Financial markets

Buttonwood's notebook

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Currencies

Super QE, or beggar-thy-neighbour

Sep 6th 2011, 13:43 by Buttonwood

CURRENCIES don't tend to move 7-8% in one day in the modern era but the Swiss National Bank has achieved the feat today. It announced a "minimum" exchange rate target of 1.20 francs per euro (here is the announcement) and the markets fell into line. In reality, the target rate is a ceiling, not a floor; if you turn the cross-rate round, the Swiss want the franc to be worth no more than 83.33 euro cents.

As was remarked in a previous column, the Swiss franc has been rivalling gold as a safe haven and the authorities are worrying, as the statement shows, about the deflationary threat. So it will create Swiss francs to buy "unlimited" amounts of foreign exchange. Since the target rate is based on the euro, presumably it will buy euros. Traditionally, we think of central banks as pursuing the opposite policy; using its foreign exchange reserves to buy the domestic currency (like the UK's doomed effort in 1992). But this is doing the opposite, creating Swiss francs to accumulate reserves. And, in theory the scope is unlimited; the Bank of England ran out of resources in 1992, but the SNB can create francs without number.

Other countries have used QE without explicitly aiming to drive down their exchange rates, although the Bank of England has broadly welcomed the decline in the pound and QE enthusiasts cite the decline in the dollar as an example of the success of the Fed's policy. But this is shock-and-awe stuff and makes one wonder whether other countries will follow suit. As Chris Turner, head of FX strategy at ING, comments

> *This marks a major new round in the currency war. Could not Japan also set a minimum USD/JPY exchange rate at 75 as a means to battle deflation?*

Any policy as aggressive as this is bound to have some side-effects, both domestic and international. The Swiss had been attempting to weaken their currency by a more roundabout route, repurchasing Treasury bills and diverting the money into bank deposits. This policy had already had the effect of making interest rates negative, in the very practical sense that UBS was charging institutional customers who held excess

1 day 1 week 2 weeks

deposits in their accounts. The trouble with this strategy is that most currencies are currently paying little-or-nothing; investors might not mind paying 1% to hold a deposit if they felt the Swiss franc was set to rise 5% a year against the dollar or euro. And as Geoffrey Yu of UBS points out, this approach was limited in scope; deposits had ballooned from Sfr30 billion to Sfr230 billion in just a few weeks, already more than the Sfr200 billion target.

Eventually, one would expect such money creation to fuel inflation. The Swiss monetary base is already 50% of GDP (the equivalent figure for America is 18%) but there are no signs of inflation yet. There are also questions about the financial health of the SNB and about the potential losses if this strategy fails (the losses incurred on previous interventions have sparked calls for the governor's resignation).

The international side-effects may be even greater. It seems that all countries would like to see their currencies decline bar the Chinese who will only let the renminbi strengthen gradually. Some currencies must rise, however, and the Europeans may not be too happy to see the Swiss trying to drive the euro up, especially if the Fed opts for a third round of QE. And what will the Swiss buy exactly? A report in the Frankfurter Allgemeine Zeitung suggests the cautious Swiss have been buying French and German government bonds, not Italian or Spanish (let alone Greek) debt..

But this has had unfortunate consequences. As Mr Yu remarks

> *It is highly likely that the SNB inadvertently made things worse for themselves (and everyone else); swiftly diversifying into German paper in large amounts caused periphery spreads to widen which only increased market fears and the subsequent risk aversion forced the euro lower (against the Swiss franc)*

This process may continue if the Swiss live up to their promise to buy unlimited amounts of euros. Worse still, the Swiss may still attract deposits from elsewhere who may still despite the currency's perceived safety. Some of the flows into Switzerland may be coming from alarmed Italian and Greek depositors. As Simon Derrick of BNY Mellon comments

> *Rather than recycle these funds back into the markets they came from the (Swiss) money will be invested into French and German debt (if we believe the FAZ story). In other words, the money continues to flow from the south to the north of the continent (albeit by a slightly indirect route).*

It is all a bit reminiscent of the 1930s. When countries went off the gold standard, they gained a competitive march on their rivals, increasing the pressure for such countries to leave the standard as well. If one country devalued by 10%, the next might do so by 15%. QE may similarly begat more QE.

