

Thomas Jordan: International money market disruptions, central bank reactions and lessons learnt

Introductory remarks by Mr Thomas Jordan, Member of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 13 December 2007.

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As early as the first half of 2007, turbulence could be observed now and then on international financial markets. However, each event was isolated and short-lived. In the second half of 2007, there was a fundamental change in the situation. The sub-prime mortgage crisis in the US had a substantial impact on international financial markets, the extent of which had never been anticipated. I will cover three areas in my following remarks. First, I will discuss the upheaval on the international money markets. Then I will talk about the reaction of central banks, in particular that of the Swiss National Bank. Finally, I will outline some of the lessons learnt from this crisis to date.

Serious disruptions on international money markets

At the beginning of August, the US sub-prime mortgage crisis spread like a shock wave into the money markets of the most important currencies. In doing so, it hit the vital nerve of the international financial system. Well functioning money markets are essential in ensuring that financial market participants can adjust their liquidity positions. Ultimately, they are crucial for banks' solvency and long-term commercial viability. With attention focused on money markets, the spotlight also fell upon central banks who implement their monetary policy in money markets by influencing the level of interest, via the supply of liquidity. Moreover, the central banks are the only market participants who are in a position to create the liquidity used in the interbank payment systems.

The kind of upheaval observed in the international money markets over the past few months has never been witnessed in living history. Rumours and reports of substantial sub-prime positions at banks led to a sudden loss of confidence in international financial institutions. Moreover, these banks are, to some extent, uncertain about their own future liquidity situation. Consequently, banks subsequently began hoarding liquidity and became extremely cautious when granting credit to each another. The market for unsecured interbank loans over longer terms collapsed and at times the market for foreign exchange swaps dried up. Since then, banks have been unable to obtain unsecured funds for terms of more than a few days or weeks – or have been able to do so only by paying substantial interest premiums.

There were three factors that exacerbated the money market disruptions. First, bank securities holdings that had supposedly been first class and liquid proved to be illiquid, thereby failing to serve as a source of supplementary liquidity. Second, other participants in the financial markets also faltered in their supply of liquidity to the banks. Their confidence in banks suffered because money market investments that had been considered safe suddenly turned out to be risky. This led to the third exacerbating factor: Instead of helping the situation, off-balance sheet investment vehicles established by the banks made it far worse. Suddenly, these investment companies could no longer refinance themselves in the market and the banks were therefore forced to inject their own liquidity.

Initially, the liquidity bottleneck manifested itself in the US dollar money market, above all. On the one hand, this was due to the fact that sub-prime losses and refinancing needs mainly affected US dollar positions. On the other, it was because liquidity hoarding also occurred chiefly in US dollars. US dollar liquidity was particularly tight for European banks. Thus

tensions spread rapidly from the dollar money market to the euro money market, but also to the Swiss franc money market. The extent of the upheaval on these three money markets can be seen in graph 1 which shows the path of risk premiums, using three-month funds as an example. Before the crisis, these risk premiums were almost negligible. They now amount to between 50 and 100 basis points, depending on the currency. The graph also shows that, so far, the crisis has moved forward in two waves. After normalising to some extent in October, the situation became increasingly tense from mid-November onwards, after more bank losses had been reported.

Stabilisation by central banks

The turbulence on the money market is challenging central banks. Although the way in which they steer their individual money markets differs, ultimately they provide just the amount of liquidity that is necessary to maintain the key monetary policy rate at the targeted level.

The SNB reacted rapidly, and was the very first central bank to provide additional liquidity, which it did on 9 August, by means of fine-tuning measures. In the course of the following days, we continued to provide the banking system with generous supplies of funds as part of our regular auction procedure. In this way, we succeeded in rapidly defusing tensions on the call money market. Since then, we have been carrying out fine-tuning measures on a consistent basis, in order to dampen sharp fluctuations in the call money rate in either direction. This has allowed us to stabilise the very short-term Swiss franc money market.

