Central Banks Liquidity Swaps (CBLS)

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Central Banks Liquidity Swaps

- Central bank currency swaps (CBCS) allow central banks to provide foreign currency liquidity to the commercial banks in their jurisdictions. Since the end of 2007, these swaps have emerged as a de facto key feature of the international monetary system (IMS), with the US Federal Reserve (FED) having extensive recourse to them during the financial crisis, and their exploitation by the People's Bank of China (PBOC) to help internationalizing the renminbi.
- This trend was further confirmed in the second half of 2013 with
  - The signing of two swaps agreements between the PBOC and the Bank of England (BOE) and the European Central Bank (ECB)
  - The little remarked decision by six major western central banks including the US FED, announced on October 31st 2013, to make permanent previously temporary swap lines.
- Currency swaps combined with the unlimited and exclusive power of central banks to create money can match the volatility of international capital flows. They have proved very effective and extremely helpful during the recent financial crisis. However, so far, central bank swaps have not been associated with conditionality, and are more precarious than alternative institutional arrangements, such as the International Monetary Fund (IMF) or regional financial agreements (RFA). Large scale use of CBCS can render central banks subject to significant counterparty risk.

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- In financial markets, swaps are a derivative in which two counterparties exchange only the cash flows of both counterparties' financial instruments, against the instruments of the other party. In the context of CBCS, foreign currency swaps involve two currencies, and therefore introduce the possibility to make the currency issued by one central bank available in the constituency of the other central bank(s) involved in the swap agreement. Thus, CBCS are more similar to a set of two reciprocal loans than to a financial derivative.
- Unlike the swaps signed by the FED, the myriad of swap agreements signed by the Chinese central bank, the PBOC with other countries' central banks are not a reaction to an emergency situation. Rather they are one of many dimensions of a long term policy aimed at internationalizing of the renminbi. So far, the PBOC has 24 active local currency swap agreements (including one with Hong Kong) amounting to a total of RMB 2.71 trillion or approximately USD 420 billion

Hedging - Central Bank Liquidity Swaps

Liquidity Swaps

Liquidity Swaps are very important tools with Central Banks during huge FX Volatility. In case of huge FX Volatility Central Banks do Swaps like Fed would share $ with PBOC and PBOC would return the same at same rate like Principal Only Swaps (POS).

Assuming Chinese Yuan is trading at 7.70 which is very high vs normal spot rate of 6.60. In that sense PBOC would need huge amount of $ to bring down the volatility.

PBOC would use some part of FX Reserves, Selling of UST , using Central Banks Swap lines with Fed.

Assuming FX Reserves is $ 2 Bn , UST Selling is $ 10 Bn, Central Banks Swaps lines is $ 26 Bn which PBOC to return after 6 months to Fed.

The hedging of the same is done using Principal Only Swaps (POS) by PBOC either within China or using any Offshore Treasury Centre like:-

- Singapore
- NY
- London
- Luxembourg
- Frankfurt
- Japan
- Australia

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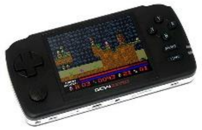

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