
Prelims and Mains focus: about the currency swap agreement and its significance

News: Reserve Bank of India (RBI) governor made a case for international multilateral agencies like the International Monetary Fund (IMF) launching currency swaps for countries affected by the spread of COVID-19, also known as coronavirus.

Need

A swap line was critical from the point of view of preserving global financial stability. The global economy has been hit hard by COVID-19. According to IMF projections, the outbreak’s impact on the global economy will be 0.1 per cent and 0.4 per cent on the Chinese economy.

What is the benefit?

A coordinated swap line would act as a second line of defence to bolster national reserves across nations.

What is a currency swap agreement?

- The word swap means exchange. A currency swap between two countries is an agreement or contract to exchange currencies (of the two countries or any hard currency) with predetermined terms and conditions.

- Often the popular form of currency swap is between two central banks. Here, the main purpose of currency swap by a central bank like the RBI is to get the foreign currency form the issuing foreign central bank at the predetermined conditions (like exchange rate and the volume of currency) for the swap. Besides supporting the domestic currency and foreign exchange market, another main purpose of currency swap is to keep the value of the foreign exchange reserves kept with the central bank.
What is the purpose of currency swap?

- As mentioned, the main purpose of currency swaps is to avoid turbulence and other risks in the foreign exchange market and exchange rate. Central banks and governments engage in currency swaps with foreign counterparts to ensure adequate foreign currency during the time of foreign currency scarcity. Both works with the same objective and through similar mechanism.

- Often, the turbulence comes when a country faces scarcity of foreign currency which may lead to currency crisis and steep depreciation of the domestic currency. In such a scenario, if the central bank/government is able to get sizable foreign currency by exchanging domestic currency, it ensures availability of foreign currency. Hence the turbulence in the foreign exchange market or depreciation of the domestic currency/currency crisis can be avoided.

- Besides currency or exchange rate stability, currency swaps between governments also have supplementary objectives like promotion of bilateral trade, maintaining the value of foreign exchange reserves with the central bank and ensuring financial stability (protecting the health of the banking system).

- It is always desirable for a developing country like India to reach currency swap agreement with countries like USA/UK/EU/Japan whose currencies are hard currencies (used in international trade as medium of exchange).

- Currency swap agreement can be bilateral or multilateral. The earliest currency swap was between U.S. Federal Reserve and the Central Bank of France signed on February 28, 1962.

- Usually, currency swap agreements are of five types depending upon the nature and the status of the currencies swapped.

1) Exchange cash for cash vs cash for securities;
2) Exchange conditional vs unconditional swaps;

3) Exchange reserve currencies on both sides;

4) Exchange reserve currency for non-reserve currency; and

5) Exchange non-reserve currencies on both sides.