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COVID-19: Federal Reserve Support for Foreign Central Banks

As part of the U.S. response to COVID-19, the U.S. Federal Reserve (Fed) has taken steps to ensure that foreign central banks have uninterrupted access to U.S. dollars. First, the Fed established emergency swap lines, or temporary reciprocal currency arrangements, with a broader group of central banks and lowered the interest rate it charges on the swap lines. Swap lines allow foreign central banks to temporarily exchange their currency for dollars with the Fed. When the swap is concluded, the foreign central bank returns the dollars, with interest, to the Fed and the Fed returns the foreign currency. Second, the Fed created a foreign central bank (FIMA) repo facility. The facility, which also charges interest, allows foreign central banks to temporarily exchange their U.S. Treasury securities for U.S. dollars.

Background

In the U.S. banking system, the Fed serves as the lender of last resort to domestic banks in a financial crisis. In periods of economic turmoil, such as now, during the financial crisis of 2007-2009, and after the September 11, 2001 terrorist attacks, the Fed has provided emergency liquidity to banks to keep them from failing. According to a recent survey by the Bank for International Settlements (BIS), the dollar accounts for 88% of global foreign exchange market turnover and is key in funding an array of financial transactions, including serving as an invoicing currency to facilitate international trade. The dollar also accounts for two-thirds of central bank foreign exchange holdings, half of non-U.S. banks foreign currency deposits, and two-thirds of non-U.S. corporate borrowings from banks and the corporate bond market. As a result, disruptions to international dollar lending markets can have wide-ranging repercussions on international trade and financial transactions. The BIS also estimates that banks outside the United States have over \$13 trillion in dollar denominated assets. In a global economic crisis, banks all over the world are reliant on the Fed to make sufficient liquidity available to prevent their collapse.

In the current crisis, a massive economic shutdown due to plant closures and national lockdowns has interrupted global supply chains, which are largely funded privately with dollar-denominated credit. As supply chains break down, businesses with insufficient dollars will seek to quickly draw down pre-existing loan facilities and hoard dollars. In addition to disrupted supply chains, recent volatility in the stock and bond markets spurred a rush to dollar-denominated assets as a safe haven during the crisis. As a result of this surge for dollars, the value of the dollar has soared (see **Figure 1**). The availability of dollar access has since eased pressure in some countries.

Figure 1. Trade-Weighted U.S. Dollar Index



Source: Federal Reserve

What is the Purpose of These Facilities?

Swap lines and the FIMA repo facility are intended to provide liquidity to private banks in non-domestic denominations. Because banks lend long-term and borrow short-term, a solvent bank can become illiquid in a panic, meaning it cannot borrow in private markets to meet short-term cash flow needs. For example, many European banks have borrowed in dollars to finance dollar-denominated transactions. Typically, banks can only borrow from their home central bank, and central banks can only provide liquidity in their own currency. (The U.S. affiliate of a foreign bank can borrow from the Fed, but not the parent.) The Fed's swap lines and repo facility allow foreign central banks to provide needed liquidity to their country's banks in dollars.

Central Bank Swap Lines

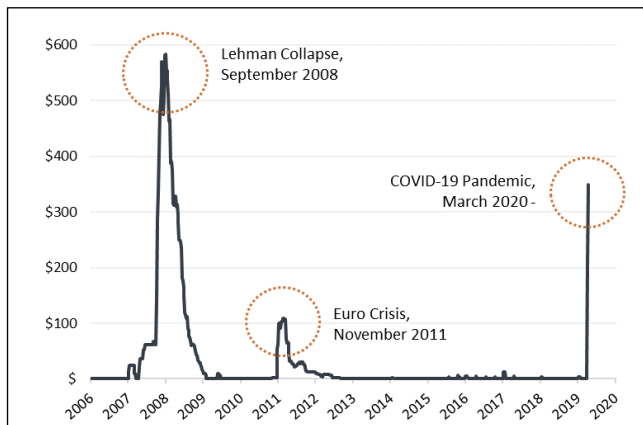
The Fed's first swap lines, which were created in the 1960s, played a prominent role during the 2007-2009 financial crisis. Overall, ten central banks drew on the swap lines at some point during the crisis, and four more were eligible to—but did not—use the swap lines. In October 2008, the Fed made the swap lines with certain countries unlimited in size. These swap lines expired in February 2010, but were subsequently reopened in May 2010 with the Bank of Canada, the Bank of England, the European Central Bank (ECB), the Bank of Japan, and the Swiss National Bank in response to the eurozone crisis. Although initially temporary, the Fed converted them to permanent standing arrangements in October 2013. On March 19, 2020, the Fed announced a major expansion of the swap lines to nine additional central banks, all of whom also had access to Fed liquidity following the 2007-2009 crisis. These new facilities will support the provision of U.S. dollar liquidity in amounts up to \$60 billion each to the central banks of Australia, Brazil, Mexico, Singapore, South Korea and Sweden, and up to \$30 billion each for Denmark, Norway,

