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Treasury's Exchange Stabilization Fund and COVID-19

As part of the U.S. government's economic response to the coronavirus disease 2019 (COVID-19), the "third" COVID-19 stimulus package (H.R. 748), as passed by the Senate on March 25, would appropriate \$500 billion to the U.S. Department of Treasury's Exchange Stabilization Fund (ESF) to support loans, loan guarantees, and investments for businesses affected by COVID-19. In addition, the legislation would temporarily permit the use of the ESF to guarantee money markets, as occurred in the 2008 financial crisis. ESF assets have already been pledged in 2020 to backstop several emergency lending facilities created by the Federal Reserve (Fed) in response to financial turmoil caused by COVID-19.

The original purpose of the ESF was to give the United States adequate financial resources to stabilize the value of the dollar by buying and selling foreign currencies and gold. In the exigencies of the 2008 financial crisis, the ESF was used differently as Treasury sought a source of unfettered money to quickly stop a run on money markets that threatened further financial instability. Although legislation subsequently forbid Treasury from using the ESF for this purpose in the future, the ESF is being looked to today as a tool to address financial unrest.

Background

The ESF was established by Section 10(a) of the Gold Reserve Act of January 30, 1934 (31 U.S.C. § 5302) to stabilize the exchange value of the dollar. Similar funds of European countries were heavily intervening in foreign exchange markets at that time, engaging in competitive currency devaluations. The ESF was established with \$2 billion appropriated from profits realized from the Gold Reserve Act's revaluation of U.S. gold holdings from \$20.67 per toy ounce to \$35.

During the 1930s, the ESF was actively used to manage the foreign exchange rate of the U.S. dollar. After World War II, when the International Monetary Fund (IMF) was established, the ESF was the source of funds for the U.S. contribution. As provided in the Bretton Woods Agreement Act of 1945 (31 U.S.C. § 5302), \$1.8 billion of the ESF's capital of \$2 billion was used to make a partial payment on the U.S. subscription to the IMF. The Bretton Woods Agreement Act of 1945 also included permanent authority for the ESF.

In 1973, with the demise of the post-World War II gold standard, where the dollar was pegged to gold and other countries' currencies were pegged to the dollar, the explicit purpose of stabilizing the exchange value of the dollar was stricken from the ESF's statute, and its purpose was expanded. Language alluding to "stabilizing the exchange value of the dollar" was deleted, and language referring to

"being consistent with U.S. obligations in the IMF regarding orderly exchange arrangements and a stable system of exchange rates" was inserted. As a consequence of this change, the Secretary of the Treasury (with the approval of the President) has almost unlimited authority to "deal in gold, foreign exchange, and other instruments of credit and securities." Decisions of the Treasury Secretary are final and may not be reviewed by another government official. Nevertheless, Treasury is required to provide monthly reporting on the ESF's operations to Congress. ESF loans are not open-ended. When Congress expanded the scope of the ESF's authority in 1978, it added a restriction that ESF loans could not exceed six months unless the President notified Congress that "unique or exigent circumstances" were present. Such notifications were provided regarding ESF credit exposure to Mexico in 1982 and in 1995 and to Brazil in 1998.

"Consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates, the Secretary ... with the approval of the President may deal in gold, foreign exchange, and other instruments of credit and securities..." – 31 U.S. Code § 5302. Stabilizing exchange rates and arrangements

In addition to its initial capitalization (\$2 billion), Congress allowed the ESF to remain outside annual appropriations and imposed no overall size limit. Instead, the ESF retains all of the earnings from its operations. The main limitation on the ESF's ability to intervene to impact the value of the dollar is the amount of dollar-denominated assets in its portfolio, which are \$22.67 billion as of February 2020. In order to secure more dollars for foreign exchange operations, Treasury could (1) seek an additional appropriation from Congress; (2) monetize its holdings of IMF special drawing rights (SDR, an international reserve asset), valued at \$50 billion, by temporarily selling them to the Fed; or (3) engage in a currency swap arrangement called "warehousing"—in which the ESF sells foreign currency to the Fed and agrees to repurchase it at a later date, during which the Fed credits dollar reserves to the ESF for the duration of the swap. The limit on warehousing is \$5 billion, but this limit was temporarily raised to \$10 billion in 1989 and \$20 billion in 1995. The last use of the warehousing arrangement was from 1988 to 1992.

ESF Use Before 2008

The ESF's primary use until 2008 was to finance short-term loans to foreign countries facing a financial crisis, including Brazil and Mexico, primarily in Latin American and Caribbean. The ESF has also been used to provide bridge loans to foreign countries while they were negotiating longer-term IMF financing.

