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Unintended Consequences of QE2

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The Federal Reserve's latest quantitative easing (QE2) program was meant to stimulate the US economy. Only time will tell how well it succeeded at that goal. Oddly, this pointedly domestic program has mainly benefited foreign banks.

As the second stage of QE2 ends, it closes a contentious chapter in monetary policy. The initiative has been variously blamed for a weak dollar, lower interest rates globally, rapid credit growth in emerging markets and soaring commodity prices. Now it appears that quantitative easing has been almost entirely an operation on behalf of local branches of foreign banks. To understand how and why funds didn't flow into domestic banks, it's first necessary to do a little detective work on how quantitative easing was implemented.

When the Fed Buys Treasury Bonds

Under quantitative easing, the Federal Reserve buys securities and pays for them with funds that it places in Federal Reserve deposits. The second round of quantitative easing involves the purchase of an additional $600 billion in Treasury bonds from November 2010 through June of this year. Under a separate program, a smaller amount of Treasury bonds is being bought to replace maturing mortgage and agency bonds.

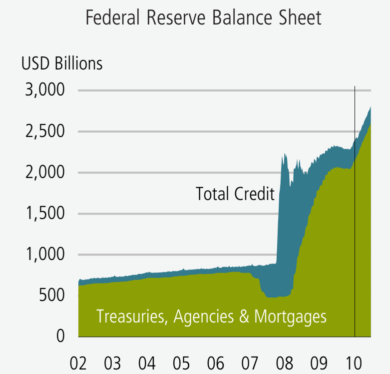
Several years of quantitative easing have caused the Fed's holdings of mortgage, agency and Treasury bonds to swell to $2.6 trillion. It has paid for these securities with obligations for bills and notes (circulating cash) of about $1 trillion and about $1.6 trillion of deposits that are due to US banks. With this massive inflow of funds well beyond what banks are required to keep in reserve, the Fed hoped to spur lending that would bolster the economic recovery **(Display 1)**.

QE2 Sailed to Other Shores

As it turns out, most of the additional funds created since December 2010 were actually accumulated by foreign-related banks—not US banks. The evidence: Federal Reserve deposits rose by $620 billion since that time while the cash holdings of foreign-related banks rose by $560 billion. Foreign bank subsidiaries funded their increased deposits at the Fed with $510 billion in net borrowing from offshore parents **(Display 2)**.

Display 1

Quantitative Easing by the Fed…

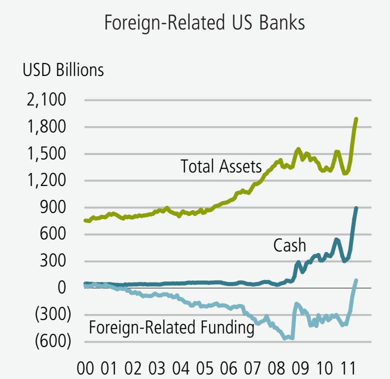


Through June 15, 2011

Source: Federal Reserve Board and Haver Analytics

Display 2

...Ends Up with Foreign Banks



Through May 1, 2011

Source: Federal Reserve Board and Haver Analytics

The Fed almost certainly didn't intend QE2 to fill the coffers of foreign bank branches with additional reserves. We think that it's an unintended consequence of several radical regulatory moves in the last few years. But is it a sign of brewing imbalances in financial markets? Probably not, in our view.

Carrots and Sticks That Changed the Picture

When it first began quantitative easing, the Fed was keen to provide reassurance that a flood of excess reserves wouldn't lead to a flood of bank lending. Given the economic environment, this outcome was unlikely to happen suddenly, but it was theoretically possible. So the Fed obtained the right to pay interest on its deposits, essentially tapping the brakes by creating a modest incentive for banks to keep funds on deposit rather than lending them out. Since late 2008, the Fed has paid 25 basis points of interest on excess reserves (IOER) held by any US-resident bank, whether it was domestic or foreign.

But another regulatory measure entered the picture this year: The FDIC began imposing a surcharge on bank funding. US banks with FDIC-insured deposits must pay a surcharge on any funding that's not covered by retail deposits, or on any debt with more than one year's duration. These surcharges, which largely range from 10 to 25 basis points, are in proportion to the FDIC's assessment of bank capital and risk—and are designed to cover against the risk of enlarged balance sheets. However, many foreign bank subsidiaries in the US are wholesale operations that don't have FDIC-guaranteed deposits, so they pay no surcharge.

Following the Money

Which foreign banks are taking advantage of this situation? You might assume that Chinese banks were involved, but Chinese officials have tenaciously continued to buy US Treasuries instead. A look at the underlying details reveals that the foreign banks building up their Federal Reserve deposits are domiciled mostly in the UK and—oddly—the Caribbean. These flows are likely coming from dollar funding drawn from the Eurodollar market, mainly by banks residing in Europe as well as hedge funds.

Remember that foreign banks have also built up enormous balance sheets in the Eurodollar market—out of the reach of US banking regulations and reserve requirements. But in the event of a panic, such as might hypothetically be triggered by events in Greece, Eurodollar funds may seem very far from home to these banks, so we can see why building up dollar balances at the Federal Reserve might be viewed as insurance by these foreign banks. Sure, worst-case emergency liquidity would still be available from their local central banks, but it's not the same as being able to immediately tap dollars from a Fed account to make payments.

Foreign Bank Benefits Beyond Safety

There may be other motivations beyond safety. Deposits at the Fed are unusually attractive for foreign banks because of the regulatory landscape. Borrowing money via deposits that don't exact an FDIC surcharge, and depositing them at the Federal Reserve, earning 25 basis points, is much more attractive to a foreign bank with a US branch than it is to a US bank. That regulatory gap also provides insight into why foreign-related banks have maintained sizable deposits at the Fed.

The combination of nearly free access to the world financial system's ultimate safe asset—balances at the Federal Reserve—and arbitrage opportunities seems to be behind the large amount of funds in the hands of foreign-related banks. As a result, QE2 has unexpectedly provided some stability to offshore dollar-based banking. ■