Central Bank Swap Lines as Bilateral Sovereign Debt

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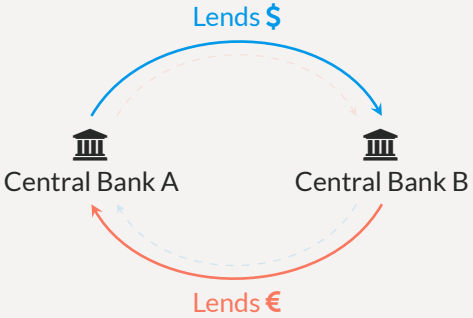
What is a Central Bank swap?

Swaps are symmetric currency exchanges

- A swap line is a contract between two Central Banks
- When activated, each institution provides an amount of its currency to the counterparty
- At maturity, positions are unwound



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... Symmetric swaps better understood, growing number of *asymmetric* ones

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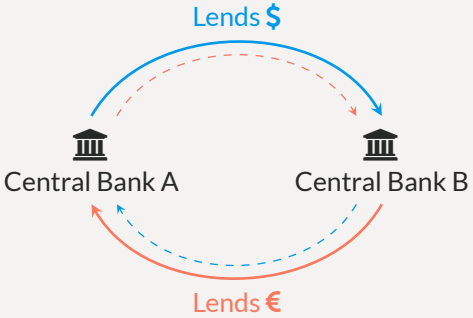

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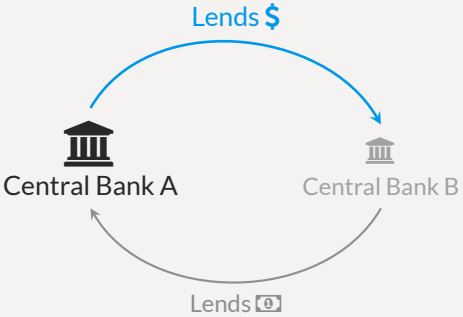

which can be asymmetric in practice

- The Fed doesn't really want Mexico's pesos
  - … treats them more like collateral
- Mexican authorities may need dollars for their BoP
  - … more similar to borrowed reserves

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How are Central Bank Swap Lines different from Sovereign Debt?

- We abstract from currencies, collateral, and focus on the borrowing

For an EM using the swap line to borrow from an AE

Regular debt (bond markets)	Bilateral loan (swap line)
• Defaultable	• Non-defaulteable (Central Bank)
• Many different lenders	• No coordination issues
• Interest rate (spreads) mainly reflects default risk	• Can be used to curb default risk
	• Interest rate?

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How do Central Bank Swap Lines interact with Sovereign Debt?

Main findings

- One type of debt affects borrowing conditions for the other
  - Borrowing from the market serves as threat in swap negotiations
  - Swap can be used when spreads on the market are high

- Lending around or in default maximizes surplus for bilateral loans
  - Availability of swaps in default:
    - … raises the value of default
    - … which increases the default frequency
    - … and worsens borrowing terms in bond markets
  - Without restricting swaps in default, welfare losses for the government

- Swap lines worsen the debt dilution problem

Literature

- Central Bank swaps among advanced economies
  - … Bahaj and Reis (2021); Cesa-Bianchi, Eguren-Martin, and Ferrero (2022)
- Data on Central Bank swaps
  - … Perks, Rao, Shin, and Tokuoka (2021); Horn, Parks, Reinhart, and Trebesch (2023)
- Sovereign debt/default with non-defaultable debt
  - … Hatchondo, Martinez, and Onder (2014)

Model with Swaps only

Environment

The government of a small open economy borrows from a monopolist

- Income $y(z_t)$ follows an AR(1) process in logs
  - … Only one good, representative risk-averse household, expected utility
- Renegotiate the swap m each period
  - … Involves a transfer x and a new loan size m'
  - … Swap is non-defaultable $\implies$ Repaying m is the natural threat point

$$x = \frac{1}{1+r} m' - m$$

- Should expect
  - … Implicit interest rate r to vary over time
  - … Interest rate to reflect market power
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Bargaining stage with monopolist

- At income state z and loan m, solve

$$\max_{x,m'} \mathcal{L}(x,m,m',z)^{\theta} \times \mathcal{B}(x,m,m',z)^{1-\theta}$$

