital markets. So what that means is that, you know, if it's a funding currency, it's the currency that you borrow in and therefore it's the currency of leverage to some extent.

And so when the dollar becomes strong, if you like, it's the leverage that becomes more costly. So it's quite natural for you to see the pullback in risk appetite, if you like, a reduction in risk taking as well. So there's a very strong risk taking element, you know, as the dollar strengthens where there's a kind of, you know, pullback from risk taking. So a stronger dollar has an effect certainly on trade, but also on financial conditions as well. So that's the kind of one sentence summary.

Tracy: (07:10)
Yeah. When we spoke to Jon Turek in the summer about this on the show, you know, he kind of described how the dollar works through an economic growth channel, given the trade angle and also a liquidity one because the dollar has this unusual position in the global financial system where it's a safe haven currency, it's considered that. And so when you get worries about economic growth slowing because of the higher dollar, you tend to get more flows into dollar assets and then the dollar goes up even more. So you get this kind of cycle, I guess. And maybe just one more basic question, but why has the dollar been going up? Is it all about interest rate differentials and the fact that the Fed is hiking or are there other factors to it? And you know, I'm thinking specifically about, again, one of the dollars' very specific or unique roles in the world of commodities pricing.

Hyun: (08:04)
Certainly the relative pace of monetary tightening has certainly played a role. And that's something that we describe in the bulletin. If you look at the relative interest rate differentials between the US and other countries, we do see a relationship there where as the interest rate gap widens, we do see an impact on the bilateral exchange rate. So the other currency tends to depreciate more. So I think that's a pretty familiar story and you know, that is a large part.

But I think there is also a very important real economy effect here as well. If we look at the terms of trade. So roughly, you know, how much has the price of your exports changed relative to the price of your imports? A very recent development has been that the US has become a net energy exporter, especially in natural gas.

So compared to past episodes when a stronger dollar went hand in hand with weaker commodity prices, you know, there has been this additional effect that comes from the terms of trade as well. So the dollar has moved to some extent in line with other commodity exporters. So that's the other factor. And yet a third factor would be what you've already mentioned, Tracy, which is that as uncertainty has increased, the dollar tends to attract the safe haven flows as well.

So I think I would say all of those are to some extent the consequence of the unusual sequence of shocks we've had. So we had obviously the pandemic, but also the war in Ukraine and the subsequent, you know, impact on commodity prices as well. And you can certainly put the monetary policy responses also in this context. So I think we have to, as it were, have a pretty comprehensive, you know, joined up picture of why we are where we are.

Joe: (10:08)
I want to talk more about the commodity angle, because that seems like what's really distinct and unusual here. And if, you know, you look at the chart of past dollar spikes that you talked about, those were the era in which the US was a big oil importer and was not a commodity exporter at all.

This is the new [thing], we're a huge oil producer, as we know, and the whole world is thirsty for our natural gas. We're exporting as much as is physically possible. How does that change things? And I'm also curious, does that create a spiral?

So I'm thinking about sort of, you know, the Japanese yen, and for a long time Japan was a big export powerhouse. Now it actually, I believe is an importing country, particularly due to energy prices. We've seen how much the yen has weakened generally. Does this create like sort of a snowball effect where the terms of trade for a country like Japan deteriorate, the yen weakens, and then energy prices get even more expensive in sort of accelerating the cycle?

Hyun: (11:07)
That is certainly one factor, Joe. And the terms of trade effects also show up in the trade figures as well, both for Japan and other commodity importing areas. And I'm thinking of Europe in particular. You know, we do see the impact of the energy and food price price increases recently.

But I think the important point here is the invoicing currency role of the dollar. The dollar is the invoicing currency for energy, food, as well as for manufacturing by the way. But especially for energy and food, because what that means is if you are in Japan or in the euro area, you've seen your currency depreciate against the dollar. And we know that commodity prices have increased even in dollar terms. And so in euro or yen terms, it's actually increased a lot more.

And, you know, there's a chart in the bulletin that shows just roughly the magnitude. And what that means is the energy and food prices are then incorporated into your inflation figures. And I think the important point to mention here, and you've covered this in your previous podcast, energy and food prices, they're really salient to commodities as far as household behavior is concerned, household perceptions are concerned. And so they do figure quite importantly in how expectations are set and therefore, you know, how behavior changes as well. And so perhaps even more than other traded goods, if you see this very sharp increase in commodity prices, especially in your own currency, you feel like that would have a disproportionate effect on inflation, you know, domestically and the way that inflation is perceived.

