POLICYUPDATE

Currency Swaps with Foreign Central Banks

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The Fed acts as the lender of last resort when financial market distress makes it difficult for banks to obtain the short-term loans that help finance their operations. That is, the Fed lends U.S. dollars to U.S. banks. But what happens when the banks in need of dollar-denominated funds are located abroad?

The Fed typically has no direct means of lending to foreign financial institutions, yet many foreign banks hold U.S. dollar-denominated assets and liabilities, and thus have occasional need to borrow from and lend to other banks in U.S. dollars. When financial markets recently grew nervous about the fiscal positions of Greece and other European countries and the exposure of financial institutions to troubled sovereign debt, investors charged a higher premium to extend funding to those institutions, including in dollars, risking a disturbance to financial and economic activity.

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That's why in May the Fed reopened a "currency swap" program with five central banks to help them act as lender of last resort in their respective countries — in dollars. The swap lines work like this: The Fed sells a quantity of dollars to a foreign central bank, and in payment receives an equal quantity in foreign currency at the prevailing market exchange rate. Simultaneously, the Fed and the foreign central bank agree to trade the funds back at a date agreed upon in advance, between one day and three months later. The second transaction reverses the first. But over the duration of the swap, the foreign central bank is free to use the funds to make dollar-denominated short-term loans to banks in its jurisdiction.

The currency swap lines were previously launched in December 2007 to address the financial crisis, but had been allowed to expire in February 2010 after interbank dollar funding markets improved. Initially, the swap lines were used because investors feared counterparties' exposures to securities related to subprime mortgages in the United States. Those assets were often denominated in U.S. dollars, and for foreign banks a large portion was financed through interbank dollar funding markets. When interbank lending became strained, these institutions had to either find alternative sources of dollar funds or sell the assets under chaotic market conditions, which potentially could have contributed further to their already plunging prices.

European Union, United Kingdom, and Swiss banks' dollar exposures on their balance sheets exceeded $8 trillion in 2008, report New York Fed economists Linda Goldberg, Craig Kennedy, and Jason Miu. Foreign banks were hit especially hard when activity in private U.S. dollar interbank lending markets slowed because they were more dependent on those markets than American banks. U.S. financial institutions are relatively flush with dollars — the denomination of a majority of their assets as well as their deposit base — and could tap into dollar backstop financing, including from the Fed, when needed. So, while actions that eased global financial distress were surely beneficial for U.S. institutions, the swap lines were not really created to benefit U.S. banks, note Michael Fleming and Nicholas Klagge, also of the New York Fed, in an April 2010 summary of the swap program.

The swaps carry little direct risk to the Fed. There is no exchange rate risk since the loans are made and reversed using the same exchange rate. And though the funds are intended to be loaned to private institutions, the foreign central bank assumes any risk that loans will default, determining independently which institutions are able to borrow and what types of collateral they can borrow against.

Similar swap lines were launched following the terrorist attacks of 9/11, in a coordinated effort by several central banks to keep global financial markets operational. In fact, other forms of swap agreements were in place from 1962 to 1998, though those existed mainly to facilitate central banks' interventions in foreign exchange markets to affect exchange rates — which the Fed rarely does today.

The recent swap lines will play only a supporting role in easing the European financial market strains, noted Brian Sack of the New York Fed in a June speech. The policy actions of European governments toward debt will do the heavy lifting. Indeed, little of the dollar-denominated funds have actually been exchanged with the five central banks involved relative to the amount traded during the financial crisis. (At the program's peak in December 2008 swaps outstanding comprised more than a quarter of the Fed's total assets.) Still, the swap lines may be important in reassuring creditors that dollar funding is available, as central banks hope to head off further dollar liquidity shortages.

"The swaps were essentially put in place in a preemptive manner, under the view that their presence would provide a backstop for dollar funding markets and help to bolster market confidence," Sack said. To firmly establish confidence that dollar liquidity will be available, the swap lines will be kept open until January 2011. **RF**