Government surplus

Lender surplus

- Government (borrower) surplus

$$\mathcal{B}(x,m,m',z) = \underbrace{u(y(z)+x) + \beta \mathbb{E}\left[v(m',z') \mid z\right]}_{\text{agreement: receive } x\text{, owe } m'} - \underbrace{\left(u(y(z)-m) + \beta \mathbb{E}\left[v(0,z') \mid z\right]\right)}_{\text{threat point: repay } m\text{, clean slate}}$$

- Lender surplus

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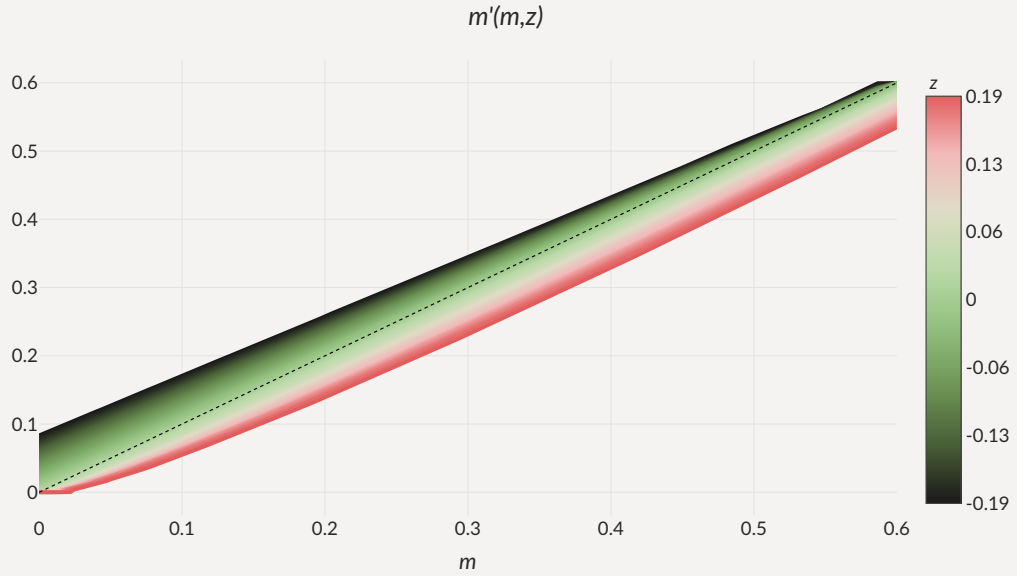
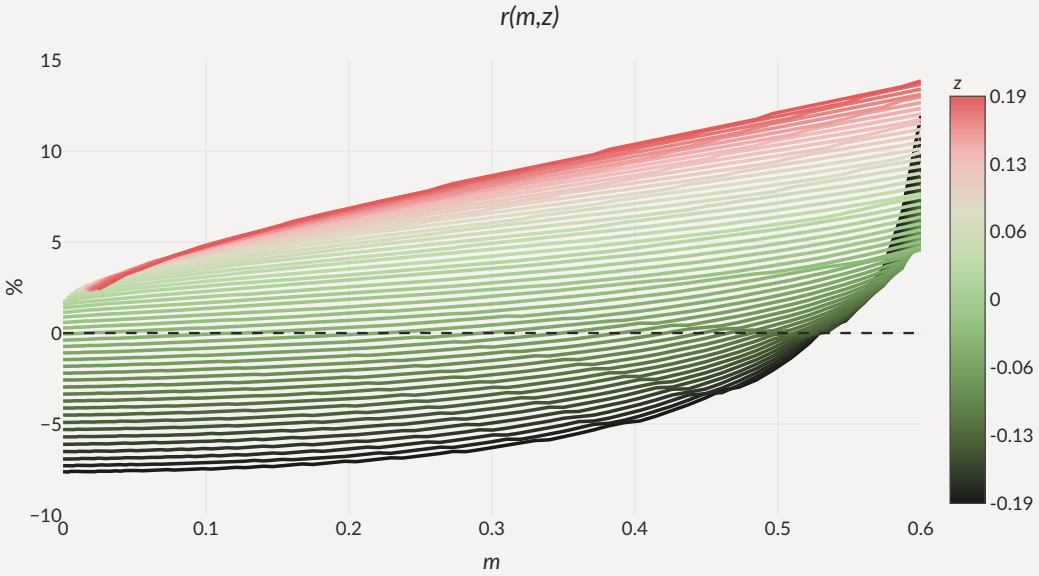
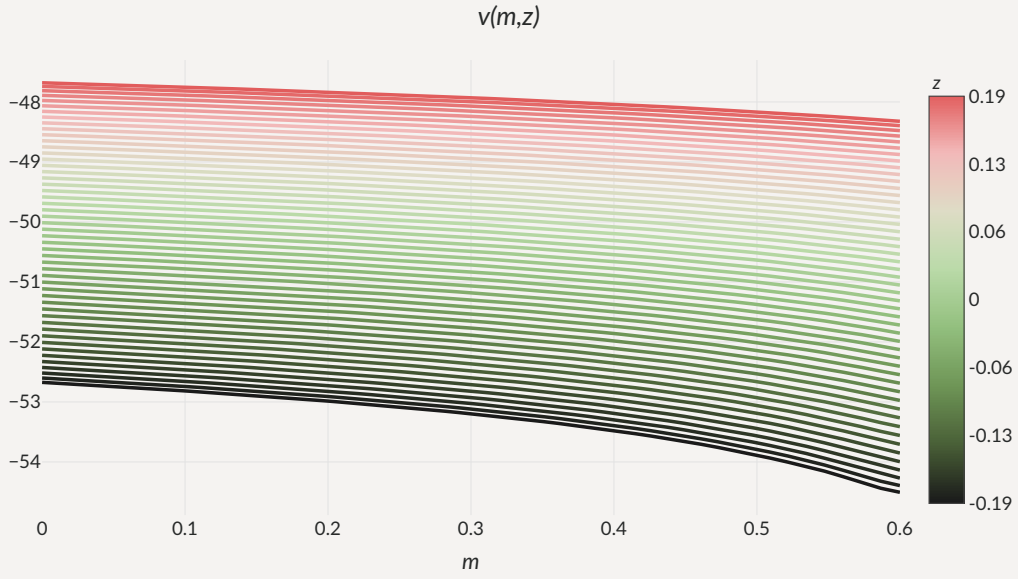
Swap Line Terms: Loan Dynamics



