Central bank measures to alleviate foreign currency funding shortages

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What had been mainly a US dollar liquidity problem for European banks turned into a broader phenomenon in September 2008. The seizing-up of money markets in the second half of September and early October rendered it exceptionally difficult to obtain US dollar funding in both uncollateralised and collateralised markets. Banks in emerging markets, which had until then been relatively little affected by the strains in the dollar money markets, also became embroiled in funding shortages. Moreover, these shortages were no longer in US dollars only. Some financial institutions with foreign currency liabilities in euros and Swiss francs also faced similar funding difficulties.

The spreading of foreign currency shortages has led to a variety of central bank responses. There are three main ways for a central bank to provide foreign currency funding to its counterparties. It can mobilise its existing foreign exchange reserves; it can use foreign exchange borrowed from the market; and it can use foreign funds borrowed from another central bank, including the central bank of issue.[1] All three options have precedents, but in the current financial crisis, the first and the last have been more widely used.[2] In particular, borrowing from another central bank under swap or collateralised lending arrangements may be preferred when there are insufficient foreign reserves in the needed currency, when there is unwillingness to dip into existing foreign reserves, or when there is concern that selling less liquid foreign reserve assets might reinforce negative market dynamics. Moreover, as illustrated by recent events, the desire to demonstrate a cooperative approach to the problem is also a strong reason for engaging in intercentral bank arrangements instead of - or in addition to - using one's own foreign reserves.

Inter-central bank swap lines and collateralised lending

The use of inter-central bank swap lines - most notably those with the Federal Reserve - has received much attention.[3] This is not only because the crisis originated in the dollar market, but also because the swap lines expanded considerably in both scale and scope over the past year (see the table). Between December 2007 and mid-September 2008, only the ECB and the Swiss National Bank (SNB) used swap lines with the Federal Reserve to deliver US dollar funds to their counterparties, complementing the Federal Reserve's Term Auction Facility. These two transatlantic swap lines had been increased in size over time to support larger dollar operations. With the intensification and spread of US dollar shortages in mid-September, swap lines with the Federal Reserve grew in number (from two to 14 by late October), time zone and geographical coverage (from one continent to five), and size. In particular, the maximum limits for the SNB, ECB, Bank of England and Bank of Japan were lifted in mid-October to allow them to conduct full-allotment US dollar operations at fixed rates. The range of US dollar distribution operations on offer at partner central banks also roadened from mainly longer-term (one- and three-month) offers to include one week and, for a period, overnight[4] offers as well, and from mainly repos and collateralised loans to include FX swaps.

There are also arrangements in euros and Swiss francs, albeit on a more regional basis. In
May 2008, the central banks of Sweden, Norway and Denmark announced an agreement to swap euros for Icelandic krónur with the Central Bank of Iceland. In October 2008, the ECB and the SNB entered into a swap arrangement to facilitate the distribution of Swiss franc funding in the euro area, particularly to smaller banks that did not have direct access to SNB market operations. In the same month, the ECB established a swap line with the National Bank of Denmark to support the latter's efforts to improve liquidity in euro short-term

markets and agreed to provide euros to Magyar Nemzeti Bank of Hungary via a repo agreement. In November, the SNB and the ECB concluded Swiss franc- and euro-supplying agreements, respectively, with the National Bank of Poland.

A number of these arrangements, though publicly announced, have not been drawn upon. This suggests that these arrangements signal precaution and the availability of a backstop, rather than an immediate need for actual external financial support.

