

CHAPTER 6 – Government Influence on Exchange Rates

Swiss stunner sends euro to 11-year low against buck

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LONDON (MarketWatch) — The euro fell to its lowest level against the dollar since September 2003 after the Swiss National Bank (SNB) scrapped its exchange rate floor of 1.20 CHF/EUR, which had been in place since 2011.

The central bank's decision reflects investors' expectation that the European Central Bank will decide to begin buying government bonds at its Jan. 22 meeting in an effort to stimulate the faltering European economy, analysts said. This helped weaken the euro against its major rivals.

The euro fell as low as 1.1566 USD/EUR after the central bank's decision sent the currency tumbling to new multi-year lows against most of its rivals.

The euro has risen off its session lows to trade at 1.0510 Swiss francs, according to FactSet data.

The dollar traded as low as 0.73 CHF/USD, but had recovered to 0.90 franc in recent trade.

The Swiss central bank instituted the peg four years ago in an effort to prevent speculators from driving up the currency's value during the European Debt Crisis. Prior to the peg, the franc had been one of three premier safe-haven currencies, along with the yen and the dollar.

For the last four years, the peg has limited the currency's potential as a safe-haven asset. But now that's about to change, according to Matt Weller, senior technical analyst at Forex.com.

"Though the SNB has taken some measures to discourage speculation...the franc may now revert to its traditional safe haven status," Weller wrote in a Thursday morning research note. "Therefore, instead of the two FX safe havens that traders have grown

accustomed to over the last three years (the USD and JPY), there's a new currency that could vie for safe haven flows in times of stress."

"At the margin, this new dynamic could reduce demand for the dollar, though it should be noted that the US still sports higher short-term interest rates than Japan and Switzerland," he added.

While the Swiss franc's valuation remains high, the peg has allowed Switzerland's economy to adjust, the SNB said in a statement.

But now, the weakening euro threatens to drag the franc down with it, depreciating its value compared to the strengthening U.S. dollar. So the central bank ditched the peg in an effort to protect the franc from weakening further.

"In these circumstances, the SNB concluded that enforcing and maintaining the minimum exchange rate for the Swiss franc against the euro is no longer justified," the central bank said in a statement.

The SNB also cut the interest rate on certain sight deposit account balances, those that can be withdrawn at any time, to negative 0.75%, as well as lowering its target for the three-month Libor to a range of negative 1.25% to negative 0.25%, down from a range of negative 0.75% to 0.25%.

Elsewhere, the dollar moved lower against the yen, trading at 116.9090 JPY/USD, compared to 117.49 JPY/USD earlier as the dollar's decline against the franc spilled over to the dollar-yen pair.

Questions

1. In a peg, the domestic currency inherits the volatility of the foreign currency it is pegged against. Explain why the SNB considered the peg against the EUR no longer good for Switzerland.
2. Following the graphs used in class explain how the SNB used to intervene to boost the value of the EUR. Do you think it was a sterilized or non-sterilized intervention?
3. Explain the behavior of Swiss interest rates, relative to Euro-zone interest rates during the SNB's peg.
4. Was there a balance sheet effect during the SNB intervention?
5. Explain why the CHF during the duration of the peg stopped being considered a safe-haven currency.