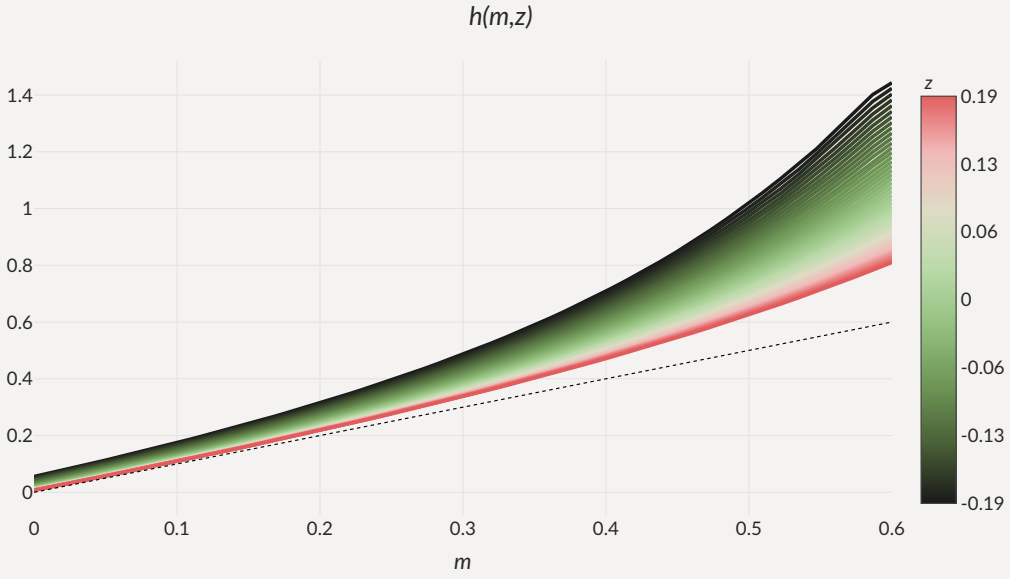
Swap Line Terms: Implicit interest rate



Swap Line Terms: Borrower's value function



Swap Line Terms: Lender's value function



Swap Line Terms: Takeaways

key requirement:
threat point value decreasing in m

The threat point is less 'credible' when m is large

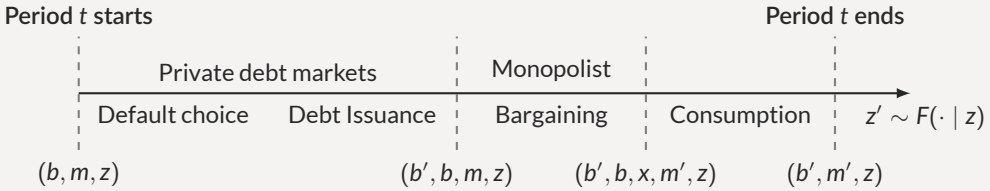
- This creates convexity in the lender's value function
  … making the lender act 'as if' risk-loving

- The lender initially subsidizes the loan to induce indebtedness and high profits
  - Gamble for debt overhang

- Initial subsidy and high rates consistent with B's risk aversion – 'Participation constraint'

Model with Swaps and Debt

Timeline of events



Borrowing from markets

- Debt is a geometrically-decaying coupon
  ... get 1, pay $\kappa, (1-\rho)\kappa, \ldots (1-\rho)^{s-1}\kappa$
- Government enters first stage owing b in debt, m in swaps, income state z

$$v(b,m,z) = \max\left\{v_R(b,m,z) + \epsilon_R, v_D(m,z) + \epsilon_D\right\}$$
$$v_R(b,m,z) = \max_{b'} w_R(b',b,m,z)$$

- Lenders in competitive markets need to anticipate interactions with the monopolist

$$q(b',b,m,z) = \beta_L \mathbb{E}\left[(1 - 1_{\mathcal{D}}(b',m',z'))\left(\kappa + (1-\rho)q(b'',b',m',z')\right) \mid z\right]$$
$$m' = m'(b',b,m,z)$$
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same sdf as monopolist

Bargaining stage

- Same as before with extra state variables (b, b')

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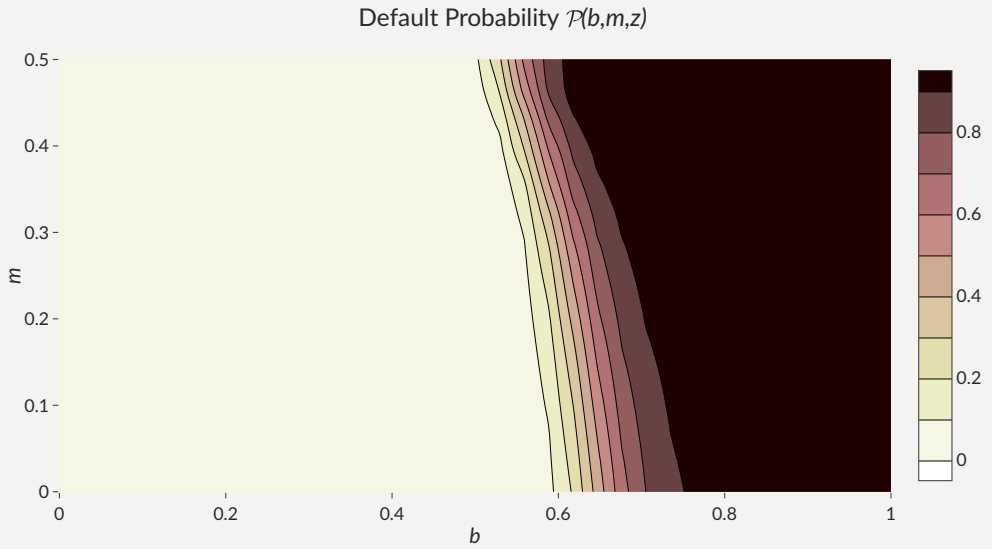
$$\begin{aligned}\mathcal{B}_R(b', b, x, m, m', z) = u\big(y(z) + B(b', b, m, z) + x\big) + \beta \mathbb{E}\left[v(b', m', z') \mid z\right] \\ - \big(u\big(y(z) + B(b', b, m, z) - m\big) + \beta \mathbb{E}\left[v(b', 0, z') \mid z\right]\big)\end{aligned}$$

