

Global Currencies During a Crisis: Swap Line Use Reveals the Crucial Ones



Global Currencies During a Crisis: Swap Line Use Reveals the Crucial Ones

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Abstract

The current crisis has confirmed the importance of the currency swap lines offered by the Federal Reserve. They enhance the role of the USD as the dominant global currency. However, one should not expect much impact on the international role of the euro when the ECB offers similar currency swap lines. Currency competition is not won by competing on the generosity of currency swap lines.

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LIST OF ABBREVIATIONS

BOJ	Bank of Japan
DM	Deutsche Mark
ECB	European Central Bank
OECD	Organisation for Economic Co-operation and Development
OIS	Overnight Index Swap
PBOC	People's Bank of China
UK	United Kingdom
US	United States
USD	United States dollar

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EXECUTIVE SUMMARY

- **Before the present crisis broke out earlier this year, the EU institutions, and in particular the Commission pushed the idea that the euro should have a stronger global role.**
- **This was based on political and economic grounds.** We discuss here only one specific aspect, namely currency swap lines.
- **One element which attracted attention was the observation that during the financial crisis of 2008-2009 the US Federal Reserve granted swap lines to a number of other central banks.** The purpose was to enable these partners to furnish their respective banking systems with dollar liquidity. These lines were heavily used (albeit only for a short time) and probably greatly attenuated the short-term dollar shortage, which had developed outside the US in 2008-2009 when US money markets temporarily ceased to function normally.
- **This episode seemed to show that providing other central banks with liquidity is one attribute of a global reserve currency.** We therefore consider the idea that the international use of the euro could be enhanced if the ECB establishes more swap lines by itself.
- **The ECB is part of a restricted network of major central banks which have unlimited swap lines among themselves** and it has over the last years also agreed to provide some other smaller central banks with swap lines in euro.
- **During the present crisis, the swap lines of the Federal Reserve have again been used extensively.** However, this has apparently not been the case for the (modest) swap lines the ECB has agreed to with some other national central banks in Europe (e.g. Denmark, Switzerland and the UK). There are also no reports of significant shortages of euro liquidity in other parts of the global financial system.
- **The basic conclusion is that the ECB establishing swap lines with as many other central banks as possible is not enough to foster the international role of the euro.** These lines will only be used if there is a real need. The current crisis has shown once again that the dollar remains the dominant reserve currency.
- **The same observation applies to another potential competitor to the USD, namely the renminbi.** The PBOC has also established an extensive network of currency swaps, but it seems that these have not been needed.
- **The broad conclusion is simple: establishing swap lines is in the self-interest of the home country of a currency that is already widely used internationally.** However, on their own, they should not be expected to contribute significantly to fostering the international use of the euro.

1. INTRODUCTION

The idea that a European currency could constitute a competitor to the USD, as the dominant global currency, has been around for a long time. It already played a role in the initial plans for the Economic and Monetary Union (EMU). More recently, the Commission published a communication with the programmatic title “Towards a Stronger International Role of the Euro”¹. Prominent members of the ECB have been somewhat less outspoken (e.g. Coeuré, 2019), but the general attitude seems also that a stronger international role for the euro would be welcome.

The underlying assumption of these pronouncements is that a stronger global role brings tangible economic benefits, or at least that the benefits outweigh the costs. Whether this is the case cannot be fully discussed in this short contribution.

Given the widespread crisis conditions that financial markets currently find themselves in, it might be more useful to concentrate on one specific aspect of the international use of currencies, namely the potential for cross-border liquidity shortages and how central banks deal with them: currency swaps.

A good starting point for the analysis is this passage from the communication of the Commission:

“In the aftermath of the financial crisis, the European Central Bank engaged with its counterparts to preserve financial stability and avoid disruptions in the world economy, for instance, with the establishment of a number of currency swap lines as a foreign liquidity backstop in case of market impairments, in line with its mandate. This practice has been beneficial for the global trading of European companies.” (European Commission, 2018).

The implicit message in this passage seems to be that establishing swap lines constitutes a useful step, with positive implications for European companies. As swap lines are intensively used once again, the present contribution will concentrate on this specific aspect of the international role of the euro.

Employing this limited scope, this contribution is organised as follows.

The next section briefly considers the present, limited, global role of the euro and the extent to which this role could expand given the size of the euro area economy (relative to that of the US). It also argues that the US might benefit less from the dominance of the dollar as a reserve currency than it is often assumed. Section 3 then turns to currency swaps among central banks to manage cross-border liquidity shortages in times of crises. It explains the nature of these swaps and shows that they have *de facto* been needed only for the USD. Section 4 concludes.

¹ European Commission (2018).

2. THE (LIMITED) GLOBAL ROLE OF THE EURO

This section takes a quick look at the limited global role of the euro. Moreover, it reviews very briefly why some of the arguments that an expanded international role of one country's currency yields benefits are less valid today.

