Currency Swap Agreements and Financial Crises in Small Open Economies

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Abstract

This paper studies the effects of currency swap agreements on the probability of financial crises in emerging economies. The analysis is based on a small open economy model with a financial constraint. A currency swap is described as an exchange of collateral goods between two countries. When the amount of the collateral goods exchanged is large enough to cover the loss of collateral caused by negative shocks, the swap agreement is shown to be an effective tool for lowering the probability of financial crises. In contrast, there are cases where it can raise the probability. These results show the importance of choosing the size of withdrawal of the currency in designing an swap agreement.

Keywords: Emerging economy, Financial crisis, Currency swap

JEL classification: E32, F41, F44

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