What's different this time is that typically, historically we see commodity prices weakening as the dollar strengthens. I mean, there's a very well-established historical relationship where a stronger dollar goes hand in hand with weaker commodity prices. What's different this time is that, given the nature of the shocks, we have this conjunction of a stronger dollar and higher commodity prices due to the war in Ukraine, for example. And that combination -- which is a very unusual one -- has had an effect in raising the food and energy prices in other currencies a lot more than it did in the past.

Tracy: (13:31)
Right. So normally you would have this inverse correlation between the dollar and commodities, especially oil, and if the dollar went up, you would expect oil prices to go down, but that's not happening this time around. Can you talk a little bit more about what that means for countries that are importing a lot of food and energy? Because I think it's pretty important.

Hyun: (13:55)
Yes, it is very important. And really it is a negative shock to your terms of trade, and it raises the price of food. It raises the price of energy in your domestic currency, and so that will feed into inflation. So it's a bit of an unpleasant set of shocks there. We see, for example, that the economies that are very geared towards manufacturing have seen a worsening of their trade balance, you know, as the terms of trade have moved against them. And it's also true that as the exchange rates in these countries have also depreciated, you know, relative to the dollar, that's also been an unwelcome factor in raising inflation as well because of the very unusual sequence, very unusual combination of shocks. It has been a double whammy.

Joe: (14:39)
Can you talk a little bit more about what it means from a policy perspective for countries that are faced with this unusual series of shocks? So there is high inflation, but much of it in areas that they probably can't control. The, you know, global commodities. What does it mean in terms of the policy space that different countries have? And, you know, we've all seen the yen charts and it looks like maybe there has been some yen intervention at some point, but you know, it's limited and it's sort of ambiguous, but what does it do to policy makers in countries that are faced with this series of shocks?

Hyun: (15:13)
Yeah, I think that's a very, good question, Joe. And I suppose the first order of business is to address the inflation that is underlying, if you like. It actually sets the terms of the trade off for all these other policy questions. Even if the source of the inflation is these higher energy and food prices, we know from historical experience that once that gets entrenched, it will feed into expectations about how inflation will develop in the future. It's going to get much more difficult to bring inflation down. And just to give you a sense of how that process has progressed, we know, and you've been covering this in your podcast a lot in the early days of the shock, you know, as we were talking about, supply chains, it seemed that the price increases were limited to, you know, certain good sectors. Some of the work at the BIS, we also follow that pretty closely, but what we've seen is that there's been a broadening out of inflation over the subsequent months. We've seen the core inflation measure also move up.

Joe: (16:24)
This is globally?

Hyun: (16:25)
And this is global.

Joe: (16:27)
So this is a phenomenon that we're seeing every country, which is not just high inflation, not just headline inflation, but this broadening effect across goods and services.

Hyun: (16:37)
Yeah, exactly. And we see it in core inflation. And this is true outside the US as well. So irrespective of the source of the shock, you know, once inflation gets entrenched, we know it’s going to be very difficult to bring it down. So addressing inflation would be certainly, you know, the first order of business.

But as you're doing that, I think there are other things one can do to mitigate some of the effects of a stronger dollar, especially if it affects your financial markets. So we know as we, you know, spoke just earlier, one of the very well-established effects of a stronger dollar is that it tightens financial conditions. It is the global funding currency, it's the currency that you borrow in, and therefore it's the currency of leverage. So a stronger dollar tends to go hand in hand with deleveraging, if you like, a recoiling from risk taking.

And that manifests itself in, you know, not only banking sector flows, bank lending, but also in capital markets. You see, for example, spreads on corporate bonds go up as the dollar strengthens. And there's a chart in the bulletin that I think illustrates that quite strikingly.

And we also have very good evidence that it affects the shadow price of intermediary balance sheet, if you like. So, you know, when you to Zoltan Pozsar or Perry Mehrling, you know, they I think have a very similar sort of approach to this. There a sort of marginal cost of balance sheet. We tend to observe, for example, through the deviation from covered interest parity, the FX basis spread, for example, is that that spread goes up when the dollar is stronger, which is a kind of telltale sign that balance sheet is becoming more expensive.