2.1. Is there a large upside to the global role of the euro?

The annual reviews of the international role of the euro prepared by the ECB provide an exhaustive survey of the many different aspects of this issue.

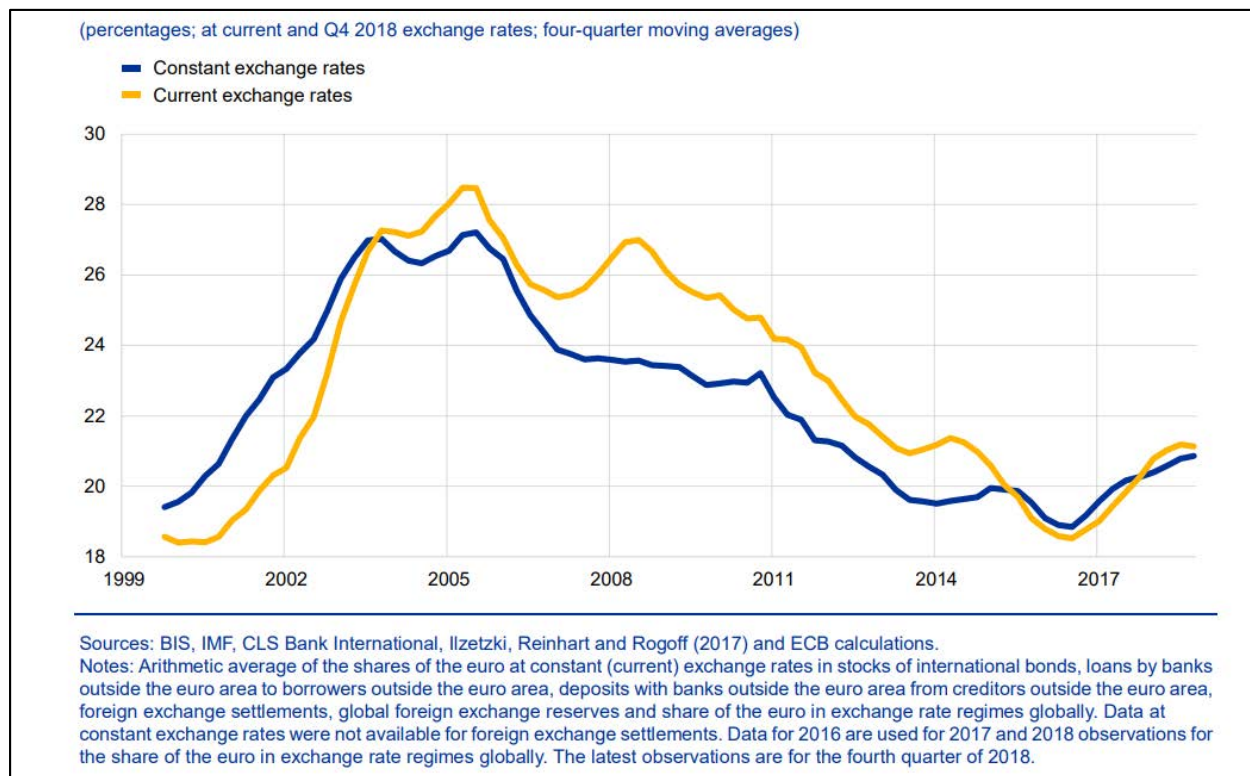
It is widely accepted that a number of factors contribute to the emergence of a global currency. Economic size is one factor, but developed financial and capital markets, confidence in the currency and a number of political factors (beyond the scope of this paper) also play a role. Space constraints do not allow us to take all these considerations into account. We concentrate here on one factor, namely economic size, which does not represent an absolute limit, but is one important element which should be taken into account.

Figures 1 and 2 provide two essential elements of the overall picture.

Figure 1 shows the evolution over time of a composite index of the international role of the euro. It is apparent that the euro started at about 20% at its creation. Its international role grew rapidly to almost 28% by 2005. This value marked a peak. It is interesting to note that the decline which set in after 2005 came several years before the great financial crisis and before the euro sovereign debt crisis of 2011-2012. More recently, there has been an uptick in the international role of the euro. It remains to be seen whether the COVID-19 crisis, with its renewed intra-euro area tensions, will lead to another decline, or whether the crisis leads to further integration which might foster the global role of the euro.

Exchange rate fluctuations influence this overall picture at times, but the broad trend is the same, regardless of whether one adjusts for this factor.

