

# Mosler: Fed's Currency Swaps – A Backdoor Way to Lower US Interest Rates

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Gillian Tett of the Financial Times [wrote today](#) about stress in the dollar funding markets, which she regards as a “curious” spillover from Eurozone market fears. Space constraints or concerns about unduly complicating her article appear to have prevented Tett from shedding useful light into how the Fed is using indirect, and in my opinion, confused methods to intervene in the dollar funding market.

Let's start with Tett:

Last week, European leaders unveiled an aid package worth €750bn that was designed to remove market fears about weak eurozone countries....and – by extension – lessen any funding pressures on eurozone banks.

But something curious has been happening in the dollar funding markets. This week, the average cost banks in Europe need to pay to borrow dollars for three months has gone on rising: it was running at 46 basis points on Tuesday, up from 30 basis points earlier this month.

Meanwhile, the spread between the three-month dollar Libor and the “risk-free” Overnight Indexed Swap rate has risen to about 24bp....worse than anything seen for almost a year. And unsurprisingly, that worries central bankers.

The issue appears to relate to an estimated \$500bn-odd funding gap haunting European banks. Until three years ago, central bankers and investors did not usually take notice of the currency in which banks funded themselves, because it was assumed modern financial markets had become so sophisticated banks would always be able to raise money anywhere.

But in 2007, it became painfully clear such faith was misplaced: when panic erupted, European banks suddenly found it very hard to get dollars, because their counterparts did not trust them and they could not borrow from the US Federal Reserve.

To cope with this, the Fed and European Central Bank eventually agreed to implement a temporary currency swap.

The issue is actually larger than the one Tett describes. This is not just that Eurobanks might have trouble funding their dollar exposures. The problem is that US domestic contracts are often indexed to Libor.

Libor is set in London when the British Bankers Association collects rates paid by the largest banks to borrow dollars that day, and posts the average rate paid according to its formula to determine that “average” rate.

So when the Eurobanks are faced with higher costs of borrowing dollars, those higher dollar interest

rates can cause the dollar Libor settings to rise. That in turn causes a variety of US domestic interest rates to increase including the rates paid on home mortgages and other wholesale and consumer lending indexed to Libor, directly or indirectly.

In other words, Eurobanks paying higher rates of interest on dollar loans causes interest rates to rise in the US.

The Fed's response was to fund those troubled banks at lower interest rates, thereby lowering the Libor settings. The Fed did this through dollar swap lines which are functionally nothing more than unsecured dollar loans to foreign central banks, who then pass through the rate set by the Fed to their member banks.

That of course begs the question as to why the Fed would not push to ban the US banking system from entering into Libor-based contracts in the first place, in which case they would not care if some foreign banks had to pay more for dollar funding.

Back to Tett:

And behind the scenes, European banks have recently been urging eurozone banks to curb use of dollar funds.

This appears to have had some success....banks have unwound SIVs and sold dodgy US mortgage bonds.

However, \$500bn is still a very big number, and as tensions have recently risen across the eurozone, the dollar Libor market has once again become a flashpoint. More interesting still, a divide is now seen between strong and weak banks. Late last week, for example, HSBC was reporting Libor rates well below those of West LB, apparently because there is more concern about German entities.

To combat this problem, the ECB and Fed agreed last week to implement another dollar-euro swap.

As we noted above, the strategy is to get the Libor setting down by lending to weaker credits at lower rates. Back to the article:

However, when the ECB offered short-term dollar funds last week, only \$9bn was taken up – a relatively paltry sum.

Some officials suspect this is because the ECB has been supplying the wrong type of dollars: though it offered short-term funds last week, what European banks really need is medium and long-term dollar funds.

If the goal is to keep the 3 month Libor settings down, the authorities need only to supply cheap 3 month dollar loans. If the goal is to keep longer-term rates down, they need to supply cheap dollars for longer time periods. Let's return to Tett:

Other financial officials, however, blame the rising Libor rate on a generalised sense of market fear...This fear is thought to be hurting weak banks because investors find it tough to work out whether to trust banks that rely on government support, if they do not know how strong the government is...

Meanwhile, the ECB is preparing to offer some medium-term dollar funds. But in the next few days, plenty of central bank eyes will be watching that Libor dial with considerable unease.

In my humble opinion, providing low rate loans to troubled banks for the purpose of lowering the Libor settings is a very confused strategy.

Some will argue that these objections are misplaced, that there is “no risk” in the Fed’s exposure to the ECB. But that is inaccurate. While the risk is low, “low risk” is not the same as “no risk”, particularly given the concerns about the future of the Eurozone.

The risk is the ECB might not pay the loan back, and if they don’t, functionally the Fed has no recourse, as for all practical purposes the loan is unsecured. The ECB borrows the dollars from the Fed and lends them to its member banks who post collateral with the ECB (not with the Fed) so the ECB appears reasonably well secured. Except for two things- the collateral is denominated in euro so in a Euro collapse the collateral loses value, and it accepts relatively low quality collateral, including unsecured bank debt which banks can generate at will and could also prove worthless in a Euro collapse.

The risk is more than miniscule. If the Eurozone breaks up, the ECB probably goes away as well, and the Fed is left with no counterparty. The national governments in the Eurozone do not guarantee the ECB, and the Fed’s ‘collateral,’ a Euro deposit held at the ECB in its name, will either be gone and/or worth less, and in any case only usable by giving the ECB instructions as to what to do with it, hoping they will honor those instructions. And it may not even be possible at that point. (Now there is a scenario in which the weaker nations leave the Eurozone, leaving Germany, the Benelux countries, and France in, which would result in a stronger Euro. But that is one of many possible endgames).

The ECB’s only asset of value is a claim on a percentage of the gold of the member nations. But again, in a breakup, it would be doubtful that would be useful as a means of paying off the Fed.

I’ve also noticed with the new swap language that looks like the ECB can roll over the dollar loans in perpetuity. This makes payback strictly voluntary, and renders the transactions fiscal transfers rather than loans, adding to the argument that these should originate from the Treasury rather than the Fed.