The Might of the US Fed*

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The Reserve Bank of India is reportedly in discussion with the US Federal Reserve to put in place a rupee-for-dollar swap line. If the Fed accedes, this would be a first for India, but not for the Fed. The Fed has had temporary and standing swap arrangements with chosen foreign central banks for many decades now. With trade and financial transactions overwhelmingly denominated in dollars, governments, firms and households across the world are constantly in need of dollars to settle transactions. Periodically some of them, especially those not earning adequate dollars from their own exports, face dollar funding shortages. The Fed's swap arrangements are aimed at providing central banks in partner countries access to dollars to meet demands in their jurisdictions.

Under a swap arrangement between the Fed and a foreign central bank, the latter can access dollar funding, in exchange for the domestic currency of the applicant. The swap involves two transactions: one involving the sale to the Fed of a specified volume of the domestic currency of the applicant for dollars at the prevailing market (spot) exchange rate; and the second being a buyback on a specified date in the future of the domestic currency with dollars paid by the foreign central bank, at the same exchange rate. When the second transaction is completed the foreign central bank also pays interest at a market-related rate, depending on the duration for which it has drawn on the swap line.

As an arrangement, a swap line allows central banks that have been provided the facility, to access dollar funding at short notice. They can use those funds directly or lend it to financial institutions in their jurisdictions in need of dollar funding and unable to easily access them from markets. The credit risk on such lending is carried by the foreign central bank, and the Federal Reserve does not enter as a party in any form in those subsequent transactions. In addition, the Federal Reserve is not faced with any foreign exchange risk on the capital provided since the sale and repurchase of the foreign currency to and from the Fed is at the same exchange rate.

The strain in dollar funding markets tends to be severe in times of economic difficulty when the foreign exchange earning of many countries fall and financial investors move their funds into the safe havens that both the US and the dollar tend to be. Such strains have only intensified after financial globalisation, which enhanced the presence of foreign investors in financial markets in developed and emerging markets, with most transactions denominated in dollars. If investors choose to pull out, dollar availability reduces. In response to this changed situation, the Fed has tended to aggressively deploy its swap instrument in times such as the global financial crisis of 2007-08, when dollar funding markets broke down, straining the financial system in foreign locations. It has also chosen to rely on this instrument in the current Covid-induced crisis that has overwhelmed both the real economy and financial markets world over.

This has created a paradoxical situation. Both at the time of the 2007-08 crisis and in the still developing Covid-induced economic crisis, the United States was or is the or one of the epicentres of the crises. Yet, that country and its central bank have become crucial when mitigating the effects of the crises. This is because, by virtue of being home to the world's reserve currency, considered 'as good as gold', and because the dollar still reigns supreme and is the favoured safe haven for financial investors, the Fed is central to management of financial markets worldwide. Crises notwithstanding, the dollar dominates and remains the world's reserve currency, and so does the Fed as the institution that manages the dollar.

Besides the collapse in world trade and commodity prices, dollar shortage in the current crisis is being driven by two factors. One is the exit of financial capital. Capital flight from emerging-market assets is estimated by the Institute of International Finance at $83 billion in March alone. Since January, the outflow has total around $96 billion, as compared to the $26 billion outflow during the financial crisis of 2008. The second is the demand for dollars from corporates across the world to service the dollar debt they had accumulated during the years of cheap and easy dollar liquidity that followed the 2008 crisis. Dollar debt of non-bank institutions outside the US is estimated at around $12 trillion by the Bank of International Settlements, up from around $6 trillion at the end of 2009. Dollar liquidity is therefore crucial to manage currencies and support financial markets.

Seeing benefit in swap arrangements, the Fed had put in place standing dollar liquidity swap lines since October 31, 2013, with a selected few central banks¬—the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank. The standing arrangements constitute a network of bilateral swap lines that "allow for the provision of liquidity in each jurisdiction in any of the five currencies foreign to that jurisdiction, should the two central banks in a particular bilateral swap arrangement judge that market conditions warrant such action in one of their currencies". The choice clearly reflects the importance of a country in the pecking order of market economies and its role as a source of or intermediary in the flow of global wealth. At its peak, in the week ending December 10, 2008, the use of these swap lines by central banks other than the Fed took the sum outstanding to more than $580 billion, or around 25 percent of the Fed's total assets.

