Financial Markets Rocked by Decision to Abandon Ceiling on Swiss Franc

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Financial markets were sent reeling Thursday when the Swiss national bank announced it was removing its ceiling on the value of the Swiss franc put in place three years ago.

In one of the most dramatic movements ever seen in the history of currency markets, the value of the Swiss franc, which had been fixed at 1.20 francs per euro, appreciated by as much as 39 percent against both the dollar and the euro in a matter of minutes.

The Swiss central bank carried out the decision without informing either the International Monetary Fund (IMF) or any other authorities, a move which IMF managing director Christine Lagarde described as "a bit surprising."

The currency peg was put in place amid the euro crisis of 2011 to try to stop the rise of the Swiss currency, which is regarded as a "safe haven" in financial markets, and protect the country's export markets.

But with the European Central Bank set to introduce some form of quantitative easing (QE) when its governing council meets next Thursday, Swiss authorities clearly decided they could no longer hold the line. Any move by the ECB toward QE will send down the euro, already at nine-year lows, even further. The Swiss national bank had been buying up large amounts of foreign currencies in order to maintain the ceiling, with foreign reserves now equivalent to 80 percent of the country's gross domestic product.

The full effects of the decision are yet to be recorded, but there is no question that it has already had a major impact in financial markets, where traders who placed bets on the ceiling being maintained will have sustained massive losses.

In the words of one hedge fund trader cited by the *Financial Times*: "Anyone caught on the wrong side of this will be lying on the floor."

The *Australian Business Spectator* warned that the fallout from the decision was "likely to be huge." There could be large losses for some traders, banks and hedge funds with "some of the losing parties in real trouble being forced to sell other financial assets such as stocks and bonds to cover their losses," There would also be a move to other perceived safe havens, such as German bonds and US treasuries, with a sell-off of what are deemed to be risky assets such as low grade corporate bonds.

The decision by the Swiss national bank and the resulting gyrations are symptomatic of the deepening crisis both in financial markets and in the underlying real economy.

In a major speech yesterday in the lead-up to an IMF report on the global economy next week, IMF managing director Lagarde warned that the current growth pattern was "too low, too brittle and too lopsided." Cheaper oil and increased US economic growth would not be enough to lift the world economy.

Speaking to a meeting of the Council on Foreign Relations in Washington, Lagarde said:

> "The oil price and US growth are not a cure for deep-seated weaknesses elsewhere. Too many countries are still weighed down by the legacies of the financial crisis, including high debt and high unemployment. Too many companies and too many households keep cutting back on investment and consumption today because they are concerned about low growth for the future."

Rather than providing a boost to the global economy, falling oil prices could increase the risk of deflation, particularly in the euro zone, she warned. "This bolsters the case for additional monetary stimulus, which the European Central Bank has indicated that it stands ready to support as needed."

In an interview with the German weekly newspaper *Die Zeit* on Wednesday, ECB president Mario Draghi indicated that the bank was moving towards the implementation of a program for the purchase of government bonds in a bid to counter the effects of deflation. The chief concern of financial authorities is that the continued fall in prices is worsening the position of banks and finance houses because the real level of their debt and interest payments rise under such conditions.

The effort to shore up the position of the banks is being advanced with the claim that it is necessary to fulfil the ECB's mandate to keep inflation near but below the level of 2 percent.

Figures released by Eurostat last week showed the euro zone has fallen into deflation for the first time since 2009. Consumer prices in the euro zone fell by 0.2 percent in December 2014, compared to a 0.3 percent price increase in November.

"All members of the ECB's governing council are determined to fulfil our mandate," Draghi told *Die Zeit*.

However this show of unity is completely cosmetic. In fact, the ECB governing council is deeply divided, with German representatives opposed to QE measures, fearing that moves to purchase sovereign bonds will make German banks responsible for the debts of other countries. German banks are already under-capitalised vis-à-vis their American and other rivals, having suffered major hits as a result of the sub-prime debacle in 2007-2008, and fear that their position will be further weakened if full-scale QE goes ahead.

Notwithstanding the growing threat of deflation, the divisions in the ECB are not narrowing but becoming greater.

In an interview with the news magazine *Der Spiegel* published January 10, Sabine Lautenschläger, a German representative on the ECB's governing council, said she was not convinced of the need for large-scale purchases of government bonds.

She said the problem was not that credit institutions in southern Europe were suffering from a lack of liquidity as the ECB had taken a series of measures to ensure adequate funds over the past months. "Rather, many banks are hesitant in extending loans because they believe that there is too great a risk that debtors will not be able to redeem them," she said.

Asked whether the "successful" quantitative easing program of the US Federal Reserve, which has seen some $4 trillion pumped into financial markets, could provoke a "rethink," Lautenschläger replied that any such comparison was misleading because of the different economic and political set-up in the euro area. Earlier in the interview she had pointed out that its "peculiarities" as a "currency area encompassing 19 sovereign states" had to be taken into account.

In other words, the push for a unified policy is foundering on the division of the area into rival and conflicting nation-states.

Rather than being overcome, these divisions may deepen as a result of any ECB decision next Thursday. One of the proposals under consideration is that sovereign bond purchases be implemented with the proviso that the central bank of the country whose bonds are being purchased would stand as the financial guarantor.

As the *Financial Times* European economics commentator Wolfgang Münchau noted in a column published Monday, any such decision would "effectively be the end of a single monetary policy" and make those who had advocated it wish that "they never asked for QE in the first place."

The full ramifications of the Swiss decision have yet to be felt. But already it has pointed to the growing fragility of financial markets, while the manner of its implementation, without any information being provided to other financial authorities, reveals the way in which conflicting national interests are increasingly coming to the fore as the economic crisis deepens.

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