However, we were unable to prevent risk premiums in interbank business from rising, since this is largely independent of our measures. As can be seen in graph 2, the three-month Swiss franc Libor had risen to 2.90% by mid-September 2007, which was substantially above the level targeted by us. By international standards, however, the increase in Libor was minimal. Our monetary policy decision of 13 September was aimed at further calming the Swiss franc money market, by bringing the three-month Libor back down to around 2.75%. With this in mind, we made funds available to banks for a term of three months. We did this from the day of the monetary policy assessment onwards. It was the first time we had done so since the introduction of the repo as a monetary policy instrument. At the same time, we undertook a significant reduction in the repo rate used for our transactions. Our aim was to compensate the higher risk premiums through a lower repo rate, and to move the three-month Libor back into the middle of the target range. The desired reaction ensued within a few days and the three-month Libor stabilised at 2.75%. We thereby neutralised the monetary policy impact of the higher risk premium. As announced a short while ago, we will also be supplying the market with ample liquidity as we approach the end of the year, and will be conducting longer term repo transactions with this in mind.

At the operational level, steering the three-month Libor proved to be a challenge, due to the high and fluctuating level of the risk premium. Simultaneously, the benefits of our operational flexibility became very clear. Since we are generally present in the market on a daily basis with short-term repo transactions, we were in a position to adjust liquidity measures to individual market conditions. Over the past few months, we have made consistent use of this flexibility; first, by providing the banking system with generous amounts of seven-day money, gradually lowering the repo rates as we did so, and second, by absorbing liquidity that was no longer required as soon as the call money rate declined. In this way, it was possible to retain overall liquidity in the bank system at an appropriate level. As you will see in graph 3, the average level of bank sight deposits changed very little throughout the year, if we compare each minimum reserve period with the next.

Our other operational processes have also stood up well in the turmoil of the past few months. Payment transactions carried out between banks in the SIC system ran smoothly at all times, although banks have made greater use of SNB intraday loan facilities. In order to bridge liquidity bottlenecks at the end of the day, the National Bank provides a liquidity-shortage financing facility to banks. This allows them to obtain liquidity on a temporary basis

when needed, provided they have a limit with the SNB and provided this limit is continually covered with eligible securities. The continual coverage of the limits ensures that the banks have access to a liquidity cushion, even in critical situations. Actual use of the limits is generally restrained, and this has also been the case in recent months.

Lessons learnt

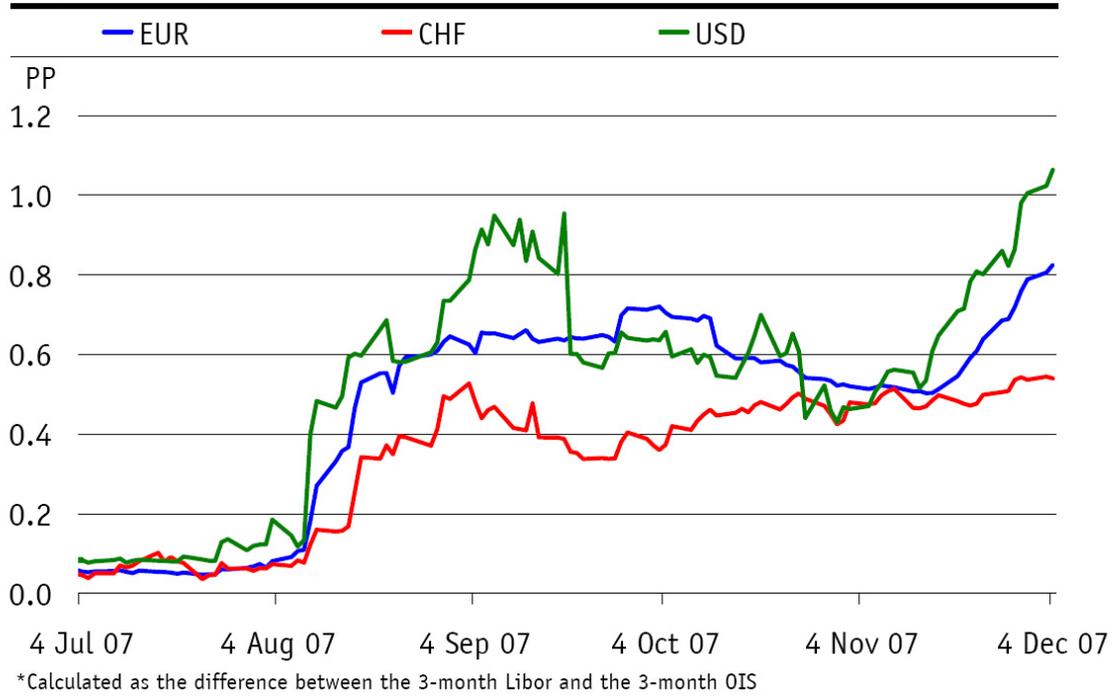
I would like to draw your attention to some of the lessons that we have already learnt from the current crisis. I will mention four points. First, the worldwide money market upheaval clearly shows how highly integrated international financial markets are today. Local crises can spread around the globe in a flash. The money market crisis is unlikely to have been overcome yet. Confidence among financial market participants remains insufficient. The pressure on participants who are still only able to refinance themselves in the market on a very short-term basis remains high. As long as uncertainty with respect to the scope of the credit problems exists, the disruptions on the money market are likely to persist.

