

SUMMARY

This morning the Federal Reserve, along with the European Central Bank, Bank of England, Bank of Japan, Bank of Canada and the Swiss National Bank, announced an extension of the dollar swap facility through February, 2013 and a 50 basis point reduction in the facilities interest rate.

BACKGROUND

The dollar swap facility was originally opened during the 2008 financial crisis to provide dollar-liquidity to foreign banks. The facility functions much like a collateralized loan, as follows:

1. The ECB notifies the New York Fed that it wants dollars. The notice indicates how many dollars are wanted, at what date, the current exchange rate (EUR-USD), when the dollars will be paid back and what the interest rate the ECB will pay.
2. The NY Fed credits an account for the ECB with the appropriate amount of dollars and the ECB credits an account for the NY Fed with the commensurate amount of Euros as collateral on the loan
 - a. It is important to note, no account is debited in this transaction: reserves are actually created.
3. While the swap is outstanding, the ECB can now lend dollars to European banks in need of liquidity by instructing the NY Fed to debit the ECB account and credit the appropriate bank's account
4. At the maturity date for the swap, the NY Fed zeros out the ECB's account
 - a. If the ECB's account has a sufficient balance, the swap is closed
 - b. If the ECB account is short, than the shortfall is rolled into a new swap (essentially making it impossible for the ECB to default on the loan)

ANALYSIS

The Fed characterizes the facility as zero risk, as the dollar-loan is collateralized against the Euros held in the Fed's account at the ECB. However, the swap provides no actual way for the Fed to ever draw on that Euro account, and since any shortfall is automatically rolled, collateral would never be seized. The swap functionally allows the ECB access to the Fed's printing press (electronic reserve creation) in return for the fee imputed in the interest rate on the swap. Because European banks – and other foreign banks – are having difficulties funding themselves in the market, the ECB has been forced to lend unusually large amounts to these banks as a lender of last resort. The ECB's loans are fully collateralized and supposed to be zero-risk. However, should a borrower be unable to repay, the ECB would be liable to the Fed for the dollar shortfall. If the Fed ever called the loan (as opposed to rolling the deficit into a new loan), the ECB would be forced to buy dollars on the open market or have collateral seized by the Fed. The danger is that the ECB would likely do so by creating Euros, leading to inflation risk that could communicate to the US. Additionally, the creation of dollar reserves by the Fed could also increase inflationary pressures.

While it is inaccurate to characterize this as a US bailout of Europe, it is true that the Fed is essentially acting as a lender of last resort to the global system and that the US taxpayer ultimately bears the risk of these loans.