AGREEMENT ON THE ESTABLISHMENT OF A FOREIGN CURRENCY SWAP LINE BETWEEN THE MAGYAR NEMZETI BANK AND THE PEOPLE'S BANK OF CHINA

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SUMMARY

On 9 September 2013, the **Magyar Nemzeti Bank and the People's Bank of China** (PBC, central bank of the People's Republic of China) concluded an agreement on the establishment of a bilateral renminbi – forint denominated foreign currency swap line with a nominal value of CNY 10 billion[1] to support trade and investment relations between the two countries. The agreement was signed in Basel, at the headquarters of the Bank for International Settlements (BIS).

This document **describes the practical application** of the concluded agreement **and the international applicability of the facility**.

Since the onset of the crisis in 2008, the central banks of the world have been **increasingly** concluding currency swap agreements between each other. The instrument **may serve various purposes:** management of liquidity problems, support of bilateral trade relations or financial stability measures. The number of parties concluding these agreements has increased significantly with the strengthening performance of Eastern economies, particularly that of China. The **PBC has concluded a growing number of agreements** – similar to the one signed with Hungary – with countries with whom it aims to strengthen trade, financial and strategic cooperation. This important result for Hungary also **indicates the development of bilateral relations;** by signing this agreement, Hungary has joined a small group of international players, as it is **among the first European central banks** that concluded a currency swap agreement with China.

1. PROPERTIES AND ROLE OF SWAPS IN CENTRAL BANK ACTIVITY

A currency swap involves the **exchange of cash flows denominated in different currencies**; it is a transaction consisting of a spot and a forward currency conversion transaction. In the framework of the transaction, the parties agree to swap the currency they hold **at a spot exchange rate** to another currency, and swap it back **at a future time**, at a **(forward) exchange rate determined in the present**, where the future exchange rate reflects the interest rate differential between the two currencies in the present.[2]

Currency swaps are applied in international financial markets for various purposes – for hedging of exchange rate risks, speculation and the rollover of FX positions. According to the comprehensive foreign exchange market survey of the BIS published every three years, **currency swap is the most actively traded product in foreign exchange markets**, where the average daily turnover amounts to approximately USD 2,200 billion.[3]

Currency swaps are not only transacted in markets, but **have become an integral part of central banks' monetary policy instruments**, as instruments supporting market stability. The expansion and development of cooperation between central banks was necessitated by the growing integration of money and capital markets in a globalised environment. Bilateral foreign currency swap agreements between central banks gained relevance under these circumstances. These agreements serve to strengthen the ability of the central bank to also provide liquidity in foreign currency to the banking system, and hence to other sectors, to **prevent spill-overs and intensification of the crisis in case of shortages in foreign currency liquidity**.

[1] The official currency of China is the renminbi, meaning 'people's currency'. The yuan is the unit of account of the renminbi.
[2] For details on the structure of currency swap transactions, see István Mák – Judit Páles: 'The role of the FX swap market in the Hungarian financial system', MNB Bulletin, May 2009.
[3] Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets Activity (2013).

The central bank swap **agreements concluded during the credit crisis between the Federal Reserve (Fed) and the central banks of several developed countries** attracted the largest publicity. The US dollar functions as a currency not only in the United States, but also elsewhere: the 'greenback' is a global instrument that serves as medium of exchange, unit of account, measure of value and store of value. To ensure that the dollar can fulfil such functions, dollar liquidity is continuously necessary outside of the United States as well. In the first half of the 2000s, the European banking system significantly increased its balance sheet; it accumulated large quantities of assets denominated in US dollars and financed this expansion with short-term funding. It became clear at the start of the credit crunch in the summer of 2007 that this financing requirement caused tensions in US dollar money markets. The **bankruptcy of Lehman Brothers** resulted in the steep rise in funding costs and the practically complete drying up of liquidity in financial markets, to which the **Fed responded by providing unprecedented levels of liquidity to other central banks.**

Foreign currency swaps had already been used during market uncertainty after 11 September 2001 to ease liquidity pressures, but only with very short (30-day) maturity and in limited amounts.[4] With the deepening of the 2007-2008 crisis, the **Fed concluded foreign currency swap agreements with a growing number of partners, with longer maturities and increasing nominal values.** At the middle of the crisis, some central banks (e.g. the European Central Bank) had unlimited liquidity available, and the **amount used by central banks reached USD 580 billion.**

Owing to the **growth of the Chinese economy**, the steadily strengthening role of the country in international trade, the **country's currency, the renminbi, plays an increasingly important role in international markets.** The currency already carries out major money functions, but **it still needs to fulfil many conditions to become an accepted currency that also functions as a reserve currency**, similarly to the dollar, euro and the Japanese yen. Perhaps the most important of such conditions is full convertibility, i.e. free exchangeability, of the currency. China is cautious in opening up its economy and financial markets to international capital; currently the renminbi has only limited convertibility as a foreign currency, but decision makers plan to change this in the coming years. Chinese economic policy makers are committed to making the renminbi one of the world's major reserve currencies.

