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Sent: Friday, December 2, 2011 1:18 PM
To: H
Subject: FW: Federal Reserve Action to Help Europe

FYI

From: Hormats, Robert D
Sent: Thursday, December 01, 2011 2:29 PM
To: Sullivan, Jacob J
Subject: Federal Reserve Action to Help Europe

Hi Jake,

I am sure you have heard about the recent measures the Fed took – using **foreign currency liquidity swaps** -- to support the dollar liquidity of banks in Europe and parallel measures taken by other central banks.

Given the importance of these measures and their impact on market psychology and markets themselves, I wanted to give you a short analysis of what happened – particularly as S will be heading to Europe next week and will want to be aware of it.

Below is a summary she might find helpful. It is followed by a few useful questions and answers extracted from today's WSJ.

SUMMARY:

Foreign currency liquidity swap lines are set up to provide the Fed with the capacity to offer liquidity in foreign currencies to U.S. financial institutions should the Federal Reserve determine such actions are appropriate and/or necessary. At the same time **dollar liquidity swap lines** provide liquidity in U.S. and foreign financial markets by providing foreign central banks with the capacity to deliver U.S. dollar funding to institutions in their jurisdictions during times of market stress.

On November 30, the Federal Reserve along with the Central Banks of Canada, England, Japan, Switzerland, and the ECB, **agreed to lower the price on existing temporary U.S. dollar liquidity swap arrangements by 50 basis points so that the new rate will be the U.S. dollar overnight index swap (OIS) rate plus 50 basis points. (down from OIS plus 100 bps)**. This new pricing will become effective December 5, 2011, and the authorization of these swap arrangements will remain until February 1, 2013.

These swap lines are being implemented as a **contingency measure**, so that central banks can offer liquidity in foreign currencies to financial institutions in their respective countries, if market conditions warrant such actions. U.S. financial institutions currently do not face difficulty obtaining liquidity in short-term funding markets. This agreement will provide the Fed with the **ability to provide foreign currency to U.S. financial institutions**. The five central banks in this arrangement make up the bulk of the foreign currency funding of U.S. financial institutions. The price cut should also contribute to Eurozone financial stability by making USD available more cheaply on a contingency basis to European financial institutions.

According to the Fed, although at present **there is no need to offer liquidity in non-domestic currencies other than the U.S. dollar**, the central banks judged it prudent to make the necessary arrangements so that liquidity support operations could be put into place quickly should the need arise.

These measures, of course, are only a temporary device to get through a difficult period. Serious structural reforms will still be required in many countries – especially Italy, Spain and, certainly, Greece

– to address more fundamental issues that cannot be resolved by monetary policy. I met with a group of Italian MPs and bankers last night; most thought that Monti would be able to get bold reforms through the parliament – but only if he moved quickly, before Christmas. The longer he waited, one said, the less the chance, because of political squabbling among the parties as they jockey for position in advance of the next elections.

Answers to relevant questions (drawn from WSJ):

Why did the central banks take this action now?

In recent weeks, it has been more expensive and difficult for European banks to access dollars. This move makes it cheaper for them to obtain dollars through the ECB, and expands swap lines if conditions worsen in other markets.

What effect does this have on markets?

The move is more of a pressure-release valve than a direct action, and doesn't do anything to address underlying problems in Europe. By making it cheaper and easier for European banks to access other currencies, it reduces pressure on markets while policy makers search for a solution.

Why were markets so cheered?

Although the announcement didn't alter any of the fundamental problems, it signals that central banks are coordinating and prepared to act in the event that conditions worsen.

How widely are swaps agreements being used now?

Since their revival in 2010, the swaps have been muted. Though the amount in use had risen a bit in recent weeks, the level of around \$2.4 billion seen in the most recent week is way below what it was during the 2008 financial crisis.

Does the Fed face increased risk under the swap lines?

Since the Fed isn't lending to banks directly, the risk is tiny. The ECB is responsible for giving the Fed its dollars back, so the central bank would have to collapse for the Fed to take a loss. The Fed also isn't exposed to changes in currency rates since the Fed gets back the amount of dollars it loans out. It also earns interest on the loans.

Hope this is helpful