$$B(b', b, m, z) = q(b', b, m, z)(b' - (1 - \rho)b) - \kappa b$$

Quantitative Effects of Swap Lines

Default probability

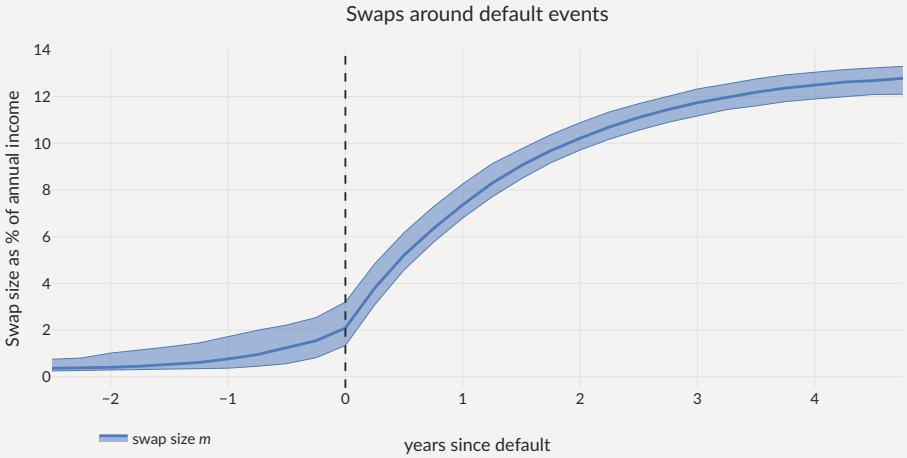
Both types of debt are clearly substitutes



When is the Swap Used?

Limited More

- In repayment, average swap = 0.42% of GDP with s.d. 0.71%
- In default,



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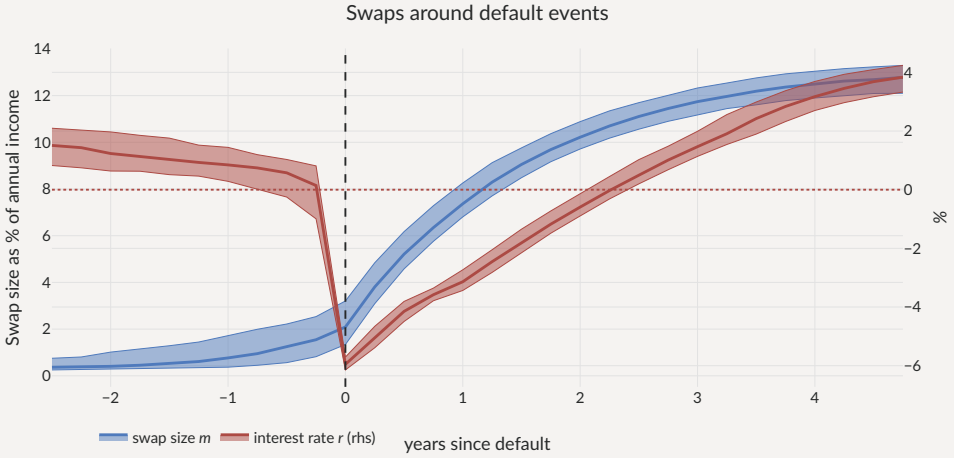

