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Bilateral Currency Swap Agreement between China and Pakistan: Expected Impact through CPEC

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Bilateral Currency Swap Agreement between China and Pakistan: Expected Impact through CPEC

By

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INTRODUCTION:

A bilateral Currency Swap agreement can be defined as an agreement between the two central banks for the exchange of a cash flow in one currency against the cash flow in another currency according to predetermined terms and conditions. The maturity period of the Currency swap agreements is negotiable for a short period (Up to one year) to the long term that can be between 3-10 years by making it a very elastic mode of foreign exchange. The interest rates attached to these agreements can be fixed or floating and are generally expressed as inter-bank lending rate such as "benchmark rate" plus or minus a certain number of points[3].

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[3] Páles, Judit, Zsolt Kuti, and Csaba Csávás. The role of currency swaps in the domestic banking system and the functioning of the swap market during the crisis. No. 90. MNB Occasional Papers, 2011.

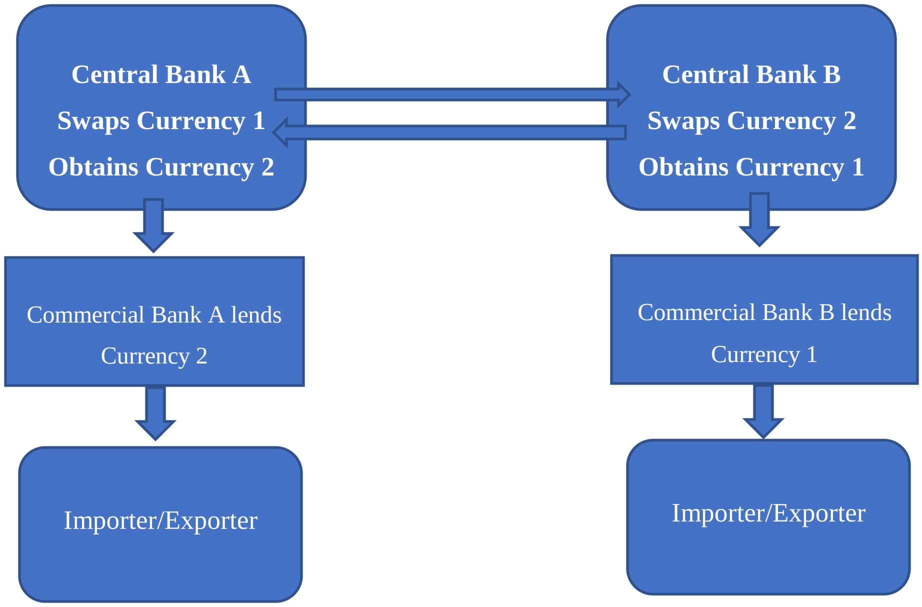


FIGURE: 1 MECHANISM OF BILATERAL CURRENCY SWAP

Source: Author's contribution

Bilateral Currency Swaps provide a feasible mode of hedging against exchange rate fluctuations. It enables the country to remain comparatively secure at the time of financial distress by managing the liquidity shortages.[1] Swap Agreements offer the opportunity to acquire foreign currency loans at a competitive and a better interest rate as compare to the direct borrowing in a foreign market. It allows the use of local currency in settlement of cross border transactions and reduces the dependence on a specific currency like US dollar[4]. Thirty-six countries have signed the bilateral currency swap agreements with China to get supported in international trade and investments. This has helped renminbi to receive the status of international currency[5].

[4] Prasad, Eswar S. *Gaining currency: the rise of the renminbi*. Oxford University Press, 2016.
[5] Anwar, Y. SBP Governor Explains Currency Swap Agreement with Peoples Bank of China. State Bank of Pakistan. (2011). Retrieved from http://www.sbp.org.pk/press/2011/China-Currency-Swap-29-Dec-11.pdf

