September 18, 2008

What's a swap line?

This morning the Federal Open Market Committee (FOMC) authorized a $180 billion expansion of its temporary reciprocal currency arrangements (swap lines). [According to the Fed's press release](), the changes allow for "increases in the existing swap lines with the ECB and the Swiss National Bank" and for "new swap facilities…with the Bank of Japan, the Bank of England, and the Bank of Canada."

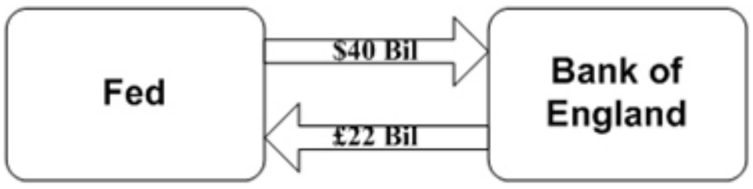
"These measures…are designed to improve the liquidity conditions in global financial markets," the release continued.

What did the Fed do and how will this action address some of the strain in liquidity conditions that recently have emerged?

A good place to start is by looking at what, exactly, a currency swap line is. A currency swap is a transaction where two parties exchange an agreed amount of two currencies while at the same time agreeing to unwind the currency exchange at a future date.

Consider this example. Today the Fed initiated a $40 billion swap line with the Bank of England (BOE), meaning that the BOE will receive $40 billion U.S. dollars and the Fed will receive an implied £22 billion (using yesterday's USD/GBP exchange rate of 1.8173).

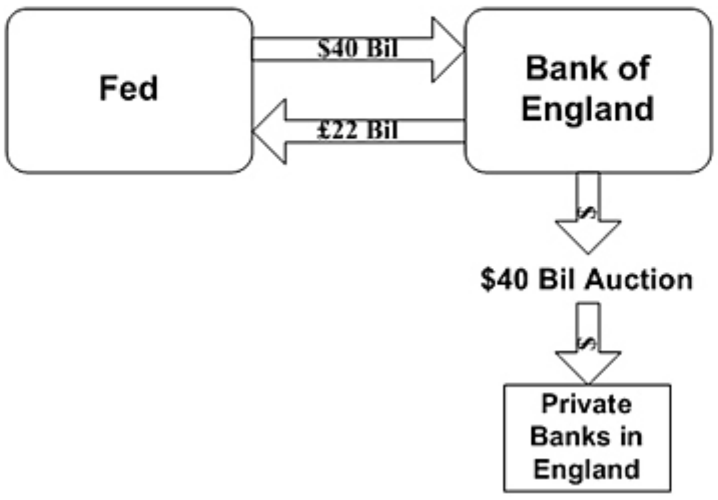
Currency Swap:



An underlying aspect of a currency swap is that banks (and businesses) around the world have assets and liabilities not only in their home currency, but also in dollars. Thus, banks in England need funding in U.S. dollars as well as in pounds.