However, with the Covid-induced global crisis wrecking financial markets, on March 19, 2020, the Fed entered into temporary, six-month duration, U.S. dollar liquidity arrangements (swap lines) with a host of other countries. According to the Fed, these new facilities will support the provision of U.S. dollar liquidity in amounts up to $60 billion each for the Reserve Bank of Australia, the Banco Central do Brasil, the Bank of Korea, the Banco de Mexico, the Monetary Authority of Singapore, and Sweden's Sveriges Riksbank and $30 billion each for the central banks of Denmark, Norway and New Zealand. This brings in emerging markets like Brazil, Korea and Mexico, European nations like Denmark and Sweden, and less important global financial centres like Singapore. The total amount available to these countries of $450 billion is still small when compared with the swaps totalling more than $580 billion availed by the Fed's five leading partners more than a decade back.

Yet, this is a change from the situation in the past where foreign exchange stringency or scarcity forced most countries to turn to the IMF. With an increase in the number of central bank swap arrangements they can turn to the Fed instead, though that option is even now open only to chosen emerging markets, besides some developed market economies. India is seeking similar access as it experiences large foreign capital outflows which, in the form of exit of portfolio equity and debt funds, totalled $15.9

billion in March this year, and $1.1 billion in the first 13 days of April. As a result, foreign exchange reserves with the India's central bank have fallen by $13 billion from $487.2 on March 6 to $474.7 billion on April 3.

The strength of the dollar, the Fed and the US these developments reflect is, again paradoxically, proving to be a problem for the US. The crises and the resulting flight to the dollar of the world's wealth holders and financial institutions has strengthened and is strengthening the dollar vis-à-vis other currencies, as well as triggering a crash in global markets. A strong dollar does not suit America's trading interests, since it raises the foreign currency price of America's exports and cheapens imports in US markets. But more importantly, a strong dollar that triggers capital flight from global financial markets, pulls down those markets, upsets the calculations of the world's wealth holders, and damages the US firms that dominate global finance. The Fed's moves are therefore not driven by altruism and aimed at helping out central banks in other jurisdictions, but motivated by its own interest and the interests of those it protects and promotes.

The motives of the Fed have also changed over time. Between the 1960s and till 1998, swap lines were standing arrangements with a set of central banks aimed at providing access to dollar liquidity for foreign exchange market intervention aimed at managing and stabilising exchange rates. These were phased out in 1998. But swap arrangements with foreign central banks were revived and used aggressively by the Fed in 2007 and 2008, when the global financial crisis damaged access to dollar funding markets. In response to the ongoing Covid-induced crisis, in mid-March, the Fed first modified its then-prevailing standing swap arrangements with five foreign central banks by reducing the interest rate on use of the swap lines to near-zero and making funds available for longer periods of up to 84 days. A fortnight later, to widen the set of countries that can access dollar liquidity, it allowed countries to exchange their holdings of US Treasuries, which are leading instruments to park foreign reserves, for dollars, enhancing quick access to dollar liquidity. It then widened the set of countries for which it had swap arrangements with central banks, bringing in some emerging markets as well.

But still there are few developing countries that have been afforded this privilege. India is as yet not among them. This is forcing developing countries to turn to the IMF and World Bank to face up to the current crisis. According to The Wall Street Journal: "More than 90 countries have inquired about bailouts from the IMF—nearly half the world's nations—while at least 60 have sought to avail themselves of World Bank programs. The two institutions together have resources of up to $1.2 trillion that they have said they would make available to battle the economic fallout from the pandemic."

India is a recipient of the largest Covid-related World Bank assistance programme as of now of $1 billion, to be used for screening, contact tracing and laboratory diagnostics, for producing personal protective equipment, and for setting up isolation wards. But it needs more dollar liquidity to manage the rupee and its financial markets. However, as of now India is excluded from an arrangement in which while the US and the dollar dominate, and a few countries have privileged access to dollar liquidity. If it fails to persuade the US to accommodate it as well, it may have to borrow from the IMF, which may impose conditions that limit India's options when dealing with the economic impact of the Covid crisis. This strengthens the case for

India joining those developing country governments demanding an increase in Special Drawing Rights (SDR) issuance by the IMF so as to increase the supply of international liquidity to all member countries without conditions.

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