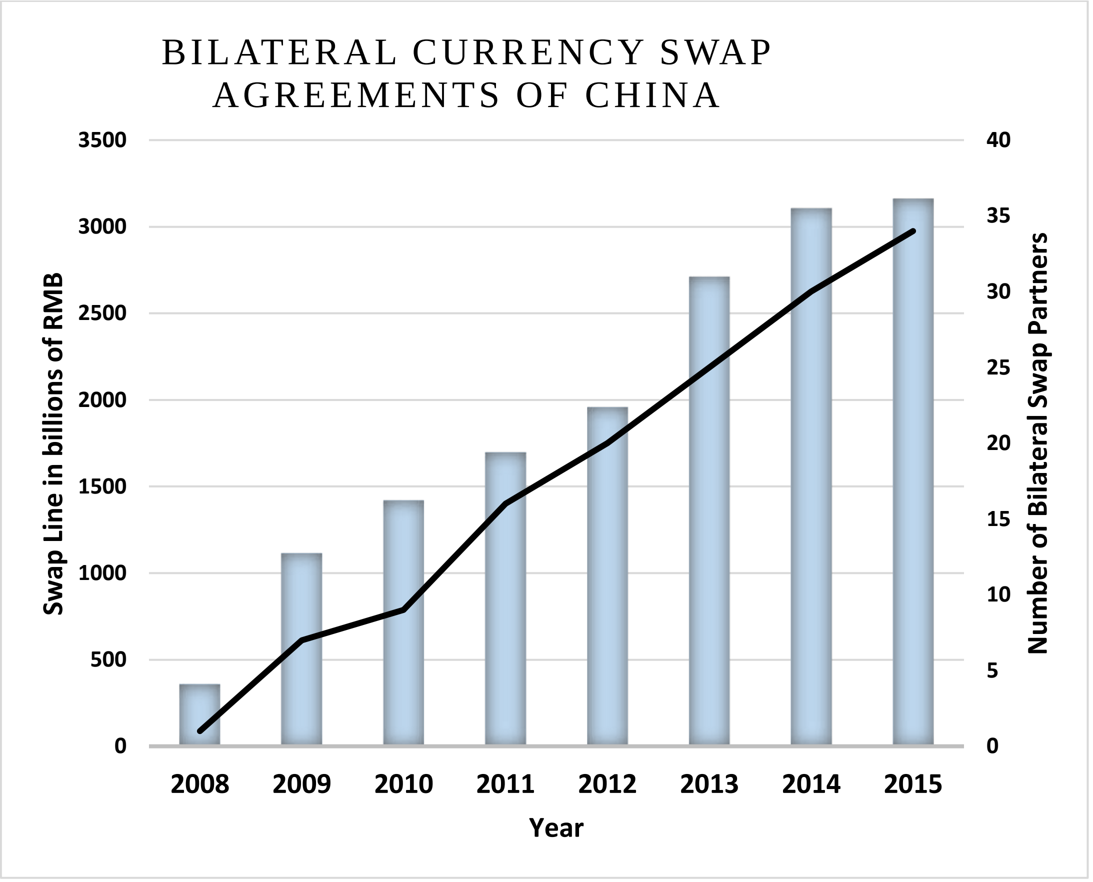
These countries have utilized the swap lines offered by China for various purposes including;

Trade: Foreign trade in China has revealed rapid growth rates and the scale of renminbi in circulation has amplified significantly in this regard. Therefore, the Swap agreements enables the central banks to restraint the dependence on any single currency e.g. US dollars for invoicing and settling the transactions.

Investment Opportunities: A positive signal is transmitted in the market with the availability of the Currency Swap agreements and foreign currency in the onshore market. This increases the investor's confidence and helps the economy to attract more investments.

Foreign Exchange Reserves: To avoid financial instability, market tensions and accumulation of excessive foreign reserves with high costs, the bilateral currency swap have proved to be a substantial, effective and less expensive tool.

Bailouts: Effective use of Swaps can save a country from sanctions in exchange for its bailout plans. For example, Argentina had difficulty in repayment of dollar-based debts, therefore a bilateral currency swap in Yuan with China was signed. Since Yuan is an international currency, therefore the acquired Yuan were converted into US dollars and the bailout through swaps was executed.



BILATERAL CURRENCY SWAP AGREEMENTS: CHINA AND PAKISTAN:

The currency swap agreement (CSA) between Pakistan and China was signed in 2011 and it allowed both countries to make transactions in either Pakistani rupee or Chinese Yuan[2]. The agreement was for three years with an aim to use regional currencies for trade settlements. In 2018, the bilateral swap line has been doubled.

> **Phase 1:** In the first phase of CSA, the execution of Currency Swap Agreement is for a term of three years and in the local currencies of both countries i.e. for 140 Billion Pak Rupees and 10 Billion Yuan.

Phase 2: The swap line has been extended with the consent of both the countries from 10 billion Yuan to 20 billion Yuan and from 165 billion to 351 billion Pak rupees.

BILATERAL CURRENCY SWAP AND CPEC-WAY FORWARD:

Bilateral currency swap agreement is expected to have a positive impact on the economy of Pakistan through the China Pakistan Economic Corridor (CPEC). Following are some prospects in this regard.

- Under the Bilateral Currency Swap Agreement between China and Pakistan, the commercial banks are permissible to arrange swap lines through State Bank of Pakistan and offer loans. This will not only let the active use of bilateral currencies for trade and investment transactions under CPEC but will also steadily decrease the dependence of Pakistan on the US dollar.
- Since the traders under CPEC in Pakistan would be able to have transactions in Yuan, therefore it is expected that it will simplify the operations of CPEC projects.
- Chinese companies investing in the projects of CPEC can have the profit repatriation in terms of Yuan instead of dollars or other foreign currencies. This will create a conducive environment for the investors and expedited implementation of the projects under CPEC is expected.
- Since Pakistan is struggling with its external account imbalance at present, and due to CPEC, investments and imports are growing rapidly. Trade in national currencies will shield both the countries against any influence from externals and will offer support against exchange rates fluctuations.