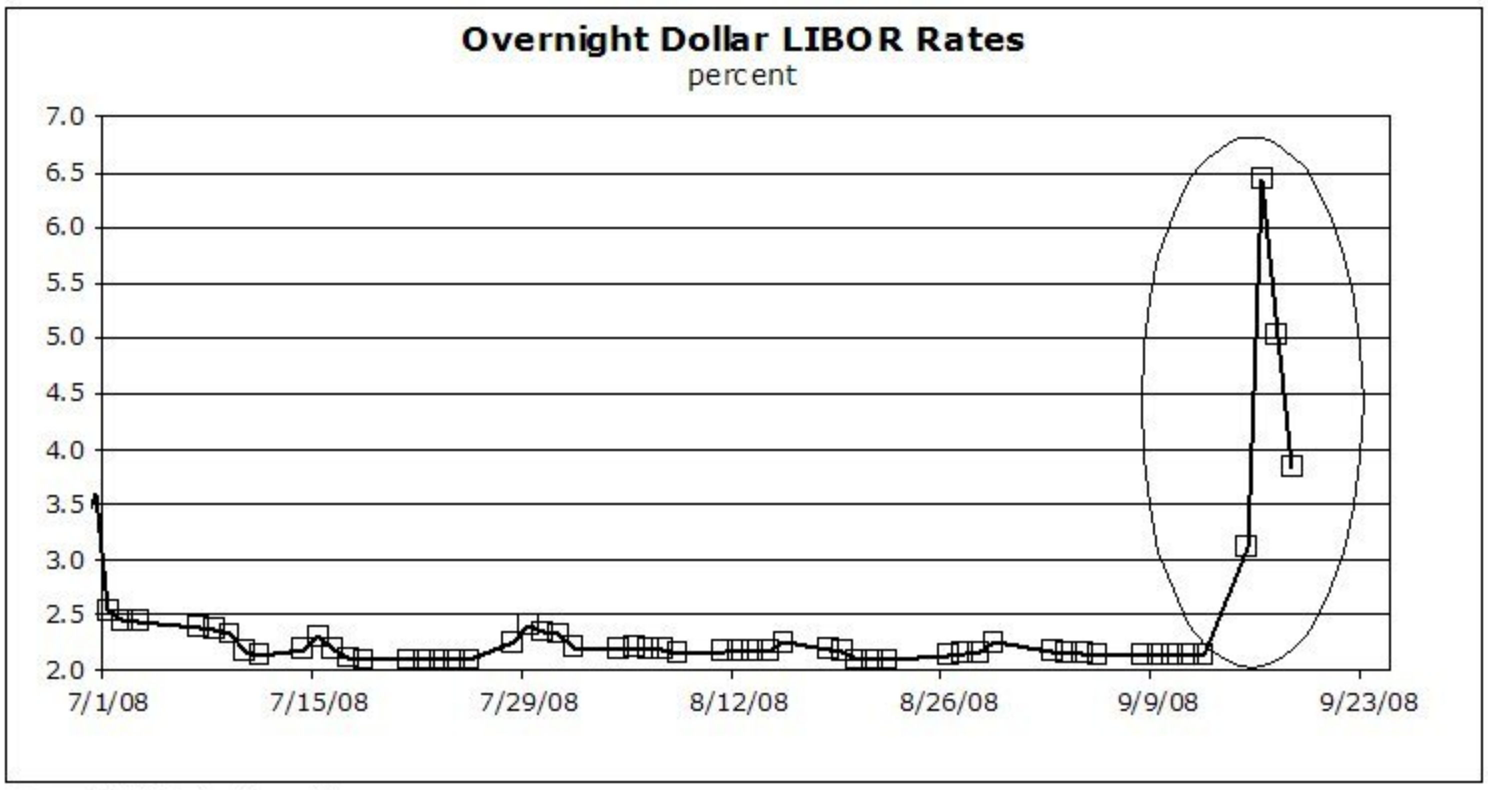
However, banks recently have been reluctant to lend to one another. Some observers believe this reluctance relates to uncertainty about the assets that other banks have on their balance sheets or because a bank might be uncertain about its own short-term cash needs. Whatever the cause, this reluctance in the interbank market has pushed up the premium for short-term U.S. dollar funding and has been evident in a sharp escalation in LIBOR rates.

The currency swap lines were designed to inject liquidity, which can help bring rates down. To take the British pound swap line example a step further, the BOE this morning planned to auction off $40 billion in overnight funds (cash banks can use on a very short-term basis) to private banks in England.



In effect, this morning's [BOE dollar auction]() will increase the supply of U.S. dollars in England, which would work to put downward pressure on rates banks charge each other.

Consistent with this move, the overnight LIBOR rate fell from about 5.03 percent yesterday to 3.84 percent today.



Source: British Bankers' Association

The bottom line is that the Fed, by exchanging dollars for foreign currency, has helped to provide liquidity to banks around the world. This effort can help to bring interbank rates back down at a time when restrictively high rates can choke off access to financing that banks and other businesses need to operate.

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