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Foreign Banks Double Dollar Deposits at Fed

By Catarina Saraiva - Nov 21, 2011 11:04 AM GMT

Foreign bank deposits at the Federal Reserve have more than doubled to $715 billion from $350 billion since the end of 2010 amid Europe's debt turmoil, buttressing the dollar's status as the world's reserve currency.

Forty-seven non-U.S. banks held balances of more than $1 billion at the New York Fed as of Sept. 30, up from 22 at the end of 2010, according to a survey of 80 financial institutions by ICAP Plc, the world's largest inter-dealer broker. The dollar has appreciated 7.2 percent since Standard & Poor's cut the nation's AAA credit rating Aug. 5, the second-best performance after the yen among developed-nation peers, according to Bloomberg Correlation-Weighted Currency Indexes.

A budget deficit of more than $1 trillion, a deadlock among Congressional supercommittee members on spending cuts and 9 percent unemployment haven't deterred investors from seeking safety in the world's biggest economy. The euro has been undermined by the region's sovereign debt crisis, while the Swiss franc and yen have fallen as their governments buy billions of dollars to weaken them.

"There's not anything close to a substitute and part of it is the deepness of the market, the liquidity," Jack McIntyre, a fund manager who oversees $23 billion in debt at Brandywine Global Investment Management, a unit of Legg Mason Inc., said Nov. 15 in a telephone interview from Philadelphia. "There's a perception, right or wrong, that we're going to make good on all of our assets."

Demand Rises

The Fed's record-low target interest rate for overnight loans among banks at between zero and 0.25 percent hasn't discouraged dollar buying as slowing global growth and turmoil in Europe spur central banks from Australia to Brazil to cut rates, reducing their appeal to investors seeking higher returns.

Foreign demand for U.S. assets rose the most in 10 months in September. Net buying of long-term equities, notes and bonds totaled $68.6 billion, the highest since

November 2010, compared with net buying of $58 billion in August, the Treasury Department said Nov. 16.

The dollar is up 6.5 percent in the past three months, recovering to about level this year with its nine peers, which include the Swedish krona and the Swiss franc. It’s trading about 4 percent below where it was in 1975, two years after President Richard Nixon ended the currency’s official ties to gold.

The U.S. currency rose 1.7 percent to $1.3525 per euro in the five days ended Nov. 18, gaining for a third week in a row. It fell 0.4 percent to 76.91 yen. The greenback traded at $1.3447 per euro and 76.90 yen as of 10:52 a.m. London time.

Banks Seek Safety

Demand for Treasury securities that mature in under a year has increased as financial institutions boost holdings of the highest-quality assets to meet new regulations set by the Bank for International Settlements in Basel, Switzerland. Bank holdings of Treasuries and government-related debt totaled a record $1.69 trillion at the end of October, up from less than $1.1 trillion in 2008.

“With the heightened emphasis on stronger liquidity positions for financial institutions around the world, we’ve seen an increase in the regulatory demand for liquid assets, but we’re not necessarily seeing an increase in the supply of liquid assets,” Lou Crandall, chief economist at Wrightson ICAP LLC in Jersey City, New Jersey, a unit of ICAP, said in a Nov. 14 interview. “They’re meeting that need by holding Fed balances.”

‘Hoarding Cash’

Rates on three-month bills ended last week at zero, down from this year’s high of 0.157 percent in February and 5 percent in mid-2007, just before credit markets froze as losses on subprime mortgages accelerated.

“People are hoarding cash because they see that there’s some difficulty in the U.S. dollar funding market” as banks shed euro-denominated assets, Charles St-Arnaud, a foreign- exchange strategist at Nomura Holdings Inc. in New York, said in a telephone interview Nov. 14.

Three-month cross-currency basis swaps, the rates banks pay to convert euro payments into dollars, were as low as 132 basis points, or 1.32 percentage point, below the euro interbank offered rate Nov. 18, the most expensive since December 2008.

The cost of dollar funding is increasing as Europe's debt crisis escalates. Last week, yields on German two-year bunds dropped below 0.3 percent for the first time, while the extra yield investors demand to hold 10-year bonds from France, Belgium, Spain and Austria instead of bunds climbed to euro-era records. The spread between German and French bonds of that maturity widened to 190 basis points on Nov. 15, the highest in the euro union's history.

