BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

August 11, 2009

The Honorable Alan Grayson
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Thank you for your letter of July 30, 2009, in which you ask a number of questions with respect to the central bank liquidity swap lines between the Federal Reserve and foreign central banks. Enclosed are the responses to your questions.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Responses to Questions Posed by Congressman Grayson

The Federal Open Market Committee (FOMC) has authorized temporary liquidity swap lines with fourteen foreign central banks, under the authority of the Federal Reserve Act.[1] These arrangements are designed to help improve liquidity conditions in both domestic and international financial markets and to mitigate the spread of difficulties in obtaining U.S. dollar funding in fundamentally sound and systemically important economies. In that respect, these facilities have supported the functioning of a safe, flexible, and stable monetary and financial system in the United States during the recent period of financial turbulence and have assisted in the pursuit of the Federal Reserve's statutory goals of maximum employment and price stability.

More information about these central bank swap lines is available on the Federal Reserve's website at http://www.federalreserve.gov/monetarypolicy/bst_liquidityswaps.htm. In particular, the information there shows that the scale of the swap program has come down considerably from its December 2008 peak, when the value of swaps outstanding was about $585 billion. As of August 5, the value had declined by more than 85 percent, to $76 billion.

Please find responses to your specific questions below.

1. **What part of section 14 of the Federal Reserve Act is the legal authority under which the Federal Reserve engages in such foreign currency swaps?**

The Federal Reserve operates its swap lines under authority in the Federal Reserve Act and the authorizations, policies, and procedures established by the FOMC. Section 14 of the Act permits the Federal Reserve Banks to conduct open market operations in foreign exchange markets and to open and maintain accounts in foreign currency with foreign central banks. That section provides in pertinent part that "[a]ny Federal Reserve Bank may,...purchase and sell in the open market, at home or abroad, either from or to domestic or foreign banks, firms, corporations, or individuals, cable transfers..." 12 USC 353. The term "cable transfers" was used at the time the provision was enacted to mean foreign exchange. Section 14(e) provides the authority for Reserve Banks to "open and maintain accounts in foreign countries, appoint correspondents, and establish agencies in such countries" and "to open and maintain banking accounts for ... foreign banks or bankers." 12 USC 358. The legal basis for the Federal Reserve's swap arrangements has been reviewed by Congress several times since the early 1960s, and Congress has never found these arrangements to be an inappropriate use of the powers granted in the Federal Reserve Act.

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[1] The fourteen central banks are: the Reserve Bank of Australia, the Banco Central do Brasil, the Bank of Canada, Danmarks Nationalbank, the Bank of England, the European Central Bank, the Bank of Japan, the Bank of Korea, the Banco de Mexico, the Reserve Bank of New Zealand, Norges Bank, the Monetary Authority of Singapore, the Sveriges Riksbank, and the Swiss National Bank. Of these, the lines with four central banks--the Bank of Canada, the Reserve Bank of New Zealand, the Monetary Authority of Singapore, and the Banco Central do Brasil--have not been drawn on.

2. **Who bore the currency risk for these swap lines? What effect did the currency movements during these swaps have on each party?**

The swap lines are structured to avoid currency risk. In a swap transaction, the Federal Reserve provides U.S. dollars to a foreign central bank. At the same time, the foreign central bank provides the equivalent amount of funds in its currency to the Federal Reserve, based on the market exchange rate at the time of the transaction. The parties agree to swap back these quantities of their two currencies at a specified date in the future, using the same exchange rate as in the first transaction. Because the terms of this second transaction are set in advance, fluctuations in exchange rates during the interim do not alter the eventual payments. As such, these swap operations carry no exchange rate or other market risks, and currency movements during the swaps have no effect on the obligations of each counterparty. The Federal Reserve gets back exactly the same amount of dollars that it swapped to the foreign central bank, plus interest.

3. **In these swap line arrangements, did the Federal Reserve pay interest to foreign central banks or anyone else, and if so, how much and to whom?**

When a foreign central bank draws on its swap line to fund its dollar tender operations--operations in which the foreign central bank auctions dollar liquidity to financial institutions in its jurisdiction--the foreign central bank pays interest to the Federal Reserve in an amount equal to the interest the foreign central bank earns on its tender operations. The Federal Reserve pays no interest to the foreign central bank or to anyone else as a part of these operations.