U.S. Injecting Billions Into Foreign Central Banks

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For more than a year, the U.S. Federal Reserve System has been increasingly acting as the world's central bank, injecting hundreds of billions of dollars into foreign government treasuries in an effort to increase liquidity in those countries.

The foreign central banks have used the U.S. currency to bail out financial institutions within their borders. The Fed program links its balance sheet directly to the fates of foreign central banks at a time when they're on the ropes.

The program has so far gone unreported in the mainstream media and is a major expansion of Federal Reserve involvement in the global economy. It represents a stark break from the prior role of the Fed, moving it into territory more traditionally occupied by the International Monetary Fund (IMF).

The program puts both the Fed and the foreign central banks at increased risk. If the bailed-out banks can't repay the loans, the foreign central bank is still on the hook to the Fed. It would have to raise the money by selling debt — which most Europeans are finding difficult today — or raise taxes or cut spending, actions that further exacerbate the economic crisis. Or, the foreign central bank could default, leaving the U.S. holding a bag of foreign currency of plummeting value.

The U.S. taxpayer has also bailed out foreign banks indirectly by pumping billions into American Insurance Group, which announced Sunday that it had forwarded that cash to counterparties that include foreign banks such as Societe Generale, Deutsche Bank, Calyon, Credit Suisse, the Royal Bank of Scotland and Barclays.

"I'm concerned about Europe," Paul Krugman wrote in Monday's New York Times. "Actually, I'm concerned about the whole world — there are no safe havens from the global economic storm. But the situation in Europe worries me even more than the situation in America."

Meanwhile, European countries are still unable to sell joint bonds.

The Fed program adds up to serious money. The most recent balance sheet released by the Fed shows that $314 billion U.S. dollars are currently doled out to foreign central banks under the foreign exchange program. That's down from a December peak of nearly $600 billion, as central banks have repaid some of the loans.

In exchange for U.S. dollars, the Fed has received foreign currency of equivalent value in an exchange known as a swap. To protect the Fed from losses due to currency fluctuation, the deals include a provision that when the moneys are swapped back, the transaction will be done at the same exchange rate as the initial transaction.

The swaps are listed by the Fed on its balance sheet as “central bank liquidity swaps.” The only reference to such swaps in Nexis or Google News comes in the trade paper Market News International, which publishes periodic summaries of fluctuations in the Fed balance sheet. The Fed hasn’t hid the exchanges and even sports an FAQ about the transactions on its Web site.

The Fed has established relationships with some major banks, such as the European Central Bank and the Bank of Japan, but also with central banks overseeing smaller, more volatile economies, such as the Banco Central do Brasil.

“It is important which countries are getting it and which don’t,” said Ralph Bryant, a currency exchange expert at the Brookings Institution. During the 1970s, he was director of the Fed’s Division of International Finance and lead international economist for the Federal Open Market Committee, which has authorized the swaps.

“What happened last fall, when the credit markets seized up so badly, was really a departure because some additional countries that would not have been in the Federal Reserve swap network in earlier years at all were brought in, like the central bank of Brazil, Bank of Mexico, and some smaller ones like the bank in New Zealand, the Norwegian central bank and so on.”

The full list of participating banks, according to the Fed, includes the Reserve Bank of Australia, Bank of Canada, Danmarks Nationalbank, Bank of England, Bank of Korea, Banco de Mexico, Reserve Bank of New Zealand, Norges Bank, Monetary Authority of Singapore, Sveriges Riksbank, and Swiss National Bank.

The program was launched in December 2007 and initially engaged in relatively small swaps with the European Central Bank and the Swiss National Bank.

On September 15, 2008, Lehman Brothers filed for bankruptcy, sending a shock through the global financial sector and freezing credit markets. While the media focused on the U.S. government’s domestic response — a $700 billion bank bailout — it missed the global response. Between Sept. 15 and October 1, the U.S. nearly quadrupled its swaps with foreign central banks, increasing the amount to $233 billion.

Two weeks later, the total was $398 billion and a week after that it was $480 billion. Two months after the Lehman bankruptcy, the Fed had swapped $572 billion.

In 1994, the U.S. provided Mexico with $20 billion in loans and guarantees to stabilize its financial sector. Congress refused to authorize the money and President Clinton instead used the Exchange Stabilization Fund, at the time a controversial decision. Today’s swap is nearly 30 times larger.

A Democratic congressional aide who asked Fed officials about the swaps says he was told they are “essentially riskless” to the U.S. taxpayer — unless, of course, a central bank defaults, at which point the value of the currency held as collateral would be called into serious question.

“The only conceivable risk is if you think some foreign central bank was going to go bust and not honor its commitment, but given this is only for larger countries, that’s a very small probability,” said Bryant.

As with every other bailout, the swaps are justified by citing the cost of doing nothing. “If the rest of the world goes down the tubes, that’s really bad for the US financial system and the US economy,” Bryant said.

The IMF has been relatively inactive during the financial crisis, a vacuum the Fed has filled. IMF lending comes with a certain international stigma and central banks are generally happier to arrange transactions with the Fed. Moreover, since the Asian financial crisis in the late 1990s, the IMF has lacked the capital reserves to engage in currency swaps at the same magnitude as the Fed.

Despite the lack of public scrutiny, the Fed’s decisions are at root political. “There is an issue as to which countries they decided to do this for and which ones they didn’t. That is a political decision,” said Dean Baker, an economist with the liberal-leaning Center for Economic and Policy Research. “The fact that they help certain countries hurts the ones they don’t help, since they get viewed as less safe.”

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