The international monetary system as a swap nexus

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Executive summary

Since the end of 2007, local currency swaps between central banks have emerged as a de facto key feature of the international monetary system. This trend was confirmed and amplified in the recent months with (i) the signing of two such agreements between the People’s Bank of China and the Bank of England (BOE), on the one hand, and the European Central Banks (ECB), on the other hand. The ECB and the BOE stated explicitly that, should the need arise, the Chinese RMB provided to them by these swaps could be lent to domestic commercial banks and (ii) the little noticed decision announced by six major western central banks, including the US Federal Reserve, on October 31st 2013 to make permanent the previously temporary swap lines among themselves. Central banks swaps have no conditionality and they can be put in place very easily. They provided much needed relief during the recent financial crisis. They are also more precarious than alternative institutional arrangements such as the IMF or the regional financial agreements. In 2010, Korea failed to include central banks swaps in a global safety net arrangement and it is likely that any attempt to constrain them at an international level will face insuperable hostility from key players who want to keep their discretionary power to enter or not into such agreements. This paper advocates in favor of a more modest approach which would result in the G20 proclaiming a set of principles regarding the transparency, the predictability and a non discriminatory approach to these swaps.

1. Central bank swaps developed quickly out of the IMF umbrella

We are celebrating next year the 70th anniversary of the Bretton Woods agreements which led to the setting up of the International Monetary Fund and a managed international exchange rate regime based on the domination of the US dollar and the convertibility (for
central banks only) of the latter into gold at a fixed price of USD 35 an ounce. In 1971, President Nixon suspended the convertibility. As the authors of a recent working paper put it ‘The end of the Gold Standard in 1971 and the economic shakeup created by the oil shock in 1973-74’ led to the creation of regional arrangements in Europe, South-East-Asia, Latin America and among Arab countries. More than twenty years later, the Asian crisis of 1997-1998 and the controversial role that the IMF played in its management led to the setting up of the Chiang Mai Initiative in 2000.

This did not prevent, however, the US dollar from continuing to assert its domination over international financial transactions. This domination has not really been challenged by the successive rise of the Japanese Yen in the 80s, the Deustche Mark then the Euro, till the recent crisis.

The Chinese Yuan (or RMB) is now widely seen as a possible contender in a distant future but its rise is still recent and impeded by the remaining capital controls between Mainland China and the rest of the world. Since the end of the last decade, the pace of experimental capital control alleviations by the Chinese authorities has accelerated. The existence of an offshore variant of the Chinese currency, the offshore RMB or CNH, was made official and its use overseas was encouraged through a bunch of initiatives, beginning with the establishment of an official offshore RMB interbank market in Hong Kong. More recently, a pilot ‘Free Trade zone’ that is promised to be free of capital controls was announced in Shanghai.

One key aspect of the Chinese policy regarding the internationalization of its currency is the myriad of swap agreements that the Chinese central bank, the People’s Bank of China (PBOC), has signed with fellow central banks from other countries.

So far, the PBOC has 23 active local currency swap agreements (including the one with Hong Kong) amounting to a total of RMB 2.56 trillion or USD 420bn. The last in the row was announced on October 10th, 2013. It links the PBOC and the ECB and amounts to RMB 350bn (Euros 45bn). On June 22nd, 2013, the PBOC and the Bank of England had signed an agreement to establish a reciprocal 3-year, sterling/RMB currency swap line for a maximum amount of RMB 200bn.
Commentators often refer to these swaps as a symbolic exposure of central banks to a rising economy laying the ground for future more substantial monetary relations between China and the rest of the world\(^2\) and official communication by the Central Banks on these swaps has often been minimal with only their amount and the term of the agreement being made public and fuzzy justifications.\(^3\)

However a growing openness on the part of certain central banks is noticeable. Last June, Mervin King, the then governor of the Bank of England, stated that ‘In the unlikely event that a generalized shortage of offshore renminbi liquidity emerges, the Bank will have the capability to facilitate renminbi liquidity to eligible institutions in the UK. Similarly, the ECB press release which made public the swap agreement with the PBOC explicitly stated ‘From the perspective of the Eurosystem, the swap arrangement is intended to serve as a backstop liquidity facility and to reassure euro area banks of the continuous provision of Chinese yuan.’ A similar statement was made by the Monetary Authority of Singapore (MAS) on 8 March 2013.