Figure 1: Composite index of the international role of the euro



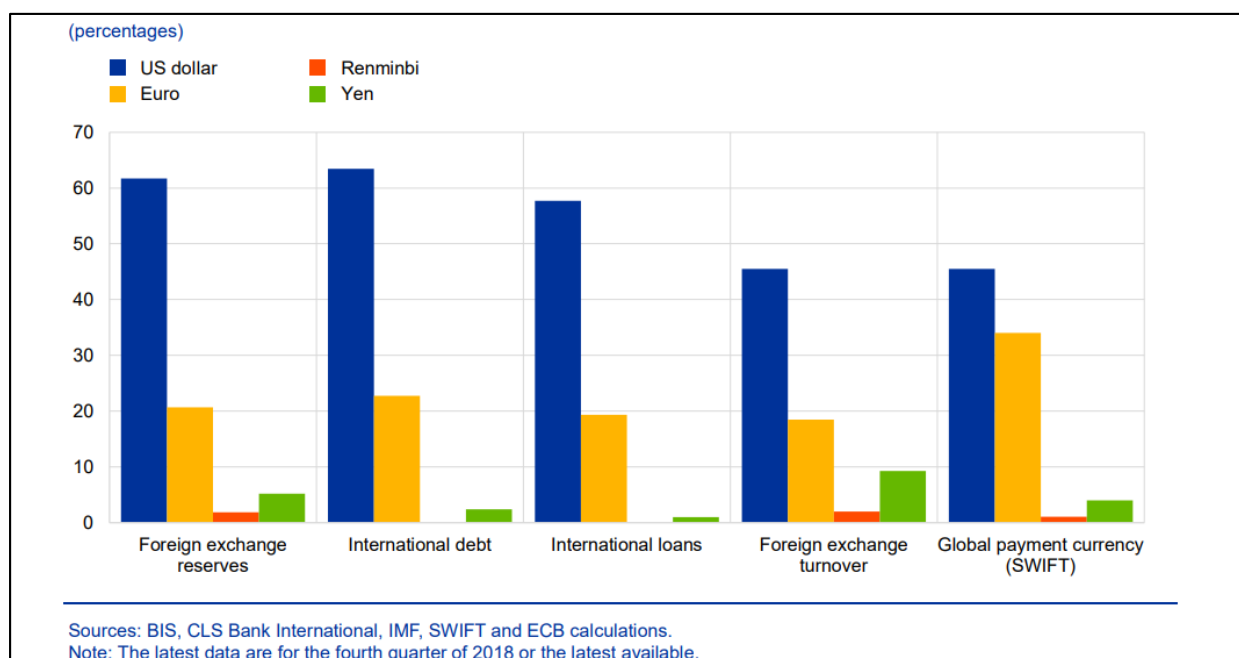
Source: ECB, 18th annual review of the international role of the euro, June 2019.

Figure 2 (also drawn from the ECB annual review) provides greater detail of the elements that make up the composite indicator, namely three stock variables and two flow variables. The stock variables are the share in foreign exchange reserves, in international loans and in international (marketable) debt instruments. The flow, or activity, variables refer to foreign exchange turnover and cross-border payments.

For the three stock variables, the share of the euro is about a third of that the US dollar. This would suggest a very large imbalance. However, one has to keep in mind that, at current exchange rates, the GDP of the euro area is only about 60% of that of the US. This implies that about one half of the relative difference could be explained by the difference in economic size.

In terms of the transactions variables, e.g. foreign exchange turnover and global payments, the difference between the share of the USD and that of the euro is much smaller, as one would expect, given that total trade turnover of the euro area (exports plus imports) is about the same as that of the US.

Figure 2: Currency use within the international monetary system



Source: ECB, 18th annual review of the international role of the euro, June 2019.

This extremely cursory examination of the raw data suggests that there probably is indeed some room for increasing the international role of the euro. However, the extent to which the euro could expand its international status relative to the US dollar may be more limited than implied by the facile view that the euro and the USD should be considered competitors of equal size.

We leave aside the obvious consideration that the continued dominance of the USD is of course not guaranteed forever. For example, the renminbi might become more attractive, relative to both the USD and the euro as a reserve currency. Over time, the size of the Chinese economy is likely to increase (at current exchange rates, it is already larger than that of the euro area), becoming much larger than that of the US. Investing reserves in renminbi might become more attractive if China's domestic capital market also evolves in terms of openness, reliability and liquidity. Moreover, the US is accumulating huge public and foreign debt given its long-standing pattern of substantial current account deficits. In the long-term, a switch out of the USD is thus a distinct possibility.

Recent research (Eichengreen et al. 2019, foreshadowed in Eichengreen 2005) has discredited the idea that there can be only one dominant reserve currency. The emergence of a credible alternative to the USD should thus, *per se*, not be viewed as a source of instability. However, the experience of Great Britain after the war shows that a combination of a loss of reserve currency status and domestic weakness can lead to considerable difficulties. The US has already a public debt to GDP ratio of close to 100% and has been running a current account deficit for more than two decades. The public sector deficit currently projected is 15% of GDP. Moreover, if the external current account deficit were to stay at its present level of 3% of GDP (and if the growth rate of nominal GDP were to remain about 5%), the US would over time accumulate a foreign debt of about 60% of its GDP. This is slightly more than the upper thresholds which Eichengreen et al. (2017) consider acceptable for a solid reserve currency.

