Economic SYNOPSES
short essays and reports on the economic issues of the day

2005 ■ Number 1

Open Mouth Operations: A Swiss Case Study

Michael J. Dueker and Andreas Fischer

Nearly all central banks, other than those that peg an exchange rate, now explicitly communicate policy changes through an announced target level for a short-term interest rate. Notably, in 1999, the Swiss National Bank replaced its monetary base target with an operating target for the 3-month Swiss franc interbank lending (LIBOR) rate that the central bank adjusts as part of its strategy to maintain price stability. One question that has arisen with interest rate targets is whether a central bank can cause the interest rate to move simply by expressing its intention to establish a new target level—so-called open *mouth* operations—or whether transactions of securities in the central bank's portfolio—open *market* operations—are necessary to initiate a shift in interest rates. (See Thornton, 2004, for such a study of U.S. monetary policy in the 1970s.[1])

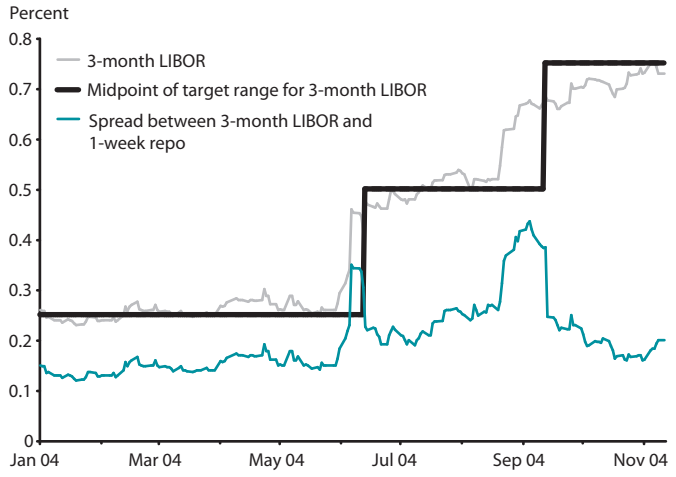
A narrow definition of open mouth operations concerns the ability of the central bank to achieve changes in its target interest rate without corresponding open market operations. A broader definition of open mouth operations, however, would include the proposition that the central bank can alter the slope of the yield curve at the very short end (at maturities between the overnight rate and 3 months, for example) through an announcement regarding a target rate change. Here we consider such a case study from the Swiss money market.

The Swiss National Bank targets the 3-month Swiss LIBOR rate, but it seeks to affect that rate by entering into securities repurchase (repo) agreements with commercial banks. The typical maturity of a repo agreement is a week and the typical spread between the 3-month LIBOR rate and the 1-week repo rate is approximately 15 basis points. Twice in 2004, the Swiss National Bank raised its target range for the Swiss LIBOR rate by 25 basis points. The midpoint of the target range is shown on the accompanying chart.

The market anticipated the first target change, which accounts for the preceding spike in the LIBOR-repo rate spread in June 2004. Nevertheless, money market participants did not appear to realize that the Swiss National Bank sought to implement the smallest initial rise in the repo rate that would achieve their new target for the LIBOR. The fact that the 3-month Swiss LIBOR rate immediately rose by the full 25 basis points, while the repo rate rose by only about 15 basis points, suggests that the Swiss National Bank used open mouth operations to increase the rate spread above its usual level of 15 basis points. By the time of the second target change in September 2004, however, the Swiss National Bank did not achieve its objective of raising the Swiss LIBOR rate by 25 basis points (to a level of 75 basis points) until it had raised the repo rate to a level of approximately 60 basis points—that is, not until the typical rate spread of about 15 basis points was restored. Together, these two episodes suggest that policy announcements—open mouth operations—*can* cause rate spreads to deviate temporarily from their expected levels, although not necessarily on a regular basis or for an extended period of time. ■

[1]Thornton, Daniel L. "The Fed and Short-term Interest Rates: Is It Open Market Operations, Open Mouth or Interest Rate Smoothing." *Journal of Banking and Finance*, March 2004, *28*, pp. 475-98.

Swiss Money Market Rates



Views expressed do not necessarily reflect official positions of the Federal Reserve System.