Currency Swap agreement

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- 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.

What is the purpose of currency swap?

- To avoid turbulence and other risks in the foreign exchange market and exchange rate.
- 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 (read the RBI/Government) are able to get sizable foreign currency by exchanging domestic currency, it ensures availability of foreign currency.
- 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).
- Currency swap agreement can be bilateral or multilateral.
- **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.

- India and Japan have signed a currency swap agreement during the visit of Prime Minister Modi to Japan on 28th of October 2018.
- The currency swap agreement is for US $75 bn and is a great opportunity for India to obtain foreign currency by exchanging rupee to Japan.
- According to the initial reports, the swap involves US Dollar besides Japanese Yen and Indian Rupee. As part of the agreement, the Bank of Japan (Japanese central bank) will accept rupees and give dollars to the Reserve Bank of India (RBI) and, similarly, the RBI will take the yen and give dollars to the Bank of Japan to stabilize each other’s currency.