and New Zealand. These dollar liquidity arrangements will be in place for at least six months. The swaps were created under the section of the Federal Reserve Act (12 U.S.C. § 226) providing authority for open market operations (Section 14); they did not require the emergency authority found in Section 13(3).

Data on Usage

During the 2007-2009 financial crisis, swap lines were used expansively by the Fed, peaking at \$583 billion in December 2008 (see **Figure 2**), and accounting for a quarter of Fed assets at the time. They subsequently fell to zero by March 2010. During the eurozone crisis, swaps outstanding increased suddenly in late 2011, averaging more than \$100 billion from late December 2011 to February 2012. Their use declined after the eurozone crisis, and less than \$1 billion was outstanding after August 2013. Before March 2020, most of the swaps were with the European Central Bank; the Bank of Japan was the second-largest counterparty. In March 2020, there has been a sudden surge in usage as a result of COVID-19. As some banks have become reluctant to lend to each other, central banks have taken a much larger role in providing banks with liquidity directly. During the week ending March 25, 2020, the European Central Bank, Bank of England, Bank of Japan, and the Swiss National Bank cumulatively drew \$206 billion from the Fed.

Figure 2. Fed Central Bank Swap Usage



Source: Federal Reserve

Notes: As of April 1, 2020

How do Central Banks Swaps Work?

As standing facilities, central banks can draw on the swap lines as needed. Under a swap with the ECB (for example), the ECB temporarily receives U.S. dollars and the Fed temporarily receives euros. After a fixed period of time (up to three months), the transaction is reversed. Until March 2020, interest on swaps was paid to the Fed at 0.5 percentage points above the U.S. dollar overnight index swap rate (OIS), a private borrowing rate. This was reduced to 0.25 for the new arrangements. Another change is the duration of the arrangements. Funding can now be accessed not only for 7 days, but also for 84 days (approx. 3 months).

The swaps are repaid at the exchange rate prevailing at the time of the original swap, meaning that there is no downside risk for the Fed if the dollar appreciates in the

meantime (although the Fed also does not enjoy upside gain if the dollar depreciates). Because the swaps are only with other central banks with the most widely used currencies, there is essentially no credit risk involved (the foreign central bank bears losses if the private bank it lends the dollars to defaults). The Fed has reported no losses under the program. Initially, the swap lines were designed only to provide major foreign central banks with access to U.S. dollars. In April 2009, the swap lines were modified so that the Fed could draw on foreign currency as well; to date, the Fed has not done so.

FIMA Repo Facility

The Fed offers certain services, including the foreign repo pool, to foreign central banks and other official international institutions which maintain accounts with it. The foreign repo pool allows these institutions to engage in reverse repos with the Fed, in which the Fed temporarily invests foreign central bank dollar balances held at the Fed in securities owned by the Fed. The foreign repo pool has always drained liquidity from the U.S. financial system since its creation in the 1970s, but the effect has increased in recent years because balances have grown much larger, averaging over \$200 billion outstanding daily since 2016. Despite the overall dollar scarcity, balances have remained large since the pandemic.

On March 31, the Fed announced the Foreign and International Monetary Authorities (FIMA) Repo Facility, which works like the foreign repo pool in reverse. This facility allows foreign central banks to convert their U.S. Treasury holdings into U.S. dollars on an overnight basis. The Fed will charge an (typically) above-market interest rate of 0.25 percentage points above the interest rate paid on bank reserves. The facility is available to a broader group of central banks than the swap lines.

Issues for Congress

Congress has oversight responsibility for the Fed and is formally briefed semi-annually on its operations and policy decisions. The expanded Fed swap lines and new FIMA repo facility raise a range of issues for Congress:

- What are the overall costs and benefits of the Fed’s expanded global lender of last resort function? Should swap lines be extended to more countries, such as China?
- Should Congress establish new oversight functions to oversee the Fed’s expanded role?
- More broadly, does Congress think it is appropriate for the Fed to be providing this support bilaterally or should swap line facilities be coordinated through a multilateral institution, such as the IMF?

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