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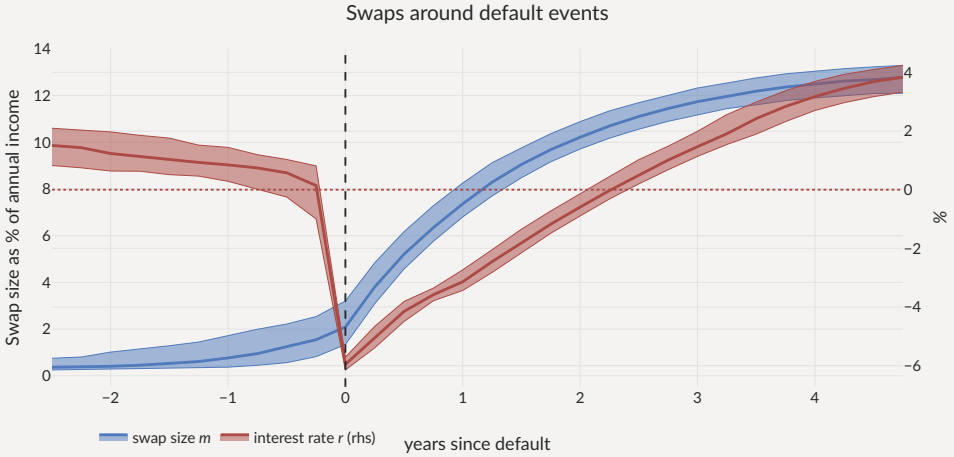

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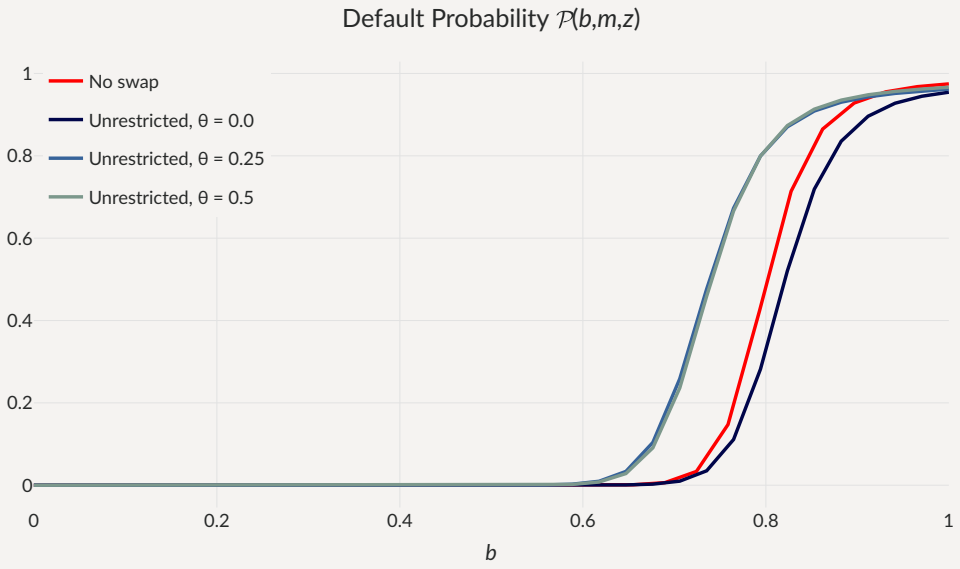
Debt Tolerance with Swaps

Repay less often when swaps present (except when $\theta = 0$). More often with Limited



