May 11, 2010

Return of the swap lines

As **the European Union jumped into crisis resolution mode** with both feet and the European Central Bank (ECB) responded to the "exceptional circumstances" with **measures to address severe tensions in financial markets**, the Federal Reserve has made its own contribution to global economic stability by announcing **the reestablishment of temporary U.S. dollar swap facilities** with the ECB, Bank of Canada, Bank of England, Swiss National Bank, and (**later**) the Bank of Japan.

Swap lines are not new tools for central banks. In fact, we covered **the basics of swap arrangements** in September 2008, explaining the rationale at that time for the facilities thus:

> "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.
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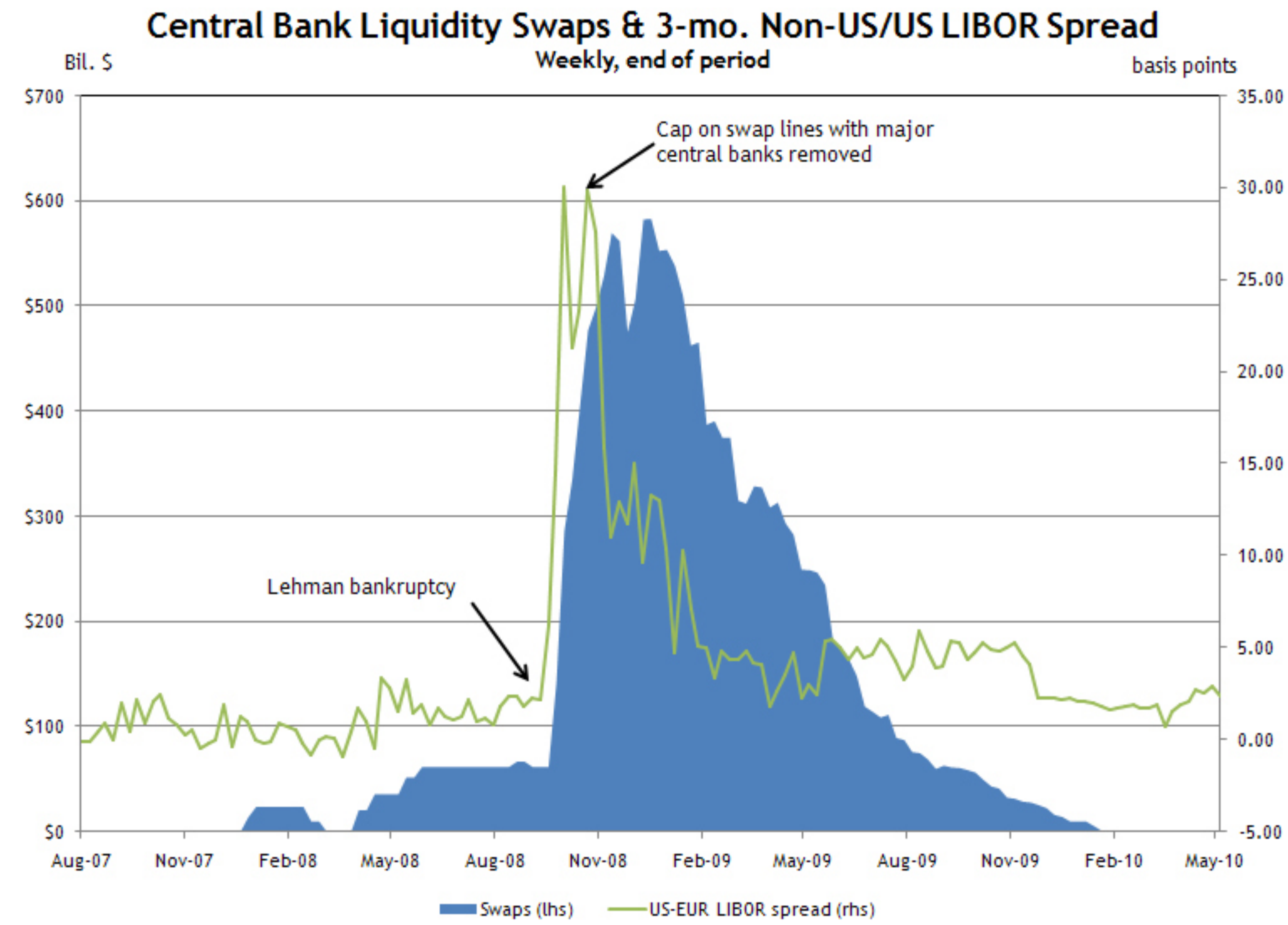
> "The currency swap lines were designed to inject liquidity, which can help bring rates down."

Yesterday's online edition of *The Wall Street Journal's* **Real Time Economics blog makes note** of a more recent, and very nice, **primer from the Federal Reserve Bank of New York**, co-authored by Michael Fleming and Nicholas Klagge. The Fleming-Klagge article describes a Libor-based measure of stress that was particularly acute in nondollar countries during the worst of the crisis that began in 2007.

> "Because foreign banks secure much of their dollar funding through interbank loans, they can expect to face greater funding pressures during times of market stress. One way to measure such pressures involves examining the individual borrowing rates of the sixteen banks that make up the Libor survey 'panel.' The difference between the average borrowing rate of the panel's thirteen non-U.S. banks and the average borrowing rate of its three U.S. banks provides a rough proxy for the increased difficulty foreign banks face in trying to borrow dollars."

Did the currency swaps help bring this spread down? Here's a little informal evidence:



Source: Federal Reserve Board/Bloomberg

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That's not proof, but it is not too hard to see why the New York Fed article would conclude with this answer to the WSJ's answer to the question "Did it Work?":

> "Early evidence suggests that the swap lines were successful in smoothing disruptions in overseas dollar funding markets. Swap line announcements and operations were associated with improved conditions in these markets: Although measures of dollar funding pressures remained high throughout the crisis period, they tended to moderate following large increases in dollars lent under the swap line program. Moreover, the sharp decline in swap line usage as the crisis ebbed suggests that the pricing of funds offered through swap lines gave institutions an incentive to return to private sources of funding as market conditions improved."

You can find more information about the Federal Reserve's previous swap facilities **here**.

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May 11, 2010 in Federal Reserve and Monetary Policy, Financial System | Permalink