The bilateral foreign currency swap agreements **concluded** by the Chinese central bank also aim to **strengthen commercial and financial cooperation with other countries and enhance the international role of the renminbi.** China concluded its first agreements primarily with emerging countries in the South-East Asian region, **but the growing importance of the renminbi is demonstrated by the Chinese central bank's agreements with an increasing number of developed countries.** The agreement with Japan and Australia is almost obvious, as both countries are major trading partners of China.[5] There is also competition in terms of which global financial centre will assume a dominant role in the offshore[6] trading of the renminbi: **London, Frankfurt and Singapore would all like to strengthen their positions.**

Both trade and financial markets can function smoothly if adequate liquidity is available. Agreements between central banks are necessary to provide for this liquidity, so that **foreign currency used in international trade and in settlements is available when funds are limited for some reason.**

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[4] The first swap transaction between central banks was the agreement concluded between the Fed and the Bank of England in 1925, where the Fed provided gold in exchange for pound sterling. Foreign currency swap agreements were also used in the 1960s to support the gold exchange standard, and to provide liquidity and stability of the system.

[5] The markets are developed by other means as well in case of Japan and Australia. While the renminbi could only be converted into Japanese yen and into Australian dollars via USD in the past, these foreign currency pairs can now be directly traded, which generates substantial savings for the corporate sector, as the transaction cost is paid only once.

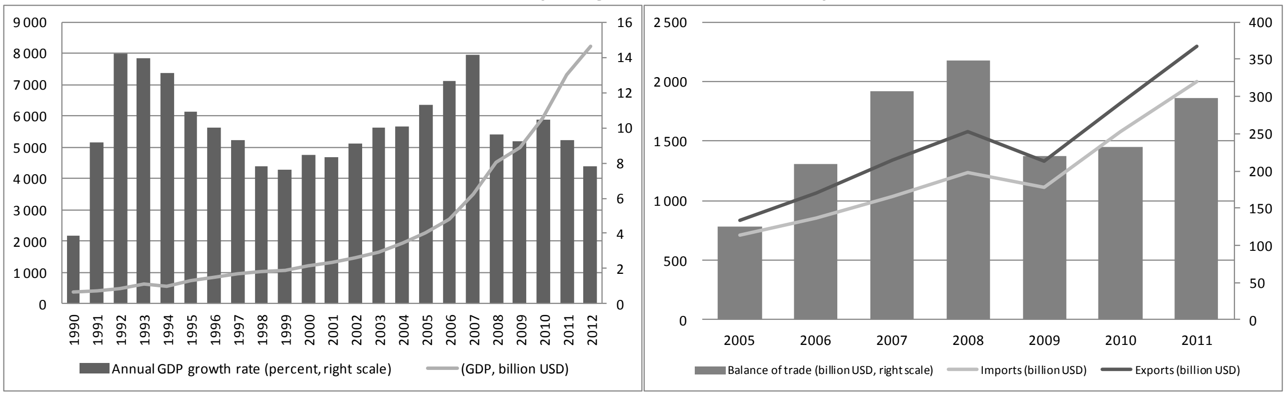
[6] Onshore renminbi (CNY) is a non-convertible currency traded on China's internal markets, the exchange rate of which fluctuates within the narrow band managed by the central bank. The offshore renminbi (CNH), however, is a currency traded on markets outside of China, and can be used in international settlements; it is convertible, but its exchange rate is not managed, allowing it to shift from the exchange rate of the onshore currency.

2. CHINA’S ROLE IN THE GLOBAL ECONOMY

The People’s Republic of China abandoned the Soviet-style planned economy in 1978, and gradually shifted to the model of a socialist market economy. **As a result, it has become the second largest economy in the world after the United States** – an achievement attributable to average annual economic growth of over 10 per cent in the past 30 years.

In the 1980s, China’s cheap and abundant workforce became the primary investment target of Western companies; as a result, **China now has the largest manufacturing sector in the world.** In the years before the crisis, the average annual growth rate of Chinese GDP significantly exceeded 10 per cent, and then approximated 10 per cent. **Although the rate of economic growth declined to 7.8 per cent in 2012, China is still considered to be the fastest developing country among the largest global economies.** It took over the place of Japan as the world's second largest economy in 2010; some analysts expect the Chinese economy to even surpass the size of the American economy in the 2020s.