David Bloom of HSBC has a further reflection on the consequences.

> *We have long argued that the Norwegian krone is a better safe haven play than the Swiss franc. In every respect, the krone has superior qualities. However, the market will now fear that if it pushes the krone (or the Singapore dollar) too far. there will be push back from the various central banks. The market must fear this will cause a sharp escalation in the currency wars. The only safe haven that will not do QE, put in capital controls, or complain about its strength is gold. It must emerge as the winner.*

UPDATE: In response to various comments, I don't think this issue is a matter of patriotism or Anglo-Saxon perspective; see the quotes of Mr Yu from Union Bank of Switzerland, for example. This has indeed been a tactic pursued by many countries including the British; a recent blog note pointed out that the pound has undergone a record devaluation in recent years. The Swiss are very much reacting to pressure that has arisen from the actions of other governments; it is still worth pointing out that their actions will simply shift the deflationary pressures elsewhere, a game of "pass the parcel".

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Doug Pascover wrote: Sep 6th 2011 3:26 GMT

Funny, I'm reading this from Iceland and both the contrasts and the similarities kind of stand out. Both Iceland '08 and Switzerland '11 are denominating more than their economies can support in local currency. On the other hand, kudos to Switzerland for their reluctance. The next kreppa will at least be sympathetic.

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NotAGenius wrote: Sep 6th 2011 4:21 GMT

More like "bugger-thy-neighbor"

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LoveIsrael wrote: Sep 6th 2011 4:25 GMT

The Swiss National Bank signaled today, very clearly, that it will not be a "Shock Absorber". While the S.N.B. reduced the volatility in the Swiss Economy, it increases the volatility in the Gold Market and in the Forex Markets.

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Yukon Dave wrote: Sep 6th 2011 4:42 GMT

WOW, Defensive move, it is almost like the super rich in Europe (banking in Switzerland) are acting like the Federal Reserve to the Treasury.

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Steve Thompson wrote: Sep 6th 2011 5:28 GMT

Here's an article showing how ineffective quantitative easing has been at propping up Japan's stock market over the long term:

http://viableopposition.blogspot.com/2011/08/americas-sliding-economy-wh...

QE is a central bank experiment being foisted on the sweaty masses by bankers who really have no understanding about the predictability of their actions. God help us all.

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history student wrote: Sep 6th 2011 6:41 GMT

I wonder if Buttonwood would judge the British pound the same as the Swiss franc.

Beggar-thy-neighbor yeah!

http://blogs.reuters.com/great-debate/2011/08/31/the-fed-must-print-mone...

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khmTzic3YT wrote: Sep 6th 2011 6:42 GMT

No Swiss bubble? Have you ever heard of Swiss Cheese.

Swiss neutrality, independence and self preservation traits will not save the land locked nation when Europe declines. Switzerland goes along for the ride when the Apocalypse comes.

And it is the cocooning mentality is an antique trait. The world is global and interdependent. The Chinese have saving habits that rival the Swiss. And double the population of the combined European Union. And GDP growing at 4x the rate of the healthy Swiss economy. And Hong Kong recently surpassed London, New York and Zurich as the world's largest banking center. And unlike the Arabs, Chinese believe in interest, working capital, and usury. High risk must yield high return.

Despite the contrary, Switzerland is in Europe and is a part of the EU. The Swiss Franc is a stealth Euro. Its fate is linked.

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JuanDSolano wrote: Sep 6th 2011 6:47 GMT

QE was effective?

That would be interesting news! Or, at least, an interesting topic for debate.

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dhpar wrote: Sep 6th 2011 7:46 GMT

Very poorly written article for the Economist standards.
To start with CHF is a different story from JPY. For instance it started to be very volatile recently (while Yen is pretty much stable), it is objectively overvalued (compared to Yen) and SNB does not try to regularly prop up Swiss exporters in the way BOJ does. In the medium term Swiss always adjusted via productivity gains in the past 30+ years - which other countries can say that?