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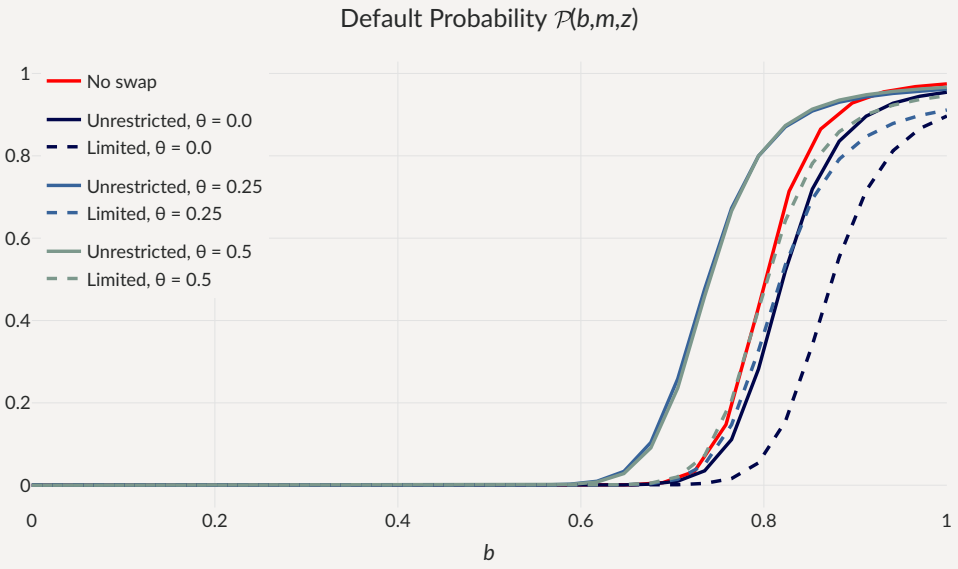
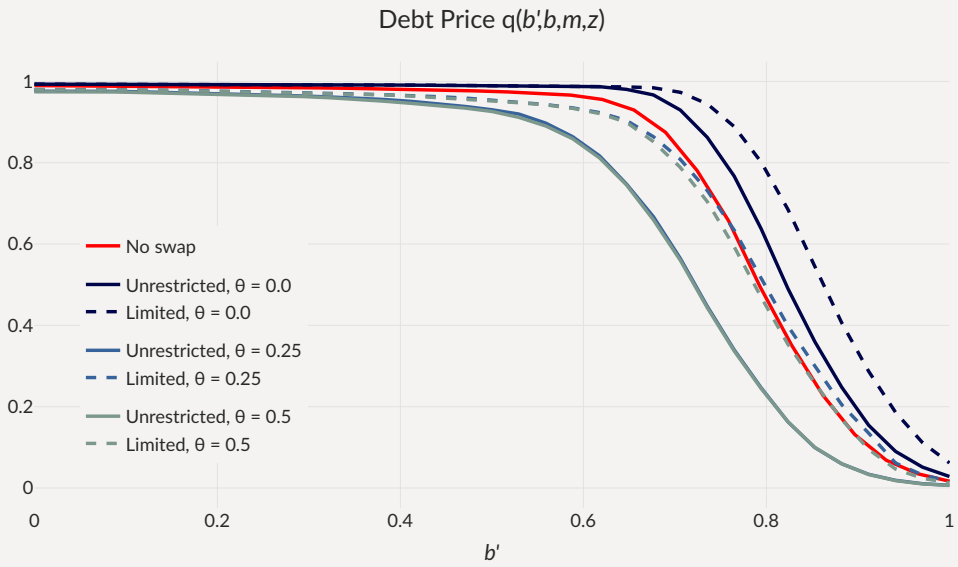


