When Jay Powell, US Federal Reserve chair, was grilled in Congress this week, the focus was on how the central bank has helped American companies and consumers during the pandemic. Senators should have also asked — but did not — what the Fed has done recently to help dollar markets outside US shores.

That was a big oversight. When future financial historians study the Covid-19 shock, they will conclude that the Fed’s intervention in offshore dollar markets via swaps deals with other central banks was one of its most significant policy moves. Not only has the Fed’s action calmed markets, it has shored up the hegemony of the dollar-based global financial system for years to come.
To understand all this, some history is required. The concept of central bank swaps, in which two institutions exchange currencies, is not new. Such central bank co-operation had a “sustained pre-history from 1962-1998”, **according to a Bank for International Settlements paper**. But their use faded in the early 21st century as the Fed focused on onshore dollar markets and the American economy.

That changed abruptly in the 2008 crisis. **Historian Adam Tooze** notes that policymakers suddenly realised that non-US financial companies, particularly in the eurozone, had built up massive, unbalanced dollar exposures. They owed dollars to investors but were unable to obtain enough of the currency in private markets, sparking panic.

Lacking a big stock of US currency, the European Central Bank could not help. So the Fed created swap lines that allowed the ECB and central banks in four other countries — Switzerland, the UK, Japan and Canada — to supply dollars to their local markets. “The Fed effectively turned the other central banks into its branches to extend its reach into the offshore USD segment,” write **economists Steffen Murau, Joe Rini and Armin Haas**.

Since the crisis, there has been scant public discussion about whether the Fed should leave these “emergency” measures in place and about the vital question of the Fed’s responsibility to offshore dollar markets. The Covid-19 shock has unexpectedly clarified this.

In mid-March, panic erupted again in offshore dollar markets. The Fed responded and even doubled down. First, it reactivated swaps deals with the five original central banks. Then it added nine players, including Mexico and Brazil. Last, it offered a new “repurchase” facility allowing entities outside the 14-member club to swap assets such as Treasury bonds for dollars.

This expanded safety net is not comprehensive. Emerging market countries without big Treasury holdings, such as Turkey, are **left in the cold**. And using the repo programme is costly, so few have done so. But 10 of the 14 members of the swaps club have **grabbed $446bn** dollars, at last count. Moreover, “the programme has been incredibly successful” at calming markets, says Zoltan Pozsar, an analyst at Credit Suisse. In mid-March, euro and yen-based borrowers had to pay an additional 200 basis points and 250bp respectively to borrow in dollars; by late April, **the gap was a mere 30bp and 50bp**.

This is good news for non-US financial players. It also comes with a new and striking geographical twist.
Since 2008, the main imbalances in offshore dollar markets have migrated from the eurozone to Japan, as Japanese savers, banks and life assurance companies dived into dollar markets to chase higher yields. Thus Norinchukin, the agricultural bank, became the world’s largest holder of dollar collateralised loan obligations. Smaller banks, such as Shizuoka, have jumped in too. Meanwhile, Mr Pozsar says that Japanese “life insurers’ US dollar needs in the FX swap market exceed $1tn”.

Before the pandemic, these imbalances were starting to make some Japanese regulators uneasy. The Fed’s intervention has calmed fears. At last count, the Bank of Japan had taken $224bn from the Fed, a lot more than the ECB’s $143bn, and presumably passed it on to dollar-hungry Japanese entities. In plain English, a safety net is now in place.

Will this be retained after Covid-19? Almost certainly: Fed and Treasury officials increasingly believe that preventing excess dramas in the offshore dollar markets is necessary to avoid shocks to the onshore dollar markets and the all-important Treasuries sector.

Call this a new manifestation of American self-interest; or just the inevitable consequence of financial globalisation. Either way, the crucial point is this: even if US global leadership is faltering in many areas, the Fed’s support for dollar hegemony is not. This could entrench dollar usage still further after the Covid-19 shock, even if countries such as China hate that.

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