And so for all these reasons, if the tightening of financial conditions gets excessive and it might sort of trigger episodes of, you know, stress, then of course there are ways of mitigating that kind of stress. I think central banks have the tools to do that. You can mitigate that partly by, you know, supplying liquidity in a very sort of strategic way, but also FX intervention to, as it will lean against the wind, is another way to address partly this kind of tightening of financial conditions as well.

Tracy: (18:53)
This is what I wanted to ask you about, we used to worry about competitive devaluation in the years since 2008, but should we be worried about competitive, I guess, interventions now? People trying to strengthen their currency against the dollar, and how sustainable are those types of moves?

Hyun: (19:13)
You know, I can see some parts of the argument for why a stronger dollar might lead to, you know, high interest rates in other jurisdictions, higher than perhaps it could be in the absence of a stronger dollar. But I'm not sure that the argument sort of fully comes around to a conclusion that this leads to kind of competitive strengthening. So one part that certainly does, you know, make some sense is the idea that as the dollar strengthens, it raises the local currency price of food and energy, and that certainly has an effect on domestic inflation, for the reasons that we discussed. So that has to be met by a monetary policy response domestically. So there would be a tightening there, but for a kind of feedback loop to be established, you need some kind of way of completing that circle.

And I think that additional step for us, it's not as clear. If anything you would imagine that, you know, the causation goes the other way. So as the global economy weakens, you might, you know, see the Fed sort of moderating, you know, if there is a demand spill over. But clearly this is something that, you know, we need to keep an eye on. It’s certainly a departure from the usual story about competitive devaluations, you know, currency wars in the traditional sense. But I think the effects are pretty multifaceted here.

And if we just look at some of the more, you know, recent events in capital markets, I mean, you mentioned that the dollar has sort of slightly topped out now in the last few days, but more generally, if we look at the monetary policy responses around the world, I would say that there are sort of signs that this kind of reverse currency wars scenario probably isn't as strong as we might have thought. And so yeah, so I would accept some parts of that, but probably wouldn't embrace it wholly.

Joe: (21:06)
So you mentioned our conversation recently with Zoltan and Perry, that was about the future of the dollar, but I actually want to sort of look backwards for a second because, you know, as we've been discussing the dollar is the invoicing currency, it's the funding currency, currency, it's the everything currency. It's the borrowing currency. When you look back either at sort of real activity or borrowing in hard currency for other countries, over the last few years, has there been any change to the trajectory of the importance of the dollar or has it been sort of just going from strength to strength in terms of its role in the world economy?

Hyun: (21:45)
Well, Joe, I think, I can sort of give you some hard numbers here because as well as the bulletin, we have just come out with the BIS Triennial Survey. Every three years, we do a pretty thorough stock take of what's going on in the FX market, in particular, but also in the interest rate derivatives market.

But let's focus on the FX market. So we do a pretty, you know, detailed stock take, we gather data from all our partner central banks, so we have a pretty good take. And we've just come out with the latest tri-annual survey, and the answer is not much has changed. If anything, the role of the dollar has strengthened somewhat. So just to give you some broad numbers here, the headline number is that 88% of all FX transactions have the dollar on one side.

So, you know, it's a pretty big number. And that was the same in our last Triennial Survey back in 2019. And the other currencies, I mean, they pretty much were treading water in that respect. The euro 31%, the yen 17%, the pound sterling 13%. So that's, you know, pretty much what they were last time round. The renminbi has gone up, it went up from 4% in 2019 to 7% this year. So there's a sort of, you know, marginal pickup in in the renminbi, but on the scale of things...

Joe: (23:11)
It still seems small.

Hyun: (23:11)
It's pretty small and, you know, for those listeners who say, 'Well, how come these numbers add up to more than a hundred?' Well, remember we are talking about a currency being on one side of a transaction, right? So, you know, in theory, if you add it all up, it'll add up to 200%.

Tracy (23:30):
That's a useful footnote.

Joe: (23:31)
Yeah, that is a useful footnote.

Tracy: (23:32)

This will help us with Twitter people.

Joe: (23:33)
No, I realized that because, it took me, I realized that halfway through, but at first I was like, wait a second, 88 plus 13 plus seven. And it took me... but then I got it.