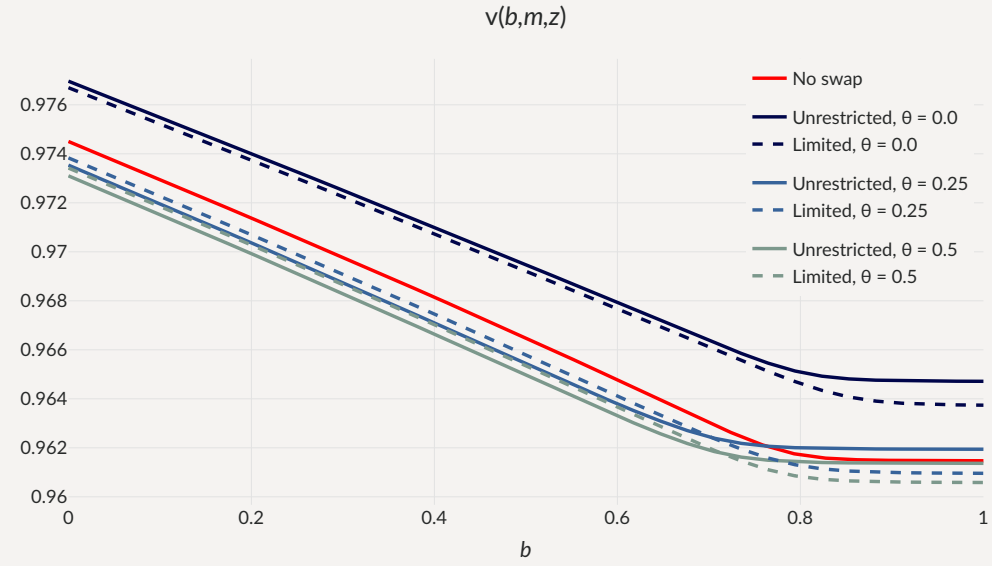
Debt Prices with Swaps

Limited: more likely to repay but lower prices ⟶ Tell-tale sign of debt dilution



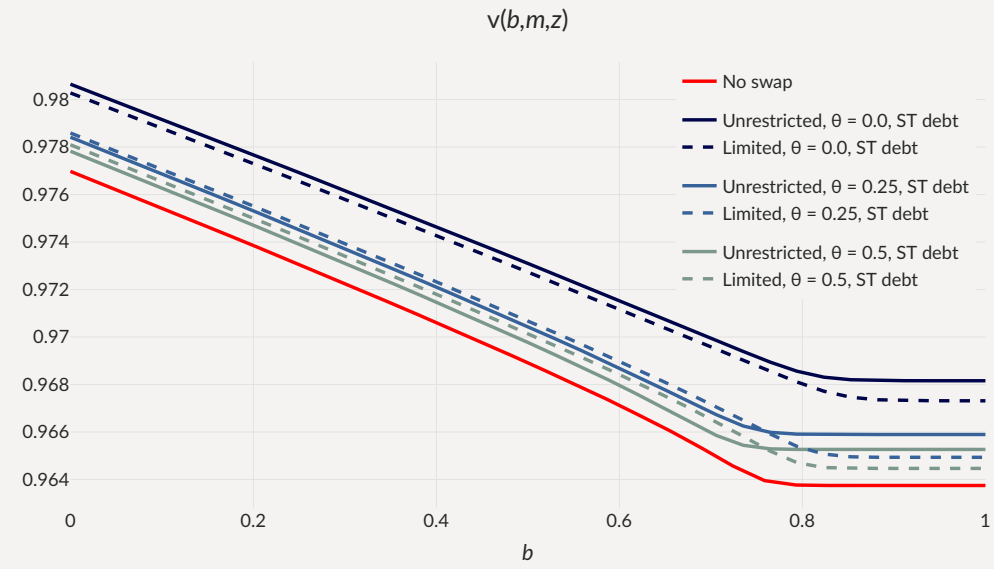
Welfare effects of swap lines

with interior bargaining power, Limited $\succcurlyeq$ Unrestricted, but…



Welfare effects of swap lines — Debt dilution

Solving model with short-term debt: gains of swaps



Concluding remarks

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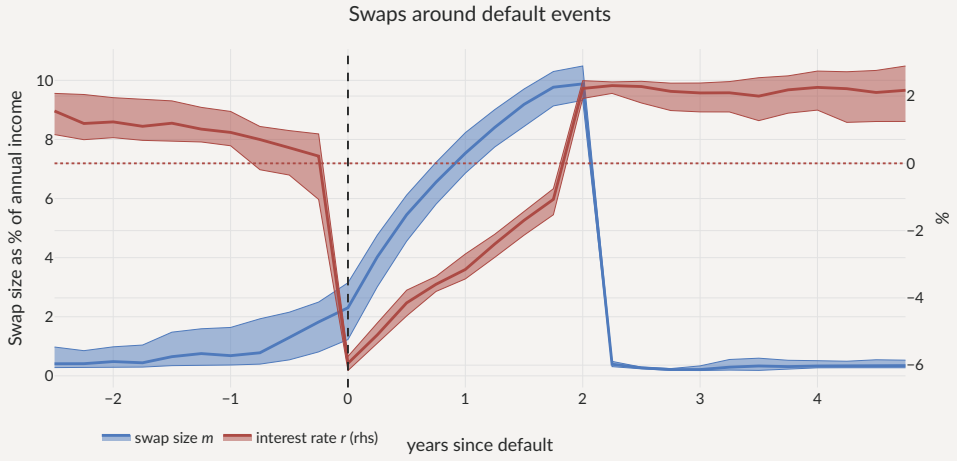
- Simple model with monopolist/fringe structure
- Strong interaction between two markets for sovereign debt
  - … even if swaps are not used intensely on the equilibrium path
- Market power crucial in model
  - … how to discipline in model?
  - … how to affect in reality?
- Large welfare effects, policy challenges
  - How to limit their use during defaults?
  - Strengthened debt dilution – more gains from fiscal rules, state-contingent debt?

When is the Swap Used?

Back

- Further conditioning on default events lasting exactly two years



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