Currency swaps between central banks on a large scale are recent. To our knowledge, prior to the recent financial crisis, they were solely used in Asia as a reserve pooling tool. The modest Asean Swap Agreement, first established on 5 August 1977 was included in 2000 in the Chiang Mai Initiative (CMI) which also included a network of bilateral swap arrangements (BSAs) among the ASEAN+3 countries. The main idea behind the initial CMI was to swap US dollar reserves with local currencies of the swap participants (Sussangkarn 2011). In December 2009, the CMI became the Chiang Mai Initiative Multilateralisation (CMIM) which consolidated the BSAs into a single swap contract and included the creation of a regional surveillance unit, the ASEAN + 3 Macroeconomic Research Office. The purpose of the CMIM remains to provide financial support in US Dollars, which is a currency that is not issued by the participating central banks (Joint Press Release 2009). The other regional agreements provide loans, credit lines and, in the case of Europe, interventions on the secondary debt market (Rhee 2013). The relatively large foreign exchange interventions mechanism that took place within the European Monetary System (EMS) in the 80s were financed by mutual credit lines between central banks (Giavazzi, 1988).

Another significant step was taken at the onset of the recent financial crisis, when the FED played the de facto role of global lender of last resort. Between December 12, 2007, and
October 29, 2008, the US Federal Reserve Board authorized temporary dollar liquidity swap arrangements with 14 foreign central banks. These arrangements, which bore no conditionality, expired on February 1, 2010. In May 2010, in response to the re-emergence of strains in short-term dollar funding markets, the dollar liquidity swap lines between the FED and five foreign central banks were reactivated through January 2011. The authorization for these lines was extended several times. On October 31st 2013, these six Central Banks decided to make these temporary swap lines permanent. This news was hardly noticed. The stated aim of these new facilities is to foster financial stability and they have no stated conditionality. Other foreign exchange swaps took place during the crisis not involving the Fed. The ECB’s were ‘extraordinary modest’ (Rhee 2013).

The International Monetary Fund was or is part to none of these transactions, neither through its balance sheet nor through its executive bodies. Neither is, to our knowledge, the Bank of International Settlement (BIS). The G20 leaders and the G20 ministers of finance and central bank governors have repeatedly call for ‘cooperation’ and a ‘flexible and voluntary dialogue’ between the IMF and Regional Financing Agreements’ (RFAs) presumably referring mostly to Europe and Asia. None of its communiqué mentioned PBOC’s or the FED’s swap agreements.

In this matter as in others, central banks can act creatively and swiftly. The easiness and the flexibility through which they generate and manage these swap agreements offer a stark contrast with the difficulties that the IMF is facing to adapt.

As it is well known, the IMF was not granted at its inception 70 years ago, the power to create an international currency. It must therefore balance its commitments with its external resources. The latter consists of Member States’ funding commitments, the so-called quotas, and Member States’ loans.

Whereas loans from Member states to the IMF have proven to be a flexible tool in order to quickly increase IMF’s funding at the peak of the crisis, the IMF quota increase that was decided at the Seoul Summit in October 2010 have not yet been ratified by the US Senate despite repeated calls from the international community, including every single meeting of the G20 leaders or ministers of finance and central bank governors ever since.
While strictly framing central banks swaps at an international level is probably neither desirable nor realistic, G20 issued soft law may be both useful and within reach.

Until recently, the development of swaps between central banks might have appeared to be the result of exceptional and temporary circumstances. Between 2007 and 2010, the Fed was keen to avoid taking risks on non-US commercial banks and, therefore, to transfer these risks to the central banks of the countries where the headquarters of these banks are located while, at the same time, it was willing to prevent a liquidity crisis on the Eurodollar interbank market.