Hyun: (23:44)
Absolutely. So, that's useful to know. And Joe, maybe just to finish the thought, so why might it be the case that, you know, there is this very, if you like, resilient role for the dollar, the premier international currency? Well, if you think about how all the pieces fit together, and I think we talked about this in one of our previous conversations, all the pieces support the other pieces.

Think about starting from invoicing. So if you invoice in the dollar, then it makes sense to finance – trade financing – in dollars because you're going to be receiving dollar cash flows. And similarly, if you are going to make an investment and the cash flow is in dollars, then of course it makes sense to borrow in dollars because you want to eliminate at least one of the uncertainties between your obligations and incoming cash. So you tend to borrow in dollars even if you are not located in the United States.

And if that's the case, then the capital markets will have a preponderance of dollar instruments, which is exactly what we see. So the capital market development will very much follow in the wake of these currency decisions. Asset managers will have a preponderance of dollar securities – dollar assets more generally. And if you are a pension fund or a life-insurance company from a non-dollar jurisdiction, you're limited in your domestic currency instruments. And so in your portfolio, there's going to be a very large chunk of dollar-denominated assets. And so if that's the case, then you have to find a way of hedging the currency risk because your obligations to your beneficiaries, your obligations to your policy holders, are going to be in your domestic currency rather than dollars.

And so there's a role for dollar hedging. There's a hedging for the dollar risk, which means that, you would take up swaps with the global banks and the global banks are lending you dollars short term. And of course they would need to source those dollars in global capital markets. And so the global banking system, the global capital markets, there's a very good reason why that's a very heavy dollar ecosystem because it builds on all these previous steps.

And so as you know, one layer is supported by the layer beneath. The whole thing sort of, you know, hangs together. It's going to be very difficult to see how that kind of arrangement would change. Perhaps over the very, very long run, you know, we would see possibly some changes at the margin, but it's going to be something which has inherent, if you like, resilience because of this mutually reinforcing layer, the layers of the global financial system.

Tracy: (26:43)

You know, you mentioned the impact of a stronger dollar on global financial conditions historically given its centrality in global trade. And I wanted to ask you, in the bulletin there's a line that says "more generally. it's unclear whether the impacts of swings in the dollar exchange rate on global financial conditions is now stronger or weaker than in the past." Can you explain that a little more? What potentially has changed here?

Hyun: (27:11)
So what we were thinking of in that passage is that, you know, we have to distinguish between the aggregate impact given the size of the rise in the dollar index versus the point for point impact. So, you know, as one point goes up in the broad dollar index, how does that affect financial conditions? So clearly, given the very large moves, we have seen quite substantial impact across the board, but what we had in mind in that paragraph was really about the point by point impact.

And there I think we do see some interesting things this time round. So, you know, on the one hand, it's certainly the case that emerging markets are much more resilient or seems to be much more resilient this time round. And if anything it's advanced economies that have really been perhaps more affected by tightening global financial conditions.

So one, one way to think about the emerging market story here is, first of all, if we look at the changes in the bilateral exchange rate, it is very telling, for example, that the Brazilian real and the Mexican peso have actually appreciated relative to the dollar this year. And that's really quite a turn up for the books.

You know, when you typically think back to, you know, recent periods of dollar strength in particular, that period in the middle of the 2010s, you know, 2014, 2015, 2016, that was an episode when a stronger dollar hit the emerging markets particularly hard and also actually commodities. That was a period when oil reached very, very low levels. So the emerging markets are actually doing reasonably well this time round. And we also see it in the spreads of domestic currency, sovereign bonds issued by emerging markets.

I mean, there's a chart in the bulletin that shows in a quite a striking way that when you look at advanced economy corporate bonds or indeed the dollar-denominated bonds of emerging markets, we have the usual story where a stronger dollar has gone hand in hand with higher bond spreads. But the one exception is the local currency emerging market sovereign bonds. I mean, there, the spread has actually come in. And so that's another sense in which emerging markets have actually done pretty well.

And I think part of this story is the fact that emerging markets started to tighten earlier. You know, they anticipated what was coming down the road. Brazil started to tighten quite early last year and quite far as well. Same with Mexico, although to a lesser extent. And emerging markets have actually learned the lesson. I think one of the good stories to come out of this current episode is that emerging markets have been a bright spot relative to, you know, all the other difficulties that the global economy is facing.