But there is no reason SNB shouldn't step in when the Swiss manufacturing is threatened to annihilation by huge currency moves in the past few months which had nothing to do with the trade balances, productivity, etc.

And why all that currency moves? Because all the reckless economies worldwide decided to speculate once again and put their money into the "safe heaven" CHF? As their own currencies were screwed? The argument here is not about competitive devaluation but rather about preventing currency appreciation due to the speculation. We are not talking here about some dreamworld free markets anymore - do you remember Asian currencies? It is enough to look at the CHF chart to see that SNB does NOT try to give their exporter a free lunch - but there are limits to every craziness and nobody wants to have the rest of the world shit on your head.

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filipzyk wrote: Sep 6th 2011 8:03 GMT

If negative interest rates trickle down to small account holders at the smaller community banks, there will be a resurgence of money being stored in mattresses and money boxes buried in back yards. Could the capital losses to small banks be catastrophic and result in a deflationary spiral? Just asking. This could be another unintended consequence of central financial planning.

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oneofthepeople wrote: Sep 6th 2011 8:03 GMT

No wonder citizens around the world are fleeing to gold like their ancestors did. Paper is once again proving itself to be unreliable.

The amazing thing is that too much debt is the real problem here. The banks printed too much debt, just like they did in the 1920s, which caused the Great Depression. Now central banks are furiously printing even more debt as the "solution", just like they did in the 1930s. Yet more debt just makes things worse, when there is already too much debt. Printing the housing bubble as the cure for the Y2K bubble just made things worse.

All we need now is a revival of the Smoot tariffs to complete the mistakes of the 1920s and 1930s. The banks have printed us up a disaster once again.

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Mesdames wrote: Sep 6th 2011 8:08 GMT

Since these new Swiss Frances are being produced soley for export it is very unlikely they will cause domestic inflation.

Instead, they will likely cause asset price inflation across the EU - not Switzerland.

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oneofthepeople wrote: Sep 6th 2011 8:39 GMT

Beggar thy neighbor. Paradoxically, the bank that succeeds in making imports unaffordable for citizens is the bank that succeeds in beggaring voters in their own country. Citizens in nations with a strong currency get to live like kings, importing cheap oil, food, and televisions. Citizens of nations with devalued currencies get stuck with expensive petrol, food, and unaffordable televisions.

Beggar thy neighbor works out to bankers pay themselves lofty bonuses, and everyone else gets poor. People are still unemployed either way, since too much debt is what is causing unemployment.

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Dasha Petrova wrote: Sep 6th 2011 9:06 GMT

Frederic Bastiat would not be pleased.

More interventionism and protectionism. I don't get what's wrong with deflation? Exporters are forced to lower prices, wages go down, but prices are now lower, so are real wages actually going down? Savings/investments are encouraged, leading to lower cost of capital.

Under the gold standard in the 19th century there was constant deflation.

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Keflex wrote: Sep 6th 2011 9:22 GMT

¨It is highly likely that the SNB inadvertently made things worse for themselves (and everyone else); swiftly diversifying into German paper in large amounts caused periphery spreads to widen which only increased market fears and the subsequent risk aversion forced the euro lower (against the Swiss franc)¨

WHOOPS. Probably better to have bought a bunch of stuff in further removed currencies/locales. The real problem that should be dealt with is this statistic:
¨The Swiss monetary base is 50% of GDP (the equivalent figure for America is 18%)¨

Rather than increase the amount of SFR in circulation, the amount needs to be REDUCED. The only way I see to do this is in parallel with measures which restrict non-Swiss from holding SFR deposits... That obviously only affects Swiss banks, but it´s a start. Capitol-importation and holding rules would need to be instituted for corporations as well, obviously.

