

Wednesday, September 25th, 2019

Dear Mustafa,

Late monsoon rains turned the roads around Karachi's Sind Club into surging rivers. This flood stands in stark contrast to the drought of US\$'s in the local market. Months ago one could get \$'s at the banks or money changers, and send them out of the country. Today both these actions are major struggles, even in small amounts. Such problems exist in other emerging markets. So what is going on? Where did the \$'s go?

A short backdrop - there are actually two types of dollars. The first dollars (FRNs - Federal Reserve Notes) are issued by the Fed with backing from the US Treasury and, ultimately from America's military. The second dollars are actually '\$ IOU's' issued by the interbank market in London and are known as 'Euro Dollars' (E\$'s). These E\$'s are offshore, unsecured and backed by banks' trust in each other. So we have 'gun-backed' FRN\$'s and 'trust-backed' E\$'s.

The Bank for International Settlements estimates the E\$ issue size as being in excess of E\$10 trillion. This is the dollar used in international trade and settlement everywhere other than the USA. But the 'bank trust' market shattered in 2008, as banks stopped believing each other; the production of E\$'s was curtailed. This means, simply, that the world is running short of E\$'s, its traditional settlement currency.

The Central Banks 'solution' to this dilemma is to transition from the unreliable offshore, unsecured 'trust-backed' dollar to the reliable onshore, secured, 'gun backed dollar'. But now everyone has to get their hands on this version of the dollar.

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The result is currency devaluations throughout emerging and even developed markets, as they make their currencies more attractive in order to get their hands on the gun-backed dollars.

And this \$ shortage is now showing up not just on the streets of Karachi but also in the beating heart of the global financial system, specifically the overnight lending window of the New York Fed. This is where financial institutions come with their various pieces of paper collateral, and place them overnight, in order to receive cash for their use.

The rate charged for this 'repo' should be near prevailing interest rates (2%) but last week it traded up to in excess of 8%. This forced the New York Fed to try to calm this obscure but essential market and they offered an additional \$75b a day for 3 days, all of which was oversubscribed. This shows that the lack of dollars has now arrived from the periphery to centre. Fed intervention will now become regular, as the collateralised 'gun-backed' dollar is not enough to feed the global settlement system - we will need more and more settlement \$'s - gun backed or otherwise.

In the meantime my pile of £ was still creditworthy at the club, even if soaked in the rain. See you Friday. Chris.