Equilibrium in FX swap markets: analogy with repo, funding pressures and the cross currency basis

Mario Pascoa [1], J.M. Bottazzi[2], J. Luque [3]

[1] University of Surrey

[2] Capula and Paris School of Economics

[3] U. Wisconsin-Madison

Resumo/Abstract:
Departure from Covered Interest Parity (CIP) exacerbated during the 2008 great financial crisis and has not gone way ever since, even for major currencies pairs. To understand this new normality, we turn the CIP logic on its head and look at the FX swap market as the very market where limited funding abilities in different currencies are exchanged. By analogy with repo for securities, we introduce a possession value for currencies. Cross currency basis is driven by the relative possession values in a currency pair. The holder of the scarcer currency earns higher interest when agreeing to swap it. Underlying this possession value are currency funding pressures in balance sheets of international reach. We show this by modelling banks' funding constraints and leverage requirements. We analyze in this context the role of central banks' FX swaps lines.