Second, the central banks have played a fundamental role in calming and stabilising the money markets through close consultation and targeted operations. The SNB reacted rapidly to the tensions in the Swiss franc money market. The flexibility of our monetary policy instruments demonstrated its value in this difficult setting. Above all, short-term interest rates calmed as a result of the measures taken. The difficulties in bank refinancing over longer terms and the rise in risk premiums in the money market came about through the loss of confidence. Central banks can not compensate this lack of confidence simply by injecting additional liquidity. On the contrary, the financial market participants themselves must take the fundamental steps needed to restore this confidence.

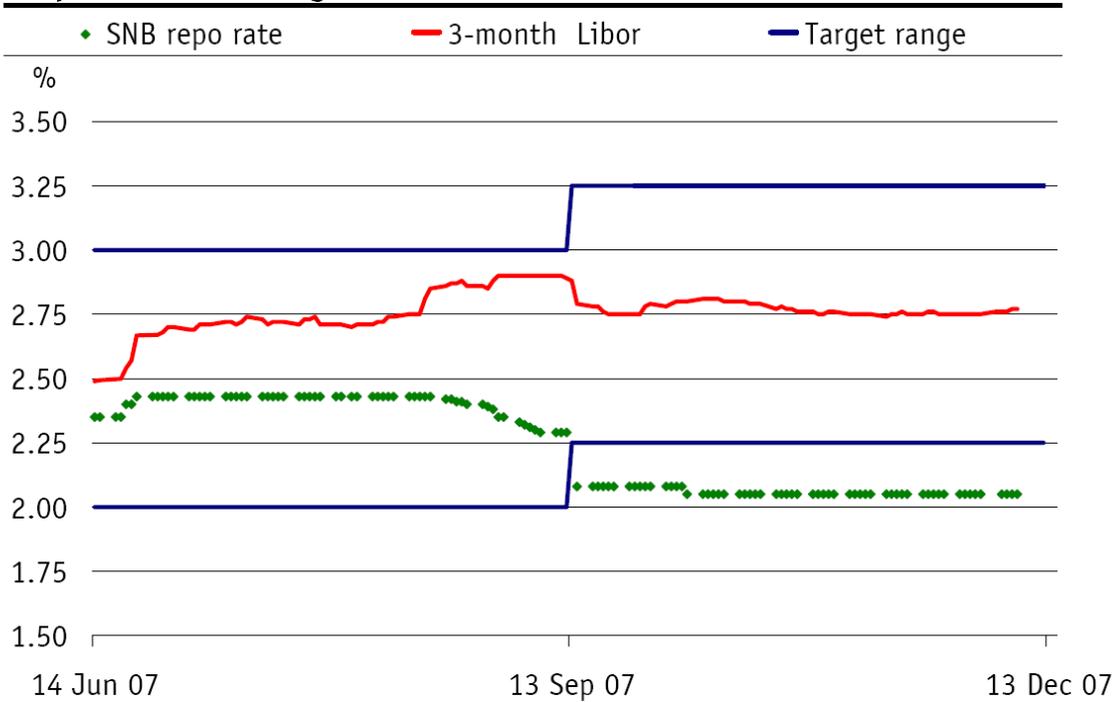
Third, the crisis in the money market once again clearly demonstrates that liquidity management is a core task of each and every bank, falling within the direct accountability of bank executive management. Liquidity provisioning must begin in good times. It is critical that sufficient liquid assets be held. Only first-class securities are suitable for this purpose. These can be sold in the markets or mobilised via repo transactions, even in difficult conditions. In an acute crisis situation, the availability of sufficient liquidity, together with a strong equity position, is absolutely crucial.