For its part, China has undertaken a long march towards the internationalization of its currency while it deems that it is too early to remove its capital controls. In this respect, PBOCs swaps have a symbolic as well as a practical dimension. With capital controls strictly limiting foreign access to the Chinese debt market, the accumulation of official foreign exchange reserves in RMB is not possible. Swaps provide a — temporary and imperfect — substitute allowing central banks to get used to the management of RMB assets and to pro.

With the recent extension of PBOC’s swaps to major non-Asian central banks and the setting up of permanent swap facilities between major western (including Japan) central banks, one can wonder whether a new permanent feature of what is coined the ‘international monetary system’ is emerging: a decentralized network of freely agreed and revocable contracts among international currency issuers and between the latter and other central banks. Such an interpretation is all the more plausible that not only central bank creative thinking and action has been unleashed by the recent financial crisis, but ‘only central banks have the balance sheet leverage to respond to volatile capital flows on the necessary scale.’ (Truman 2013).

What are the likely consequences of this new feature?

First and foremost, it is doubtless that swap agreements between central banks provided much needed relief during the financial crisis (Goldberg 2010). In this respect, their very existence generates positive externalities in terms of financial stability. However, they do not include
surveillance and conditionality provisions as it is the case for IMF facilities or the recent and still to be tested Chiang Mai Initiative Multilateralisation (CMIM) Agreement. Making them permanent could potentially generate some sort of moral hazard.

Contracts between money creating institutions will always be a prompter way to adapt to an ever changing monetary and financial landscape than an international financial institution, whatever its intrinsic qualities. The IMF is more flexible in many respect than other international institutions, not least because it can sign borrowing agreements with member states (but it is not permitted to borrow on markets) and easily change its lending facilities and policies. However, the IMF remains an international institution. Any change to its Articles of Agreements, and in particular, to the quotas which are the basis for its core funding and the resulting voting rights require a long, complex and politically loaded ratification process.

On the other hand, contracts can quickly be reconsidered. Moreover, they give international currencies issuers, in particular the dominant one, the possibility to pick and chose their counterparties for reasons that are not necessarily the superior interest of the world’s monetary and financial stability. The interference of geopolitics can be even more important than in international institutions where the game is more collective.

Is there a need for further institutional design?

Since 1971, redesigning and re-establishing a centrally regulated international monetary system has proven to be too ambitious a project. The successive attempts lacked to reach a minimal consensus on an institutional design that would match the interests and meet the agreement of all key parties. In particular, the projects that would have given a greater role to the IMF, such as the creation of a substitution account under the auspices of the IMF in the 1970s or the ideas promoted by various Chinese and French authorities or academics during the recent financial crisis have fallen short.

Regional financial agreements may provide either an alternative or a complement. It is true that common denominators are less difficult to identify between the currencies of countries that belong to the same geographical area for proximity often fosters trade and financial relations. They contribute to the diversification and the multipolarization of the international
monetary transactions. Their scope will nevertheless remain limited as long as the main reserve currency issuer, that is the US, is not part to these agreements. Furthermore, regional institutions may suffer from similar rigidities to the IMF’s. It is therefore no panacea.7

Prior to the Seoul Summit, in November 2010, the Korean Presidency tried to devise a framework on global safety nets that encompassed these regional financial agreements as well as central bank swap agreements, which it proposed to institutionalize. Given the resistance it met, however, Korea shifted its focus to strengthening the IMF lending toolkit (Rhee 2013). Further work was done on RFAs, especially in the light of the IMFs experience with Europe and, since the Cannes summit in 2011, the G20 leaders and the G20 ministers of finance have focused the relationship between RFAs and the IMF. Currency swap agreements per se have, so far, never be mentioned in their statements.