Joe: (30:07)
Just looking in the bulletin, and I'm looking at the third chart in particular, the changes in terms of trade since January of 2022, and I mean, part of the story is just that Europe, euro area and Japan are extremely dependent on foreign sources of energy, particularly gas. And of course we all know the story with the pipelines and to Europe and, Japan's lack of domestic energy production. How much, when we look at that other chart showing in particular the extremely strong performance of the Brazilian real, is it a sort of simple terms of trade story?

Hyun: (30:44)
I think that terms of trade definitely have a role to play, but it's also, I think, the monetary policy story as well. So, you know, I should certainly have mentioned the terms of trade effect for Brazil as well. I mean, there's a scatter chart in the bulletin that shows that those countries that tighten more relative to the US, you know, those are the ones that have actually maintained the currency values. There are lots of other effects going on. So this is by no means a clean relationship...

Joe: (31:11)
I see Canada is one that is relatively better -- of the sort of dirtier shirts - and it looks like it's tightened more than some of the others.

Hyun: (31:22)
Yeah. And of course Canada is a very large oil produce as well.

Tracy: (31:27)
So this is the big question, and I feel like I've asked it a couple times this year, but is there a point at which a strong dollar becomes problematic for the US economy itself -- despite the uniqueness of the role of the US currency in the global financial system and despite the energy independence, which Joe was just talking about?

Hyun: (31:50)
That's a great question, Tracy. You know, there definitely are consequences. I think the issue is how much of the impact of the dollar globally will then spill back to the US. And here I think the demand channel certainly will be one. If you have a weaker global economy, that's certainly not good news for the US economy either.

And this is why actually the reverse currency war stories, you know, needs to be somewhat modified because for that sort of feedback loop to hold, there has to be something that completes the circle. And it's perhaps not as obvious, you know, as it could be there. Now, in spite of everything though, I mean, I would just go back to what I was saying earlier on, on some of the policy implications. I think the first order of business has to be inflation because you know that from that we know that once inflation gets entrenched, that that will be much more difficult to dislodge.

But it does mean that as we tackle inflation globally, there are some of these collateral effects that will definitely, you know, weigh on the US as demand slows, in particular in those countries with very high debt levels, in particular, very high household debt levels as rates go up, you know, that will actually have a pretty rapidly cooling effect on demand as well. And also perhaps financial stability issues that are coming up. So if you think about those kinds of, if you like financial stability challenges, financial stability tripwires that might be lurking, I think we just have to be much more vigilant about seeing where the fault lines might be lurking and address them in a way that the policy framework as a whole is going to give us something fairly coherent.

So, you know, it would not be a good idea if you are tightening with one hand, but then loosening with the other. If you're going to be intervening in markets, it'd better be fairly well focused with a very tightly defined rationale for why you're doing it. I think it's especially important, in the current period, because as we discussed earlier, the risk-taking channel means that the global funding currency role of the dollar means that, you know, there are constraints that are kicking in earlier and, you know, they may interact in very complex ways. And so there are tripwires strewn all over the place that we need to be tiptoeing around very carefully as well. So even as we are addressing inflation, you know, that's job number one, we have to keep a very close eye on what else might go wrong, I suppose.

We now have a lot of experience after the GFC on how to address specific market stresses. And I think it is fair to say these are primarily about capital markets and non-bank financial intermediaries rather than the banking sector. You know, we can be happy that at least the banking sector looks a lot stronger than before the GFC, but still the capital markets and the non-bank financial intermediaries, these NBFIs in the jargon, they have channels of transmission that we are not always familiar with.

I think the recent experience in the UK is a very good example of that. So while we are actually, addressing it with inflation and conducting monetary policy in the best way, and that's, you know, taking into account the spillbacks as well as the spillovers, we have to be extremely vigilant on what else is going on because there are tripwires, you know, strewn on the floor as it were, and there are those types of things that can be easily missed. They have to be vigilant.

Tracy: (35:31)
I have one more question, which is what could actually break the dollar doom loop that we've sort of been describing? Because, you know, in normal times, I think one of the accepted ways that dollar strength would kind of peter out would be the rest of the world starts exporting more goods to the US to take advantage of the stronger currency and eventually that kind of hits US domestic growth and that would cause the dollar to weaken. But as you well know, we aren't in normal times and Europe is disrupted by energy shortages and China is still disrupted by Covid lockdowns and things like that. So there seems to be a big question mark over whether or not the normal economic patterns would apply.

