The US Federal Reserve should slow down its plans to shrink its balance sheet. Or else, the deluge of US treasury issuance to fund tax cuts will dry up the dollar liquidity globally, said Reserve Bank of India (RBI) governor Urjit Patel in an article in the Financial Times.

"Given the rapid rise in the size of the US deficit, the Fed must respond by slowing plans to shrink its balance sheet. If it does not, treasuries will absorb a large share of dollar liquidity. This will lead to a crisis in the rest of the dollar bond markets. The scale of both events should be considered," Patel wrote.

Dollar funding of emerging market economies has been in turmoil for months now, he said, but the episode cannot be attributed to the US Federal Reserve's moves on interest rates, which have been rising steadily since December 2016. Rather, the issue stems from Fed's "long-awaited moves to trim its balance sheet and a substantial increase in issuing US treasuries to pay for tax cuts."

The US Fed started slowing down on asset purchases starting October 2017. The shrinkage will peak at $50 billion a month by October and total $1 trillion by December 2019. In the two years to 2019, net issuance of US treasury bills would be $1.169 trillion and $1.171 trillion, respectively.

However, even if net treasury issuance is stabilised, the net balance sheet shrinkage will keep rising, leading to a double whammy for the global markets.

"Dollar funding has evaporated, notably from sovereign debt markets. Emerging markets have witnessed a sharp reversal of foreign capital flows over the past six weeks, which often exceed $5 billion a week. As a result, emerging market bonds and currencies have fallen in value," Patel wrote.

While praising the US Fed for its flexible approach and effective communication on the withdrawal of accommodative stance, the RBI governor said details of the tax cuts by US President Donald Trump have been a surprise to the markets.

"Global spillovers did not manifest themselves until October last year. But they have been playing out vividly since the Fed started shrinking its balance sheet. This is because the Fed has not adjusted to, or even explicitly recognised the previously unexpected rise in US government debt issuance," the RBI governor said, adding, "It must do so now."

According to Patel, the US Fed does not require to change the overall policy direction, but it can "simply recalibrate its normalisation plan, adjusting for the impact of the deficit."

The US Fed should reduce the pace of its balance sheet contraction to address the dollar liquidity shortage. Otherwise, the "sudden stop" of the global economic recovery would also hurt the US economy as well, Patel warned.