Economic and foreign trade indicators of China

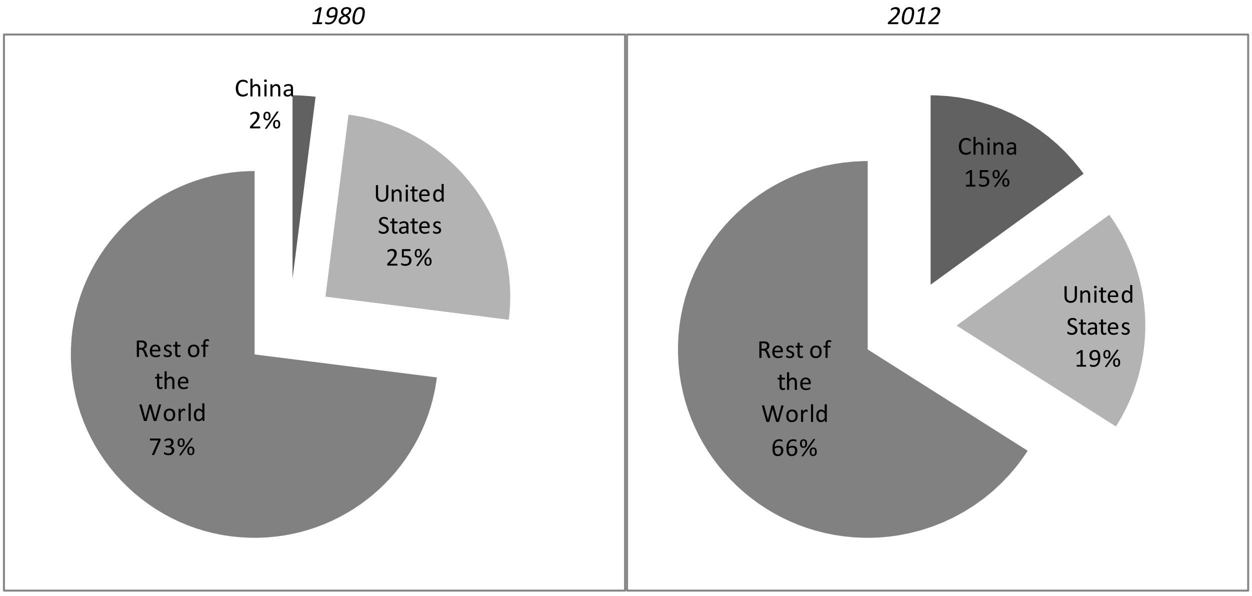


Source: IMF WEO, World Bank

China **plays a similarly dominant role in world trade** as the largest exporter and second largest importer in the world. It is now the **second largest trading partner** of the European Union and has overtaken the United States as the largest importer. The volume of trade between the two parties increased by an average of 9 per cent annually between 2007 and 2012, and currently amounts to EUR 430 billion. The picture is similar in relation to the United States; China is the largest trading partner of the US after Canada, and also ranks first in imports.

China also plays an important role in the global financial system. This is clearly attributed to the fact that the country holds the largest foreign exchange reserves in the world, which amounted to over USD 3,300 billion at the end of 2012. **China holds 20 per cent** of the debt of the United States held by foreign states. In light of the above facts, **China has a solid presence and has become a key player in the global economy**, and it is expected to maintain and strengthen this role in the coming years. As a result, the **development and deepening of economic policy ties with China has become crucial for Hungary as well.**

Change in the share of Chinese and US GDP of the global economy



Source: IMF WEO

3. HUNGARIAN–CHINESE RELATIONS

As a result of the above developments, **the building of relations with China has recently gained in importance for Central and Eastern European countries.** From 2010, the People's Republic of China has laid new foundations for its relations with countries in the Central European region.

China published a 12 points set of measures with respect to cooperation with the region. The main steps outlined include, among others, the provision of a USD 10 billion investment credit, the establishment of a USD 500 million investment cooperation fund, and **the establishment of trade development and investment incentive missions in Central and Eastern European countries.** It has also **set the aim of examining opportunities of more effective financial cooperation.**

According to 2012 figures of the Ministry of Commerce of China, **trade between China and the Central and Eastern European region has picked up significantly in the recent years.** In 2011, imports rose by 16% and exports by 37% over the previous year. **The parties wish to double the current trading volume of over USD 50 billion by 2015.**

Hungary is a recognised partner of China in Central and Eastern Europe and among the Member States of the European Union. There are no major conflict of interests between the two countries; the building of relations and dialogue are based on mutual benefits, non-interference in internal affairs and friendly partnership in cooperation. The new strategy of China is in line with the eastern opening policy of the Hungarian Government. As part of this policy, Hungary aims to deepen its economic relations with several Asian partners – particularly with China – in the areas of foreign trade, direct capital investments and other financial cooperation.