Instability of the US external and fiscal position, possibly associated with inflation risk premia, would likely affect the dominance of the USD also in other domains than simply foreign exchange reserves.

Investors would probably prefer more stable currencies and international banks would also reduce their holdings of USD in this case.

These brief considerations show that the dominance of the USD dollar is not ensured. But this also applies to the rather limited role of the euro today. There is certainly some upside for the international use of the euro from completing the Banking Union and the Capital Markets Union or creating a European 'safe asset' to provide international investors with a deeper menu of assets.

However, it would appear prudent not to expect too much from such measures. The euro would have to become much more attractive than the USD in other domains to overcome the size 'handicap' – at least if the aim is for the euro to become as important as the dollar.

2.2. The economics of a global currency: rethinking the benefits?

The data already suggest that the room to expand the international role of the euro is limited by the size of the euro area economy. The next question is whether one should expect large gains from any increase in the international role of the euro.

Based on Gros (2019), we provide only some limited considerations here.

One benefit, which used to be important, is supposed to derive from the widespread use of one's bank notes abroad. On this account, the euro has been a big success since currency in circulation has more than doubled (even as percentage of GDP) over the last 20 years, and it is widely estimated that a large fraction of euro cash is used abroad (ECB, 2017).

Issuing banknotes used to be a profitable business for central banks as they could invest the proceeds from their cash issuance in government bonds with a decent yield. The total value of euro bank notes in circulation now exceeds EUR 1 trillion. With interest rates at 5%, this would have meant a revenue stream of about EUR 50 billion per annum; small fry if compared to the overall euro area economy with a GDP of more than EUR 10 trillion, but equivalent to about one third of the EU's annual budget.

However, issuing currency is no longer a profitable business for central banks when interest rates turn negative, as explained by Gros (2016). The ECB has estimated (ECB, 2017) that about EUR 500 billion are held abroad. At a negative rate of 0.5%, this would imply a cost for the euro area of EUR 2.5 billion per annum. The amount is of course relatively negligible, but the key point is that it is a cost, not a benefit. In these conditions, any increase in the international use of euro cash only leads to higher costs.

The more lasting argument is what the French President Valéry Giscard d'Estaing used to call the 'exorbitant privilege' of the US. It is supposedly cheaper to issue debt in one's own currency because in this case the home country authorities might decide at any time to devalue the real value of the debt. However, the fact that the real value of the debt is under the control of the home country authorities is a double-edged sword: On the one hand, it protects against any liquidity problems because the national central bank could in a crisis just issue enough liquidity to ensure that all debt can be repaid in nominal value. On the other hand, this potential for a rescue in a debt crisis through money creation and inflation will be factored in by investors, who might then demand a risk premium.

The US might thus have enjoyed an 'exorbitant privilege' in the past, when its fiscal and external positions were strong. But 'this time is different'. The external position of the US remains weak and the debt to GDP level of the federal government might soon reach Italian proportions, making it more and more likely that investors will demand a substantial risk premium on USD-denominated debt.

Moreover, issuing debt to foreigners in its own currency is not a big advantage for the euro area, which sits on a growing net creditor position. In fact, interest rates (real and nominal) tend to be higher in US dollar terms. For example, over the last 20 years the long-term interest in USD (10-year Treasury) was

about 1 percentage point higher than that on riskless euro (i.e. German) debt. Even the average long-term government interest rate for the euro, which takes into account risk premia in the periphery and liquidity premia on other core currencies, has been lower than that of riskless US debt. Given that the exchange rate is now at almost the same level as 20 years ago, this implies that dollar debt has been more expensive even after one adjusts for exchange rate changes. The ideal for the euro area would thus be issuing its own debt in euros and investing in dollars.

Finally, one needs to consider the potential cost of having one's own currency become an anchor currency of other countries. The number of countries which peg to the euro (over 60 according to the Commission) is rather large. But most of them are small, of negligible economic weight. The key issue here is again the weights of costs and benefits. A pegged exchange rate has the advantage of reducing (bilateral) currency volatility, but it also means that it becomes more difficult to adjust to shocks to relative competitive positions. The second consideration becomes paramount if one considers the euro area relative to China. It would not necessarily be an advantage for Europe if China were to peg its currency to the euro, instead of the USD. In that case, the exchange rate of the euro to its biggest trading partner (and competitor) would be determined by the Chinese authorities. Being an anchor currency can actually mean a loss of control.