Hyun: (36:17)
Well, Tracy, I think even in normal times a story that a depreciation would actually stimulate exports and therefore that's going to be pulling the economy to stronger activity, I think even in normal times, that mechanism wasn't quite right. We know that the influence of dollar invoicing also extends to the impact on trade balances as well. If your price is sticky in dollar terms, your export prices don't adjust very much, but the dollar invoiced goods domestically, you know, will rise in domestic currency terms. And so that has an immediate effect on consumption. So typically what we see is that a stronger dollar goes hand in hand with both weaker exports and weaker imports -- weaker imports much more strongly felt. And in addition, there are these financial channels that operate.

What would break the current episode? Well, I think, you know, if we can get inflation under control and if we can see inflation visibly coming under control, we see a path back to target, that's going to undoubtedly influence the thinking behind monetary policy actions around the world. And for the reasons that we discussed, the monetary policy actions in one country will definitely affect those in other countries. And to the extent that the exchange rates will also move as the path of monetary policy adjusts way into the future, that's going to affect exchange rates in particular.

But asset prices more generally, I'm less pessimistic than some other commentators that you've had on your podcast in that, you know, once we get inflation under control, you know, that's the key if you like. So if you think that we've been in some kind of vicious spiral, getting inflation under control will allow us to convert that vicious spiral into a virtuous spiral. And, you know, this could happen much more quickly than many of us could imagine. As you know, things move very, very quickly in financial markets. And so I think, once we see the light at the end of the tunnel, that's going to change the general complexion of the discussion, I would say.

Joe: (38:26)
I like that optimistic end. That there's a chance that maybe...

Tracy: (38:29)
... The headwind turns into a tailwind. All right. Well, we could easily talk to Hyun for another hour on this. But thank you so much for coming back on the show and if you're a listener who is interested in this, please check out the bulletin from the BIS and some of Hyun’s previous academic work as well.

Hyun: (38:48)
Thanks Tracy. Thanks Joe.

Joe: (38:50)
Yeah, thank you so much. Always fun.

Hyun: (38:51)
Great conversation.

Tracy: (38:54)
Thanks Hyun, really appreciate it. So Joe, I thought that it was great to get that kind of historical and nuanced perspective on this issue because it is true with currencies, it tends to bring out a lot of emotions and strong opinions on either side, I would say.

Joe: (39:22)
There's so much good, I mean first of all, it is interesting and novel, this idea of a dollar upcycle and a commodity upcycle at the same time. So to start, that's just a really interesting phenomenon that's going on that makes this moment different than the other. I also, obviously I liked when Hyun sort of talked about, I guess maybe you'd call it the interlocking puzzle pieces or the layers of dollar dominance.

Tracy: (39:47)
Yeah.

Joe: (39:47)
You start with invoicing that leads to hedging that leads to, you know, you invest in dollars, you need to borrow in dollars to avoid FX risk. And then that leads into the question of, well if there are different components of dollar positioning you get in this situation in which the financial tripwires break before the real economy cools down.

Tracy: (40:08)
Yeah. I thought that was a really important point. And also, you know, we kind of touched on this with Jon Turek as well, but the idea that when we talk about something breaking in the market, you know, the idea of the Fed hiking until something breaks has become something of a trope or a meme at the moment. But it's really like something that would cause something in the *US* to break because to some extent we've already seen things internationally start to break down. Like for instance, the BOJ having to intervene in the yen and things like that. The Bank of England and the situation in the UK. So the thing that we're kind of looking for is the tripwire that ends up impacting the US directly.

Joe: (40:46)
You know, I also think, and again, listeners should go check out the new BIS bulletin out today, but this idea of like, oh it's unusual that it's the EM countries, the EM currencies and not just the currencies. Because I kind of knew that on the currency front. But the spreads on domestic bonds also staying pretty tame and not blowing out the same way that we're seeing in, say, the UK or Germany and elsewhere. I think that's also an interesting phenomenon. And of course, there are multiple drivers of that, both the terms of trade and the fact that many of these countries actually got a jumpstart on the hiking. So very interesting dimensions to this dollar rally.

Tracy: (41:22)
Absolutely. All right. On that note, shall we leave it there?

Joe: (41:23)
Let's leave it there.

You can follow Hyun Song Shin on Twitter at @HyunSongShin.
