



BUSINESS DAY

Fed's Aid in 2008 Crisis Stretched Worldwide

By NEIL IRWIN FEB. 23, 2014

WASHINGTON — Tuesday morning, Sept. 16, 2008, was perhaps the darkest time for the United States economy in modern memory — even if nobody knew it quite yet. It was barely 24 hours removed from the bankruptcy of Lehman Brothers, and a few hours before the government would rescue the insurer American International Group.

Events had been set in motion that would drive the unemployment rate to double digits and cause half a decade of economic misery.

But before they would confront any of that, the men and women of the Federal Reserve received an urgent briefing on Norway.

A few minutes into the meeting of the Fed's policy committee, according to newly released transcripts, William C. Dudley, then the head of the markets desk at the New York Fed, brought dangerous tidings from across the Atlantic.

“I have just sketchy details based on a phone call,” Mr. Dudley said. “But my understanding is that this morning Norway put in place a facility by which they are going to offer their banks dollars, up to \$5 billion,” adding that “the fact that Norway is doing this suggests that the situation has broadened quite a bit further.”

In conversations with counterparts at the European Central Bank, Mr. Dudley said, he learned that there was “quite a bit of interest” in “an open facility where European banks could come and get dollars.”

So began what would become the biggest United States government

bailout that most people do not know anything about.

The new transcripts, released Friday after a customary five-year delay, shed light on one of the most significant but least understood parts of the Fed's expansive rescue efforts in the crisis.

While reporters and lawmakers focused on the bailouts of American financial institutions, the Fed was quietly pumping hundreds of billions of dollars to nations stretching from Switzerland to South Korea to bolster global banks when dollars were in short supply. European banks were particularly heavy beneficiaries.

At their peak in December 2008, these "liquidity swap lines" totaled \$580 billion. The money was extended to 14 central banks from Sweden to South Korea to Singapore, which, in turn, lent it to private banks. The bailout of A.I.G., which attracted bigger headlines and louder public fulmination, was a comparatively paltry \$85 billion.

"The crisis was global," said Francesco Papadia, who helped engineer the program as markets chief at the European Central Bank and is now an affiliate fellow at Bruegel, the Belgian research organization, "and the central banks had to get global to answer the crisis."

The root of the problem was this: Global banks did lots of business in dollars — buying up United States mortgage-backed securities, financing international trade between companies operating around the world, and more. But at that moment in 2008, private lending markets were essentially shut down. Banks did not trust one another enough to lend freely the way they might in normal times. Everybody was hoarding dollars at once.

In the United States, the Fed, the one entity in the world that can create dollars out of thin air, addressed the dollar shortage with the time-honored practice of serving as the "lender of last resort," making emergency loans to banks and other financial institutions, as central banks have done for hundreds of years.

But the Fed was in no position legally to extend the same courtesy to international banks. (Their United States affiliates were a different matter

— during this period the American arms of European banks took billions in emergency loans.)

So the Fed and its international counterparts turned to a tool that had been used only on a much smaller scale, including during the disruptions after the Sept. 11, 2001, terrorist attacks.

The idea is simple: The Fed sends dollars to, say, the European Central Bank, in exchange for a comparable value of euros, plus interest. The bank then lends those dollars to European banks against collateral. At a fixed date, the transactions are reversed; the Fed gets its dollars back and the European Central Bank gets its euros back.

Ultimately, the Federal Reserve and American taxpayers profited from the arrangement.

No one had ever imagined such transactions could be used on such a huge scale. “If I had said to the F.O.M.C. in 1998 that 10 years later you’ll have \$600 billion in credit outstanding to foreign central banks, they would have said, ‘You’re nuts,’ ” said Edwin M. Truman, a former head of the Fed’s international division, referring to the policy committee, the Federal Open Market Committee. Mr. Truman is now a senior fellow at the Peterson Institute for International Economics.

The program started with the central banks of major industrialized nations, including the European Central Bank, Bank of England and Swiss National Bank. But that fall, the Fed began undertaking arrangements with emerging nations’ central banks.

At the October meeting where Fed officials agreed to swap lines with Mexico, Brazil, South Korea and Singapore, Timothy F. Geithner, then chief of the New York Fed, framed the decision in part as the United States fulfilling its role as issuer of the world’s most widely used currency.

“Another way to think about this is that the privilege of being the reserve currency of the world comes with some burdens,” Mr. Geithner said during the meeting, on Oct. 28 and 29. “Not that we have an obligation in this sense, but we have an interest in helping these guys mitigate the problems they face in dealing with currency mismatches in

their financial systems.”

That said, Fed officials, then and now, framed the program as intended to help the United States economy. After all, international banks were supporting lending in the United States by buying securities backed by Americans’ home mortgages, credit cards and other debts. If the dollar crisis continued, there could be even more of a fire sale of those securities, driving up interest rates in the United States and making credit even harder to obtain.

“To the rest of the world, I don’t think these transcripts are going to be very reassuring,” said Eswar S. Prasad, a Cornell economist and author of “The Dollar Trap,” a book that examines the currency swaps. “What they show is that the U.S. policy makers are very narrowly focused on U.S. interests, and their actions are not so much determined by any moral obligation to save the world economy, but rather a clear self-interest in preserving U.S. economic interests.”

The Fed rejected some nations that wanted dollar swaps but, in the Fed leaders’ judgment, were not important enough to American economic interests to warrant participation. The transcripts redact the names of those countries, but diplomatic cables released by WikiLeaks indicate they included Indonesia, Turkey and the Dominican Republic.

The Fed was approached by other countries, Nathan Sheets, the leader of the Fed’s international finance division, said at the October 2008 meeting.

“But we have not encouraged that,” Ben S. Bernanke, then the Fed chairman, chimed in.

“We have done everything we possibly can do discourage it,” Mr. Sheets added. “We’re not advertising.”

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