The euro area is a very open economy, much more so than the US. This implies that a loss of control over the exchange rate is much more important for the euro area than for the US. A high degree of openness also explains the revealed preference of other potential reserve currency 'candidates' in the past. For example, the German authorities were never keen to enhance the status of the DM as a (minor) reserve currency, fearing that this would lead to more volatility and potential upward pressure on the exchange rate. The euro area has today a similar degree of openness as Germany in the 1970s and 1980s and its weight in the global economy is shrinking; tending towards 10%, which is the level Japan had not so long ago. The euro area is gradually becoming a 'small open economy' for which the disadvantages of reserve currency status are increasing while the benefits remain uncertain.

3. CURRENCY SWAPS AND GLOBAL CURRENCIES

The US dollar is used extensively in other countries, not only as a reserve currency, but also for invoicing and payment of a large fraction of global trade (Gopinath and Stein 2018, Gopinath 2019). In practical terms, this means that, in many countries, exporting firms receive dollar payments and therefore start to arrange for financing in dollar terms as well.

There exists thus in many countries, within the domestic financial system, a part which is based on dollars in which banks accept deposits from exporting enterprises, extend credit to them etc. During normal market conditions these 'off shore' USD markets work well with export receipts providing the underlying stream of dollars needed to service local USD debt. However, local banks always have need for short-term dollar liquidity (or surplus). This liquidity need is usually covered by borrowing on the US market, tapping, for example, money market funds. However, when US financial markets freeze in a crisis, the foreign banks have a liquidity problem. Unlike US banks, they cannot access the various liquidity windows of the Federal Reserve.

This is where currency swap lines become important. The Federal Reserve provides USD liquidity to foreign central banks, which, in turn, can then lend dollars to their domestic banks. From the point of view of the Federal Reserve, the purpose of swap lines is thus to help preserve financial stability abroad, which then prevents market distress from having an impact on the real economy abroad and ultimately on the US economy as well.

3.1. What are currency swaps?

Currency swap lines came into prominent use among major central banks during the global financial crisis of 2008-2009. They became necessary again during the euro area sovereign crisis.

In November 2011, the Bank of Canada, the Bank of England, the Bank of Japan, the ECB, the Federal Reserve and the Swiss National Bank formed a network of unlimited and temporary bilateral currency swap lines. In 2013, these central banks announced that their bilateral swap lines had become permanent standing facilities (di Mauro and Zettlemeyer, 2017 and ECB, 2003).

In principle, this was a symmetric agreement. In reality, the key participant was the Federal Reserve.

The only exception to this *de facto* asymmetry came in March 2019, when the Bank of England activated a currency swap line arrangement with the ECB, to reduce possible sources of market stress due to Brexit uncertainty.

In the past months, since March 2020, at the onset of the COVID-19 crisis, currency swap arrangements between central banks have again been used. They have been playing an important role in limiting the fallout from US financial market instability (Reis, 2020).

An important recent innovation is that the Fed extended the US dollar swap lines with the other 5 central banks part of the permanent facility network to longer maturity, charging also a lower interest rate. Moreover, it also gave other 9 central banks access to swaps, but only for limited amounts (whereas the lines with the inner group are in principle for unlimited amounts). The participants in this 'outer group' are: the Reserve Bank of Australia, the Banco Central do Brasil, Danmarks Nationalbank, the Bank of Korea, the Banco de Mexico, the Reserve Bank of New Zealand, the Norges Bank, the Monetary Authority of Singapore, and the Sveriges Riksbank (Federal Reserve, 2020).

The ECB (re)-activated existing swap lines with the central bank of Denmark and established temporary precautionary swap lines with the Croatian and Bulgarian central banks of a maximum of EUR 2 billion each (ECB, 2020b; ECB, 2020c; ECB, 2020d).

Through this instrument, foreign central banks are able to provide foreign currency liquidity to domestic banks, especially when the funding market is deteriorated. By helping to stabilise foreign markets, avoiding bank failures or fire sales, swap lines provide support to the foreign economy and, by reducing risk of financial distress abroad, also to the domestic one.

Box 1: What are currency swaps (and swap lines)?

Currency swaps are contracts among central banks to exchange their respective currencies for temporary use.

A currency swap line is an agreement between two central banks to allow each partner to initiate a currency swap within certain, pre-defined parameters.

For example, within an existing swap line, the ECB can borrow a certain amount of dollars from the Federal Reserve while handing over the equivalent market value of euros as collateral or security. The interest the ECB has to pay to the Federal Reserve is set in the swap line agreement. It is equal to the overnight index swap (OIS) USD rate plus a small spread (today it is 25 basis points).

The Federal Reserve keeps the euros as collateral during the duration of the loan, usually one week, now also up to three months. When the transaction is closed, the ECB pays back the amount of dollars due (given by the loan plus interest) to the Fed and will get back the euros it had handed over as collateral. These two amounts had been determined at the time when the contract was signed. Therefore, the swap lines carry no exchange rate risk unless the borrower (in this example the ECB) defaults.