Basically, going forward Swiss banks will offer their services to international clients in international currencies, and the reduced SFR demand will let the SFR drop. Swiss banks themselves could help shoulder this burden by buying non-Swiss client SFR holdings with other currencies... Leaving them with SFR capital which wouldn`t be sold except in limited circumstances (and given that international SFR usage would be drastically reduced, selling SFR at that point would just lower the currency). Perhaps simultaneously put forward a gold, or other resource-backed, `hard` currency for international financial usage.

@oneofthepeople: You seem to be confusing the Swiss situation with that of the US. The Swiss National Bank issued NO debt in this situation. Swiss paper money has in fact been a refuge vs. currencies which lose value (as have the Euro and Norwegian Kroner paper currencies), and the failed intervention didn`t change that. Swiss public debt is around 38% of GDP, so issuing debt to devalue the currency ala the US and Japan is actually a fairly reasonable course of action, although how to immediately spend the money is critically important, as seen in the results from buying German and French Euro debt.

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Keflex wrote: Sep 6th 2011 9:40 GMT

Dasha wrote: ¨I don't get what's wrong with deflation? Exporters are forced to lower prices, wages go down, but prices are now lower, so are real wages actually going down? Savings/investments are encouraged, leading to lower cost of capital.¨

You`re completely ignoring the context of Switzerland.
They really would do better off simply using the Euro, but how to get there under ideal circumstances is the question. Prices of most goods are determined by Euro market conditions. There isn`t a particulary low cost of SFR capital, and Swiss are already relatively high savers.

The SFR does make one think of what would happen if Germany kept the Deutschmark outside of the Euro, or created a `hard-Euro` with Netherlands and the Nordic countries... While Germany has managed with Euro appreciation so far, it would be at least twice as much if the `soft` Southern Euro countries were excluded, meaning exports would be crushed.

The solution to debt problems of Greece/etc is pretty simple: Greece can default, which works fine if you look at Argentina. No reason for Greece to leave the Euro, which would cause more trouble than it`s worth. The problem is the banks who hold Greek debt... Solution, print Euros to partially re-pay them, lowering Euro value and helping exports and domestic economy.

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WHF9Do8DPW wrote: Sep 6th 2011 9:42 GMT

The Germans must be thankful they are in the Euro, otherwise imagine the capital flows into the D-Mark, and how many Euro-bonds they would have to buy to protect their exporters.

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Kevin Sutton wrote: Sep 6th 2011 10:02 GMT

"I don't get what's wrong with deflation?"

It creates a cycle of lessening economic activity. Why buy something now when it will be cheaper later? Why invest your money in marginal investments when holding cash makes as much money?

Worse, it puts people and businesses who currently have any debts in hot water by increasing the value of their debts while future profits decline.

Also, just as inflation of wages can be eroded by inflating costs, declining costs are counteracted by declining wages and profits. There's no clear gain in that.

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Tocquevillain wrote: Sep 6th 2011 10:05 GMT

Silly article. I wonder how the SNB could loose money. It's printing CHF in order to sell it at 1.20 per Euro. It uses the proceeds to buy arguably the safest asset in the world.

Four years ago EUR 1 was worth CHF 1.6825, so arguably the SNB will allow the CHF to fall back to at least CHF 1.60 per EUR, or even CHF 1.70.
CHF 1 = EUR 0.83 right now, when SNB reverses, it will be

CHF 1 = EUR 0.625, or rather EUR 0.83 CHF 1.33.

So unless the SNB manages to loose 33% in EUR terms on its German government paper, it will come out ahead of this trade. Unless the SNB or Swiss government spend the proceeds before they close out their position. (But I for one expect them to be smarter than that, at least.)

Beggar thy neighbour seems a harsh title for the Swiss refusal to simply lap up the punishment of limitless monetization in the USA and the UK. CHF has appreciated from CHF/USD 1.45 in the previous crisis (2001) to close to CHF/USD 0.72 on Aug 15, 2011. So in fact Switzerland has allowed the USA to write off half of its debt and production cost before Switzerland took umbrage.

This magazine should report such issues rather than being laughably onesided, if it is to be taken seriously.

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GuillermoMarraco wrote: Sep 6th 2011 10:53 GMT

Another lifeboat full...

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