Two recent papers advocate in favour of a coordination of central bank swaps at an international level. Ed Truman (2013) proposes the setting up of a global central banks swaps network with three keys to unlock it: the IMF, the central banks as a group and each pair of central banks. Rhee and his co-authors (2013) deem that the fact that

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\text{swap lines remains the guarded prerogative of national central banks [...]} \text{creates important risks for the system as a whole. [...] To limit those risks, there is a need for a real coordination effort of those bilateral swap lines into a globally coordinated, predictable and consistent framework [...]} \text{The BIS for instance could be an effective institution to play this coordinating role.}
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Any form of central bank swaps institutionalization would inevitably limit the prerogatives of national central banks. Therefore, any attempt to do so is likely to trigger a strong opposition from the latter especially from the countries that are in a position to provide reserve currencies to the rest of the world. Overcoming these resistances might be desirable but it does not seem very possible at least in the short and medium term.

Furthermore, the flexibility with which central banks can currently act is a very desirable feature for it allows them to act swiftly and tailor their support to the needs of each situation. The IMF has tried to devise such a framework
G20 soft law might be a more modest, yet perhaps a more realistic and effective way to encourage the emergence of an international public order in this field. In this respect, the G20 might be encouraged to work on a short set of desirable principles for these agreements. Subject to further discussion, such principles might include:

a. The creation (or, if it exists, the publication) of a repository of central bank swaps at the IMF or at the BIS;

b. Encouragements to prevent the unfair exclusion from the benefit of these swaps while at the same time acknowledging that barring some countries from them is legitimate (e.g. when they are sanctioned by the international community or when do not follow G20 approved policies such as the one on money laundering or tax evasion);

c. The idea that these swap agreements should have a minimum degree of stability over time, so that it helps make the international financial environment predictable;

d. Since these swaps are ultimately meant at providing foreign currencies to commercial banks through their domestic central banks, these agreements might be used as a lever to promote international standards which aim at improving the financial soundness of banks, such as Basel III.

**Conclusion**

Whereas the IMF is limited by its institutional constraints and the regional financial agreements are limited by their own geographical, institutional and policy constraints, currency swaps between central banks are playing a growing role as a financial instrument to allay or prevent financial instability but also as a strategic tool to assert the role of current or aspiring global currencies issuers. They are quickly becoming a key layer of a ‘multi-layered global safety net’ (Rana 2012) where the key players are the issuers of the reserve currencies. In a theoretical world, this situation might not be optimal for it gives the global issuers the possibility to deprive the access to international liquidities on non-economic grounds and to arbitrage between their own interest and the superior interest of the world’s financial stability. As far as the international monetary system is concerned, there is always the risk that aiming to reach the first best leads to a deadlock. In this respect, central bank currency swaps can
positively contribute to a second best situation provided that core principles are clearly stated and, hopefully, implemented.

Notes

1 I am indebted to my colleagues from CEPII, in particular Agnes Chevallier, Sebastien Jean and Urszula Szczezrowicz for their very useful comments. Of course, I am solely responsible for the content of this paper.

2 See for example, “People's Bank of China in swap deal with European Central Bank”, South China Morning Post, Friday, 11 October, 2013.

3 Standard sentences are used such as “The two sides believe that this renewed arrangement will help promote investment and trade between the two countries and safeguard regional financial stability.” or “For the purpose of promoting bilateral financial cooperation, facilitating bilateral trade and investment, and safeguarding regional financial stability” see Siregar 2013 Table 3 pp. 8-9.

4 The Federal Reserve established swap arrangements with the Reserve Bank of Australia, the Banco Central do Brasil, the Bank of Canada, Danmarks Nationalbank, the Bank of England, the European Central Bank, the Bank of Japan, the Bank of Korea, the Banco de Mexico, the Reserve Bank of New Zealand, the Norges Bank, the Monetary Authority of Singapore, the Sveriges Riksbank, and the Swiss National Bank.

5 The European Central Bank, the Bank of England, the Bank of Japan, the Bank of Canada and the Swiss National Bank.

6 It is interesting to note that it took roughly 60 years for the Eurodollar market to benefit from of a lender of last resort whereas the “EuroRMB” market enjoys such a comfort at its very inception.

7 The Regional Financial Agreements issue is extensively dealt with by the Rhee and his co-authors (2013).

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