There remains a (in reality negligible) risk for the lender: Currency swaps usually use the spot exchange rate existent at the time of the conclusion of the contract, but this rate could move over the contract period. If the euro were to depreciate considerably during the contract period, the security which the Federal Reserve holds would lose in value. In the hypothetical case that the ECB were to default on its obligation to deliver USD at the expiration of the swap contract the Federal Reserve would only have the euro collateral in its hands and might make a loss if it had to sell these euros in the market.

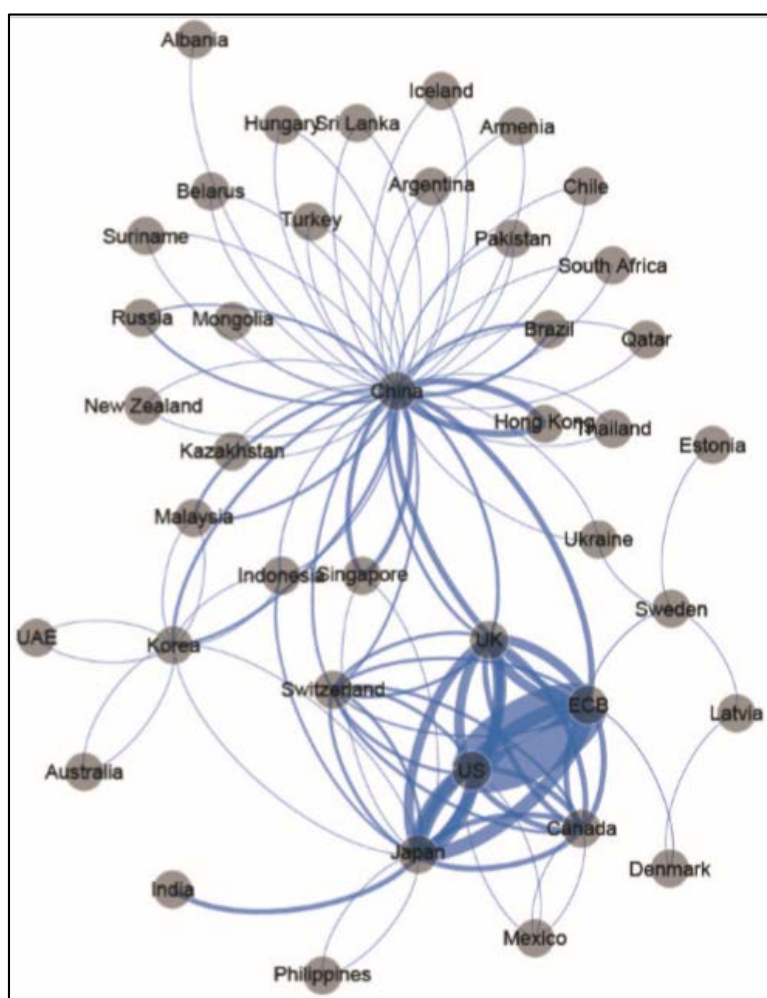
In the case of the ECB, a default is not really something which can be seriously considered. For the Federal Reserve there is thus *de facto* no risk in granting the ECB a swap line, i.e. the facility for the ECB to initiate swap agreements whenever it perceives the need. However, a default is a distinct risk in the case of the central banks of some emerging market economies. This is why the Fed has granted a group of countries with a high credit standing potentially unlimited swap lines whereas the conditions are much more restrictive for other countries.

In practice, the ECB lends the amount of dollars received by the Fed to European banks in need and with eligible collateral, charging the same rate that the Fed is charging. Therefore, *de facto* the Fed is providing USD liquidity to European banks, using the ECB as an intermediary. This indirect way eliminates credit risk for the Fed, by transferring it to the ECB. The latter is in charge of doing the selection of banks according to the eligibility criteria, and the monitoring (Bahaj and Reis, 2020).

3.2. Currency swaps as a tool of financial diplomacy

The importance of the currency swap arrangements of the Federal Reserve during the financial crisis led to the impression that they were a mark of having a global currency (European Commission, 2018). The result was a global race to establish as many currency swap lines as possible leading to the very large network of bilateral swap lines documented in Denbee et al. (2016).

Figure 3: Network of bilateral swap lines, as from October 2015



Source: Denbee et al. (2016).

This figure shows that the PBOC has the largest number of swap arrangements. However, it seems that many of them were just signed to increase the number of entries on a list. For example, the swap arrangements between the PBOC and Iceland or Albania are unlikely ever to be of any practical significance. In the most recent crises, the swap arrangements of the PBOC were only on paper as there is no renminbi financial market outside China.

The only ones that really matter are those within the immediate proximity of the Federal Reserve in the figure above (the ECB, the Bank of Canada, the Bank of Japan, the Bank of England and the Swiss National Bank).

There is little theoretical literature on why the existence of swaps lines should foster the wider international use of a currency. The brief surveys in boxes 7 and 8 in ECB (2019) come to the result that *"The direction of causality between currency swap lines and international currency usage is unclear."*

3.3. Currency swaps in reality

The reality of currency swaps is that they become relevant only in a crisis and that they are USD-centred.