Since moving to flexible exchange rates, the United States stopped intervening in foreign exchange markets, for the most part, by the mid-1990s. Since then, the United States, in coordination with other countries, has intervened on three isolated occasions—in 1998, 2000, and 2011.

2008 Money Market Guarantee

The 2008 financial crisis saw a novel and controversial pledge of the ESF for purposes that were not directly related to exchange rates or the value of the dollar—a money market guarantee.

Money market mutual funds (MMFs) are a type of mutual fund that generally invest in high-quality, short-term assets. Often the value of a share is held at \$1 per share, and fund gains are paid out as dividends mimicking interest payments. Thus, they are seen as largely analogous to bank deposits but are not guaranteed by the Federal Deposit Insurance Corporation (FDIC).

As part of the market turmoil resulting from the bursting of a nationwide housing bubble on September 16, 2008, an MMF called the Reserve Fund “broke the buck,” meaning the value of its shares had fallen below \$1. This occurred because of losses it had taken on short-term debt issued by the investment bank Lehman Brothers, which filed for bankruptcy on September 15, 2008. Money market investors had perceived “breaking the buck” to be highly unlikely, and its occurrence set off a generalized run on MMFs, as investors simultaneously attempted to withdraw an estimated \$250 billion of their investments—even from funds without exposure to Lehman Brothers.

To stop the run, Treasury announced an optional program to guarantee deposits in participating money market funds. Treasury would finance any losses from this guarantee with assets in the ESF. Treasury announced this program without seeking specific congressional authorization, justifying the program on the grounds that guaranteeing money market funds would protect the value of the dollar. The program expired after one year in September 2009. Funds utilizing the guarantee program paid fees for the guarantee of between 0.015% and 0.022% of the amount guaranteed by the program.

Over the life of the program, Treasury reported that no money market fund guarantees were invoked, and \$1.2 billion in fees had been collected. The ESF was small compared to industry assets. More than \$3 trillion of deposits were guaranteed and, according to the Bank for International Settlements, 98% of U.S. money market funds were covered by the guarantee, with most exceptions being funds that invested only in Treasury securities. However, a guarantee was credible as long as the ESF was expected to be larger than guaranteed losses.

The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) included language that directed the Treasury Secretary to reimburse the ESF for any funds used for the money market guarantee program and prohibited use of the ESF in the future for such a program. To date, a similar MMF guarantee has not been created in 2020. The Senate-passed version of H.R. 748 would temporarily remove these

restrictions until the COVID-19 crisis has ended. There is speculation about whether such a guarantee would be initiated in the current crisis if the law were changed.

2020 Federal Reserve Facilities Backed by the ESF

The ESF has been pledged again in response to financial turmoil caused by COVID-19. The Fed has created several emergency credit facilities to support liquidity in the nonbank parts of the financial system. To create these facilities, the Fed relied on its emergency lending authority (Section 13(3) of the Federal Reserve Act). Some of these facilities resurrect ones created in 2008 in response to the financial crisis, extending the Fed’s role as lender of last resort from the banking system to the overall financial system for the first time since the Great Depression.

Although the Fed did not rely on the ESF in 2008 and no 2008 facility experienced any losses, Treasury has pledged \$10 billion in ESF assets to back five Fed facilities (\$50 billion in total) in 2020. Use of the ESF may be seen to allow these facilities to meet the Dodd-Frank Act’s (P.L. 111-203) requirement that the Fed’s 13(3) lending is secured “sufficient[ly] to protect taxpayers from losses”; although, given ESF losses would ultimately be borne by taxpayers, it is unclear if this requirement is actually being met. The following 2020 facilities use the ESF as a backstop to absorb future losses.

CPFF. On March 17, 2020, the Fed revived the commercial paper funding facility (CPFF) to purchase commercial paper through a special purpose vehicle (SPV), offsetting a drop in private demand. Commercial paper is short-term debt issued by financial firms, nonfinancial firms, and entities that securitize asset-backed securities.

MMLF. On March 19, the Fed created the Money Market Mutual Fund Liquidity Facility (MMLF), similar to a facility created during the 2008 financial crisis. The facility makes loans to financial institutions to purchase assets that money market funds are selling to meet redemptions.

PMCCF. On March 23, the Fed created the Primary Market Corporate Credit Facility (PMCCF) to purchase newly-issued corporate debt through an SPV.

SMCCF. On March 23, the Fed created the Secondary Market Corporate Credit Facility (SMCCF) to purchase existing corporate debt on secondary markets through an SPV.

TALF. On March 23, the Fed revived the Term Asset-Backed Securities Loan Facility (TALF) to make nonrecourse loans through an SPV to private investors to purchase asset-backed securities backed by various nonmortgage consumer loans.

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