AQUILA

Flash

How long can the SNB keep its 1.20 floor for the Swiss franc against the euro?

For a long time the SNB has been able to avoid purchasing foreign currencies. This has changed in recent weeks, during which the SNB has once again found itself forced to intervene in forex markets in order to maintain its 1.20 floor for the Swiss franc against the euro. The national bank has also had to introduce negative interest rates. Thus the SNB's exchange rate policy is once more hitting the headlines. When push comes to shove, we doubt that the SNB will allow its forex reserves to rise without limit. Rather, some adjustment to its policy floor has become more likely. Accordingly, we advise that euro assets be hedged promptly back into Swiss francs.

The SNB's forex reserves have multiplied by a factor of five since 2009.

Forex assets of the SNB have risen roughly five-fold since 2009 with the forex purchases of 2010, 2011 and 2012 contributing significantly to this process. During the Eurozone crisis of 2010, which was triggered by the problems of Greece, the SNB bought roughly CHF100bn. worth of foreign currencies within a matter of months in order to limit the appreciation of the Swiss franc. During the second Eurozone crisis in the summer of 2011, which was amplified by the inability of US politicians to agree on a US Budget, more than CHF 100bn. of additional foreign currencies were purchased by the SNB. On September 6, 2011 the SNB introduced its 1.20 floor for the Swiss franc against the euro and, for a time thereafter, upward pressure on the Swiss franc abated. In the following year, however, investor buying of Swiss francs reemerged with renewed frenzy. The trigger was the third Eurozone crisis since 2010 which seemed to bring into question the very foundations of the Eurozone. Over about six months the SNB had to purchase nearly CHF200bn. worth of foreign currencies in order to preserve its 1.20 floor. Following Mr. Draghi's promise in July 2012 to "do whatever it takes" to preserve the euro, that crisis came to an abrupt end. Subsequently, the Eurozone experienced a period of relative calm and the SNB was able to avoid massive further forex purchases.

But in recent weeks the SNB has had to intervene once more to defend its 1.20 floor.

Had the peace that followed Mr. Draghi's intervention continued, the SNB's 1.20 floor policy would not be making the headlines. Unfortunately things have turned out differently. The forthcoming Greek elections on January 25 have already cast their shadow on the markets. Latest SNB data show forex reserves were CHF495bn. at the end of December. A part of the increase since September can be attributed to the rise of the dollar. But the weekly statistics for bank sight deposits with the central bank show an increase of around CHF20bn. during December and the first weeks of January. This suggests additional SNB forex purchases.

The Eurozone remains liable to further crises. It is confronted by serious long-term economic and political problems.

Alongside the economic challenges, in which the heavyweight economies of France and Italy figure prominently, the Eurozone now seems beset by political pressures which threaten its disintegration. Parties highly critical of the European project - such as the AfD in Germany, the Front National in France, Cinque Stelle in Italy, Podemos in Spain, UKIP in Great Britain und the True Finns in Finland – have attracted strong support. The results of forthcoming elections in Finland, the UK and Spain could provoke yet more instability. Then there is the smoldering conflict with Russia. Finally, the fact that public sector indebtedness in the Eurozone continues to rise relative to output only adds to the potential for further crises in the Eurozone.

We don't believe that, in the last resort, the SNB will allow its forex reserves to rise without limit.

The examples of 2010, 2011 and 2012 show how quickly the SNB could find itself forced to buy yet more foreign currencies on a massive scale. So it is legitimate to question the advisability of the SNB's 1.20 floor. Would the SNB really be willing to allow an explosion in her forex assets relative to their current level of around CHF500bn? If fresh francs are printed without limit, the value of the Swiss currency could well be called into question. This might lead to a severe loss of confidence, currency instability, currency reform or even the abolition of an independent currency. Given such risks we think that the SNB would eventually stop its printing press. But abandoning the 1.20 floor could unleash massive waves of Swiss franc purchases by the market, putting Swiss exporters in an almost impossible situation, at least for a time. It would also trigger enormous unrealized losses for the SNB in respect of the forex assets on its balance sheet. From this perspective the continuation of the current 1.20 floor represents a bet that the Eurozone will not be confronted with another massive crisis.

The current strength of the dollar makes it easier for the SNB to adjust its floor.

A few days ago Professor Ernst Baltensperger floated the idea that, in substitution for its current floor policy vis-a-vis the euro, the SNB should institute a fixed price regime for the franc against a basket involving the euro and the dollar. The proposal is based on the assumption that the dollar is on a strengthening trend against the franc which would allow a lower value for the Swiss currency against the euro within its exchange rate against the basket. We disagree with the professor as to the desirability of a currency regime based on a specific assumption regarding the dollar. Moreover, it is quite possible that, should the dollar rise, pressures on Swiss exporters would ease, allowing the SNB to consider seriously a reset of its floor against the euro or doing away with it altogether. We could imagine a relatively orderly and gradual exit from the policy floor, whereby the SNB adjusts the floor in response to market pressures over a period until a new equilibrium is established. It might well happen that, at the end of such a process, the equilibrium value of the franc is seen to be not so very far from the 1.20 level that is currently so troubling.

The continuation of the 1.20 floor is now being discussed. We believe that the chances of an adjustment to the SNB's current policy have increased.

We think the SNB is working on alternatives to the 1.20 floor against the euro. Whether policy is adjusted will depend on how far the central bank finds itself forced to accumulate further forex reserves. We therefore advise our clients to hedge euro assets back into Swiss francs.
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