The first point derives from the nature of currency swaps: they constitute an emergency arrangement when private sector liquidity flows are impaired. The US market is normally very liquid thus providing

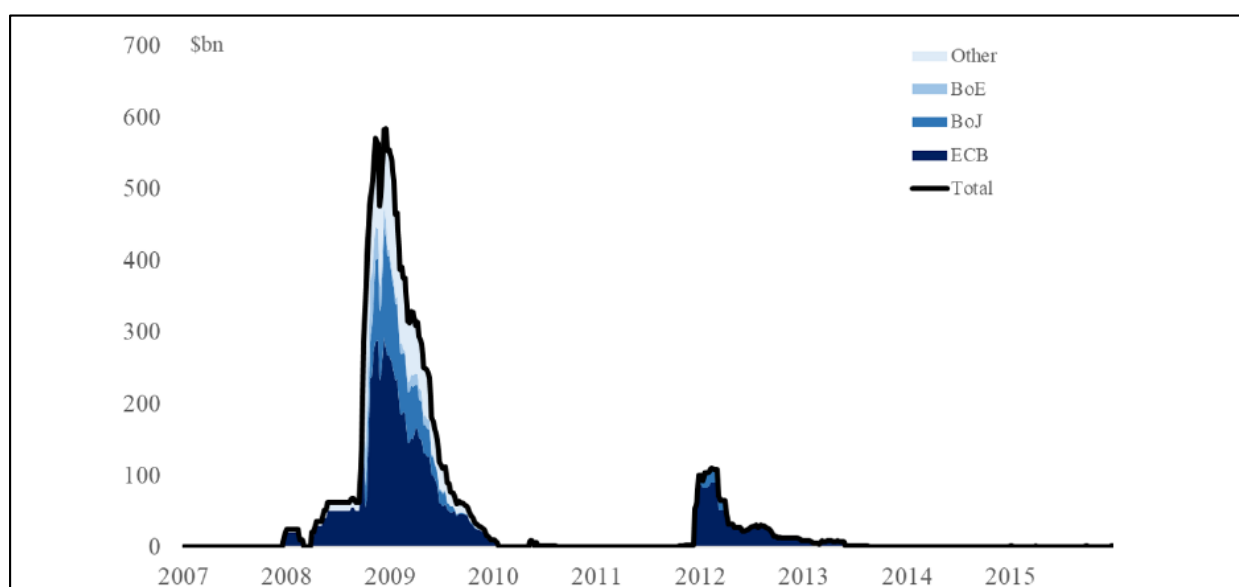
enough liquidity for the small USD based financial (mainly banking) markets in countries with a large exporting sector.

The euro area and Japan are among the largest exporters to the US and they have the most developed financial markets in USD terms outside the US. This is why these two countries accounted for the largest part (over 80%) of the total currency swaps of the Federal Reserve during the last financial crisis, as shown in Figure 3 below.

The figure also shows that the total amount reached USD 600 billion in a very short period of time, but the need of USD liquidity abroad was also very temporary, disappearing within one year.

The second episode during which the Federal Reserve swap lines became necessary was during the euro sovereign debt crisis of 2011-2012. In this case, the problem was not a malfunctioning of US money markets, but rather a generalised distrust of US investors towards all euro area-based entities.

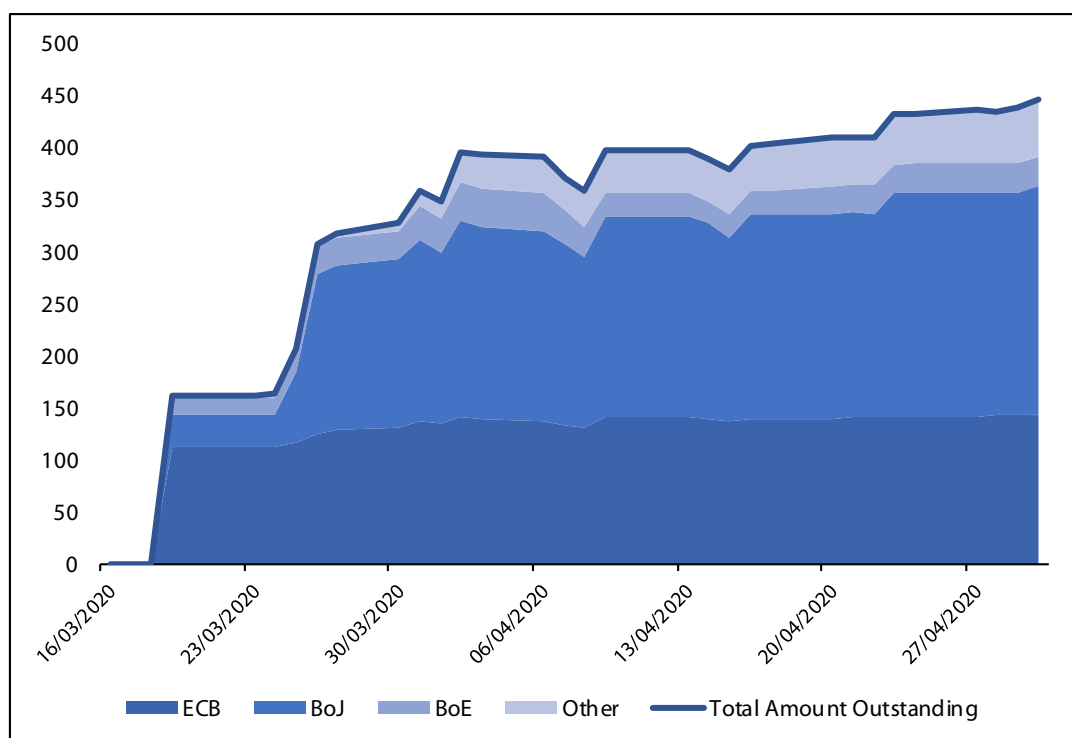
Figure 4: Federal Reserve swap lines use, 2007-2016 (EUR billion)



