



Currency Swap Arrangement

Historical Perspective

The current international monetary system is characterized by the dominance of the US dollar as an international reserve currency and the prevalence of the de-facto dollar standard. In fact, the US, compared with its two competitors Europe and Japan, has the deepest and widest financial market in the world. To correct the long lasting global imbalance, the world need to reform the current international financial architecture through currency diversification. While the euro has already become a competitor to the dollar, the Chinese Renminbi is hoping to become another, given the fact that China has become the second largest economy. A greater use of Renminbi internationally will be a balancing factor in global financial stability.

What is Currency Swap?

The currency swap is a foreign exchange agreement between the two banks to exchange the equal net present value principal of a loan denominated in a different currency at a determined time, and pay the interest corresponding to each currency.

- The currency swap arrangement is a bilateral financial transaction, all terms and conditions apply equally to both countries and the pricing is based on standard market benchmarks, which are widely acceptable in the respective domestic markets.
- Such agreements give central banks access to each other's currency but commercial banks still need to create systems to issue letters of credit and handle other transactions in those currencies before companies can use them.

Pakistan China Currency Swap Arrangement

- This is the second currency swap agreement that Government had signed with any country. Earlier, Pakistan and Turkey inked a similar arrangement with an option to trade in each other's currencies equivalent to \$1 billion.



- The swap agreement amounts to Chinese Yuan (CNY) 10 billion (\$1.62bn) and Rs140 billion (\$1.45bn) and has been operative from May 7th, 2013.
- Under this agreement, the Pakistani importers will settle their letters of credits in Pak rupee instead of dollars in the Chinese banks and vice versa.
- In order to ensure transparency in determination of market interest rates, the SBP has decided to conduct competitive auctions of CNY loan facility.
- The CSA will give a positive signal to the market on the availability of liquidity of other country's currency in the onshore market.
- Based on the participation of banks in the auction, SBP will draw on the swap line and provide CNY to banks in Pakistan. Banks will lend this liquidity to importers/ exporters involved in trade denominated in CNY.
- At maturity, the importer/exporter will repay the foreign currency to the lending bank, which in turn will repay to the respective central bank.

Benefits of Currency Swap to Pakistan & China

- Currency swap means that more foreign trade and financial transactions would be invoiced and settled in CNY and Pak rupees. Hence, the exchange rate risk would be reduced accordingly.
- The risks associated with foreign currency denominated loans/funds would be reduced.
- CSA would improve the funding efficiency of both countries financial institutions, thereby greatly increasing their international competitiveness which in turn would cause the expansion of financial service sector of both countries.
- The cross border flows of both currencies brought about by real economic activities such as cross border trade & travel could provide an effective settlement method in bilateral transactions. Currency swap would help both countries to preserve the value of their foreign exchange reserves.
- This arrangement would mitigate the dominant monopolistic role of US dollar in our foreign transactions. If this arrangement is succeeded eventually it can lead to the introduction of single Asian currency like euro.

Advantages of Internationalization of Renminbi to China



1. Internationalization of Renminbi would stimulate the development of direct finance by increasing its private usages in bonds and other debt securities and equity markets which would bring about a quicker adjustment of market interest rate to the changes in official interest rate.
2. Internationalization of Renminbi would stimulate arbitrage activities in response to monetary policy changes. In the case of monetary tightening, an interest rate hike would cause currency appreciation.
3. Internationalization of Renminbi would result in currency substitution and an increase in Renminbi deposits in third countries.
4. The rapid growth of FDI has become the most prominent factor in China's integration with global financial markets.
5. China had already signed currency swap agreements with Japan, Korea, Thailand, Malaysia, Philippines, Indonesia, Hong Kong and Belarus.

Concerns of Pakistani business community over CSA

- Some businessmen and economists suspect that China may later convert the arrangement into a loan and may charge mark up at a rate more than the Shanghai Inter-Bank Market Rate.
- China has also declined to buy Pakistan Treasury Bills with swap money which is also a sign of interrogation over the efficacy of CSA.