Drawing on existing foreign reserves

Central banks have also deployed their existing foreign reserves to alleviate foreign currency shortages. Since the onset of the more acute phase of the financial turmoil in mid-September 2008, most major emerging market central banks have conducted outright sales of foreign reserves to help meet the local market's demand for foreign currency funding, as well as to relieve pressure on the exchange rate.[5] In addition, some central banks have sought to offer foreign reserves to counterparties under repurchase agreements (eg Brazil, the Philippines). A complementary method is to conduct foreign currency-providing FX swap transactions with counterparties. For central banks that have long counted FX swaps among their normal money market operations (eg Australia), this method constitutes only an extension of purpose of an existing tool and does not require a new tool. Some central banks have announced modifications (eg widening of counterparty eligibility, extension of term) to their existing FX swap facilities to make the distribution of foreign currency more efficient and flexible (eg Korea, Indonesia). Others have set up new swap facilities (eg Brazil, Chile, Poland) or announced their readiness to conduct swaps with counterparties as needed (eg Hong Kong SAR). Moreover, some central banks also stand ready to be on both sides of FX swap transactions (eg Hungary), helping to ameliorate counterparty credit concerns.

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[1] In some cases, such borrowing may be done in conjunction with other official financial assistance, such as that from the IMF.
[2] Apart from injecting foreign exchange, a central bank can also use other measures, such as changing the reserve requirement framework, to improve the availability of foreign currency funds in the financial system.

[3] Swap lines are by no means a novel policy option, though historically they have been used to support foreign exchange market interventions rather than to alleviate foreign currency funding difficulties.

[4] The daily overnight dollar auctions offered by the ECB, the SNB and the Bank of England between mid-September and mid-November 2008 (mid-October for the ECB) aimed specifically at alleviating dollar shortages early in the European trading day.

[5] With the usual dollar funding channels (borrowing and FX swap market) impaired, many firms reportedly turned to the spot market to purchase dollars, resulting in sharp depreciations of the local currencies.

Announced inter-central bank arrangements[1]

Partners	First announced	Max amount	Drawn	Supported operations[2]
Federal Reserve providing USD:				
Swiss National Bank	12 Dec 07	–	Yes	1M, 3M, 1W
European Central bank	12 Dec 07	–	Yes	1M, 3M, 1W; and FX swaps
Bank of England	18 Sep 08	–	Yes	1M, 3M, 1W
Bank of Japan	18 Sep 08	–	Yes	1M, 3M
Bank of Canada	18 Sep 08	$30 bn		–
Reserve Bank of Australia	24 Sep 08	$30 bn	Yes	1M, 3M
Sveriges Riksbank	24 Sep 08	$30 bn	Yes	1M, 3M
National Bank of Denmark	24 Sep 08	$15 bn	Yes	1M, 3M
Central Bank of Norway	24 Sep 08	$15 bn	Yes	1M, 3M
Reserve Bank of New Zealand	28 Oct 08	$15 bn		–
Central Bank of Brazil	29 Oct 08	$30 bn		–
Bank of Mexico	29 Oct 08	$30 bn		–
Bank of Korea	29 Oct 08	$30 bn		–
Monetary Authority of Singapore	29 Oct 08	$30 bn		–
Swiss National Bank providing CHF:				
European Central Bank	15 Oct 08	–	Yes	FX swaps; 1W, 3M
National Bank of Poland	07 Nov 08	–	Yes	FX swaps; 1W, 3M
ECB providing EUR:				
Magyar Nemzeti Bank	16 Oct 08	€5 bn[3]	–	O/N FX swap[4]
National Bank of Denmark	27 Oct 08	€12 bn	Yes	1M, 3M[5]
National Bank of Poland	21 Nov 08	€10 bn[3]	–	–
Nordic central banks providing EUR:				
Central Bank of Iceland	16 May 08	€1.5 bn	Yes	–

[1] Information as of 21 November 2008; refer to swap lines, unless otherwise indicated; – indicates not specified. [2] Refer to operations for distributing foreign currency to counterparties (not the inter-central bank transactions). Central banks may have other foreign currency-supplying facilities that draw on existing foreign reserves. Repo or collateralised loans, unless otherwise indicated. 1M = one-month; 3M = three-month; 1W = one-week; O/N = overnight. [3] Based on repo agreement. [4] A standing facility was announced but its usage is confidential. [5] A three-month auction is planned for 10 December 2008.

Source: Central banks.

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