Fourth and finally, I would like to mention that, in the Swiss franc money market, repo business via the Swiss Value Chain has proved to be a crisis-resistant source of liquidity, thanks to the consistent minimisation of risks. The repo market allows participants to undertake rapid refinancing in the interbank market, independent of credit limits, thereby making a major contribution to the stability of the financial system. That is why it is important for the SNB that all Swiss and foreign banks operating in the Swiss franc money market join the Swiss repo system.

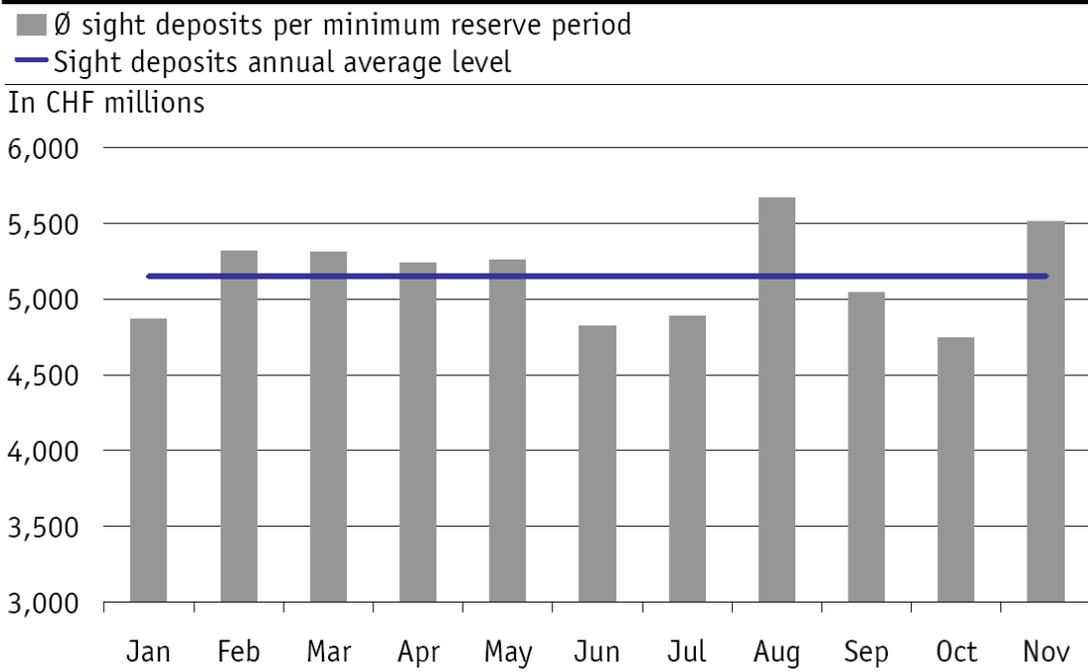
Graph 1: Risk premiums*



Graph 2: Libor steering



Graph 3: Banks' sight deposits in 2007*



*The month indicated refers to the end of the minimum reserve period.