Source: Bahaj and Reis, 2020.

During the present crisis, the currency swaps accorded by the Federal Reserve have again increased, so far to over USD 400 billion. The ECB and the Bank of Japan constitute again the most important counterparts.

Figure 5: Federal Reserve swap lines, amounts outstanding, March-April 2020 (settled positions in USD billion)



Source: Federal Reserve Bank of New York and Authors' calculations.

The ECB and the Bank of Japan account for the largest share of the swap lines actually granted by the Federal Reserve over the last months. Both Japan and the euro area run sizeable current account surpluses. These economies thus do not have a structural deficit in US dollars, on the contrary, residents in both countries have large claims on the US, both in gross and net terms. But, despite this structural, long-term surplus in dollars, the financial system of these two countries can at times have a large need for short-term USD financing.

3.4. Do they matter?

It is difficult to judge the importance of currency swap arrangements in a comprehensive manner. Bahaj and Reis (2020) show that they tend to limit the deviations from covered interest parity (under which the interest rate differential is equal to the forward rate differential). How important is it to avoid these financial market distortions?

For large developed economies, this emergency provision of USD liquidity is probably of second order of importance. Euro area banks which need short-term USD liquidity, but can no longer obtain it through their usual channels, can always obtain euros from the ECB and convert them into US dollars through the use of foreign exchange market. The cost of the disruptions created by a sudden lack of access to short-term USD liquidity should thus be limited for countries with solid domestic financial systems and a functioning foreign exchange market. This applies in particular to the euro area, the UK, Japan and the other OECD countries which are part of the inner group of 5 central banks mentioned above.

However, access to USD currency swaps will be more important for weaker economies which often experience a foreign exchange crisis at the same time as USD liquidity dries up. As shown above, the amounts going to these economies are limited, but they might have a large beneficial impact for the

countries concerned, because the USD-denominated part of their local banking systems might collapse without this support, with large spillovers to the rest of the economy.

4. CONCLUSIONS

This short contribution cannot provide conclusive arguments on what could be done to foster a greater international role of the euro. Instead, it has focused on one particular aspect of a global currency. When a currency, such as the USD, is widely used for short-term transactions outside the home country, there always exists the risk of a sudden shortage of dollar liquidity, which ultimately only the Federal Reserve can satisfy. This is why the Federal Reserve has agreed to provide a selected group of foreign central banks with swap lines under which it provides these central banks with USD when the normal supply of short-term liquidity, through the US money market or US-based banks, no longer works. These arrangements were first used during the financial crisis of 2008-2009.

During the present crisis, the USD swap lines were again extensively used. Their existence has undoubtedly enhanced the standing of the US as the dominant global currency, as users of the USD abroad now know that in a crisis they can rely on the indirect support of the Federal Reserve. However, the present crisis has also shown that creating swap lines along the US Federal Reserve model is *per se* not enough to create a global currency. The (much more modest) swap lines offered by the ECB to neighbouring countries in Europe have apparently² not been used.

The existence of these swap lines are thus a necessary condition for a dollar-based global financial system to work smoothly even during a liquidity crisis. There are of course many further dimensions and paths to achieve a more prominent international currency status for the euro. Swap lines are merely a necessity in a crisis and a partial consequence of that status.

² At the moment, the ECB does not publish data on these operations.

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The current crisis has confirmed the importance of the currency swap lines offered by the Federal Reserve. They enhance the role of the USD as the dominant global currency. However, one should not expect much impact on the international role of the euro when the ECB offers similar currency swap lines. Currency competition is not won by competing on the generosity of currency swap lines.

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