Europe Cuts Rates

European Central Bank policy makers cut the benchmark interest rate by 0.25 percent at their Nov. 3 meeting, after increasing it by 50 basis points earlier this year. Expectations for further cuts rose after Europe's third quarter gross domestic product expanded 0.2 percent from the previous three months, a Nov. 15 report showed, signaling the region may be headed for a recession.

Slowing growth drove the Reserve Bank of Australia to cut its interest rate this month for the first time since April 2009, reducing it to 4.5 percent. Brazil's central bank has lowered its rate twice since July to 11.5 percent, after raising it to 12.5 percent during the past 1 1/2 years.

Fed Stays Low

Cuts in central bank rates around the world have made the carry trade of selling dollars to buy the currencies of higher- yielding countries unprofitable. The trade, when borrowing dollars to buy the Australian, Swedish, Brazilian and South African currencies, has lost 30 percent since July, according to Bloomberg data.

The Fed said it will keep its rate at an all-time low through mid-2013 as the unemployment rate has remained stuck at or above 9 percent since March.

Consumer confidence rose to 64.2 this month, the highest since June, according to the Thomson Reuters/University of Michigan preliminary index of sentiment. Retail sales rose 0.5 percent in October, increasing for the fifth-straight month, according to a government report.

The economy expanded at a 2.5 percent pace in the third quarter, from 1.3 percent in second quarter, the Commerce Department said Oct. 27. Economists have increased their fourth- quarter economic forecasts to an expansion of 2.3 percent, from 2 percent estimated in October, according to two Bloomberg News surveys.

Bretton Woods

Faster growth may boost investor appetite for riskier assets, decreasing demand for the dollar's safety, said Lane Newman, director of foreign exchange at ING Groep NV in New York. "This is perhaps a temporary respite from the dollar losing its reserve status," he said. "I see this as a decades- long trend. Ultimately, it's the devaluation and the end of the hegemony of the big dollar."

The dollar has been the world's reserve currency since World War II, when the U.S. and allies agreed at the 1944 Bretton Woods conference to peg it to a rate of $35 per ounce of gold. After global currencies began freely floating in 1973, it has remained the most-traded legal tender, accounting for 85 percent of the $4 trillion per day foreign exchange market, according to the BIS.

Its share of foreign-exchange holdings has held steady at 61.6 percent since 2009 after peaking at 72.7 percent in 2001. The euro has stabilized at an average of 26.6 percent of reserves since 2007, up from 18 percent at its inception in 1999.

Deficit Panel

Options traders are increasingly betting that the dollar will strengthen. They paid 4.4 percentage points more for the right to sell the euro against the dollar than to buy it on Nov. 17, the most since the common currency's inception in 1999. The so-called three-month 25-delta risk reversal rate has widened for all developed-nation currencies versus the dollar and for emerging-markets such as the real and Mexican peso.

The dollar's rise comes as a Congressional panel of six Democrats and six Republicans, known as the supercommittee, has until Nov. 23 to find $1.2 trillion in deficit reduction, or cause that much in spending cuts to go into effect beginning in 2013.

The bipartisan group is expected to announce that it has failed to reach agreement on federal budget savings, a Democratic aide said. The aide, who wasn't authorized to discuss internal matters publicly and requested anonymity, said in an e- mail yesterday that it was highly unlikely that the talks could be salvaged.

Budget Deficit

If Congress removes the automatic deficit cuts, Standard and Poor's may drop the nation's credit rating to AA, after reducing it to AA+ following the debt-cutting agreement, the ratings company said in a statement Aug. 5 when it announced the downgrade.

The U.S. budget deficit was $1.3 trillion in the fiscal year ended Sept. 30, up from $1.29 trillion in 2010 and the second-highest on record, according to Treasury Department data. It reached $1.42 trillion in 2009, the most ever.

Other traditional havens in times of market stress, the Swiss franc and yen, reached record highs against the euro and dollar, respectively, this year before their central banks acted in September and October to drive them from their peaks.

"The U.S. picks up an awful lot of the slack," Alan Ruskin, global head of Group-of-10 foreign-exchange strategy at Deutsche Bank AG, the world's biggest currency trader according to Euromoney Institutional Investor Plc, said in a Nov. 17 telephone interview. "Particularly for large reserve portfolios, that need very liquid markets, they're only really going to be accommodated in the U.S. market."

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