Foreign trade between China and Hungary has continuously expanded in recent years, despite the global economic crisis. Trade in goods between China and Hungary **has increased almost sixfold** in the past **10 years**; **exports increased over tenfold, while imports rose approximately fivefold**, resulting in the decline in the foreign trade deficit between the two countries. The value of foreign trade amounted to USD 7.22 billion in 2012, with approximately USD 1.8 billion in exports and USD 5.4 billion in imports.

Machinery and transport vehicles make up most of Chinese imports, particularly communications products, and audio devices. **Machinery and transport equipment also make up the bulk of Hungarian exports to China**, with the dominance of energy generation machinery and equipment.

4. WHAT ARE THE BENEFITS FOR HUNGARY FROM THE AGREEMENT?

The swap agreement with China is **particularly favourable for Hungary for at least two reasons: it can support the future development of trade between the two countries,** on the one hand, **and contribute to reducing financial stability risks**, on the other.

As noted above, trade between China and Hungary has developed at a rapid pace in the past two decades, and **the Asian country has become one of Hungary's most important trade partners.** At the same time, there is **substantial potential to further deepen** trade relations between the two countries; **the swap agreement concluded between the Chinese and Hungarian central banks can support this process.** This instrument, namely, enables the Magyar Nemzeti Bank to **provide** – after completion of the necessary product development process – **renminbi financing through the domestic banking system to Hungarian companies that maintain trade relations with Chinese partners.** The **availability** of such foreign currency funding **enables the trading partners to determine the terms of payment in commercial contracts in Chinese renminbi, without the use of an intermediary currency (e.g. dollar or euro).**

In the foreign trade of China, **the ratio of transactions denominated in renminbi is growing dynamically: while it barely reached 0.5 per cent of total Chinese foreign trade in 2010 Q1, this figure reached 15 per cent in 2013 Q1.** The largest growth was recorded in the Asian region, particularly in countries which China concluded a swap framework agreement with. Although the share of the renminbi remains negligible in non-Asian countries, the concluded swap agreements are expected to strengthen the role of the Chinese currency in countries (Australia, Brazil, and New Zealand) that maintain strong trade relations with China.

Based on international experience,[7] **direct trade in renminbi may produce several advantages to Hungarian trading partners.** First, Hungarian companies can establish more favourable trading terms with their Chinese partners, as the possibility of a contract denominated in renminbi enables the latter to **avoid a foreign exchange rate risk.** Second, a growing number of foreign companies report that **their Chinese partners are increasingly expecting them to use the renminbi in parallel with the growing strength of the Chinese economy.** Under such circumstances, companies in a given country gain a competitive advantage if they have easy access to cheap foreign currency funding. Third, the swap transactions backed by swap agreements between central banks also **facilitate the hedging of exchange rate risks for Hungarian companies.** We should add that the elimination of the intermediary currency (dollar, euro etc.) in itself reduces the cost of hedging the exchange rate risk and also reduces transaction costs resulting from conversions.

In addition to benefits in trade, **the swap agreement concluded with the Chinese central bank may also prove beneficial for Hungary in terms of financial stability.** The foreign currency swap agreements concluded between central banks **can substantially improve risk assessment of a country.** First, because central banks can easily access external foreign currency funds even in case of market turmoil. Second, and perhaps more importantly, the **existence of a swap agreement implies a strong commitment on behalf of the central bank providing the foreign currency, indicating that it can be relied on by the other central bank in the event of problems.** This in itself can calm markets.

The benefits provided by the swap agreement concluded with China, however, will fully unfold if the role of the renminbi in the international financial system strengthens significantly, i.e. it becomes convertible. One of the manifested **objectives** of the liberalisation process in China **is to make the renminbi one of the most important global reserve currencies**, for which convertibility is an essential condition. The Chinese administration has been taking gradual steps in this direction for a long time, and these have accelerated in the past 1-2 years. Furthermore, the Chinese government has recently expressed its firm commitment to continue this process. At the end of the liberalisation process, **upon the full convertibility of the renminbi, the swap agreement of the Magyar Nemzeti Bank will reach its full potential in terms of financial stability**, as it will be able to obtain substantial foreign currency funding to mitigate possible turmoil in the spot and derivative markets.

[7] See A. Ballantyne, M. Garner and M. Wright, *Developments in Renmibi Internationalisation,* Reserve Bank of Australia, Quarterly Bulletin, 2013 June, p. 72