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MARKETS

Swiss Franc Move Sets Markets Quaking

SNB's Surprise Scrapping of Euro Cap Triggers Turmoil in Currency Market

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ZURICH—Switzerland's central bank triggered unprecedented turmoil in the currency market on Thursday after it unexpectedly scrapped a cap on the franc-euro rate, underscoring the difficulty central banks have protecting their economies from developments beyond their borders.

The abandonment of the cap, which had essentially pinned the currency at 1.20 francs a euro for the last 3½ years, prompted a 20% collapse in the euro versus the franc, the biggest single-day move in a developed market traders could remember. Swiss stocks swooned nearly 10% as traders worried the stronger franc would pressure Switzerland's exports, particularly to Europe.

With Thursday's move, Switzerland became the first domino to fall in anticipation of the European Central Bank's decision on whether to purchase massive amounts of eurozone government bonds to raise the money supply and boost the currency area's sagging economic prospects. Most analysts expect the ECB to launch such a policy, known as quantitative easing, at its Jan. 22 meeting.

The prospect of hundreds of billions in freshly created euros flooding the markets had led to a significant weakening of the euro's exchange rate, particularly against the U.S. dollar, making the SNB's currency cap an increasingly risky and costly

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endeavor. Beat Siegenthaler, a strategist at UBS, estimates the SNB faces an implied paper loss of about $40 billion on its massive holdings of foreign currencies because of the day's move.

The SNB's decision, and the frantic reaction in financial markets, highlights the challenge facing central banks that have kept supposedly temporary measures in place for many years, and the sensitivity of markets to changes in those policies. In the U.S. nearly two years ago, uncertainty over the unwinding of the Federal Reserve's quantitative-easing program ignited volatile swings across global financial markets, particularly in emerging markets.

The Swiss case also shows the limitations of central banks in pushing against forces in the financial markets for an extended period, particularly when policy makers focus on currencies as a policy tool as Switzerland's has.

Switzerland introduced the minimum-exchange rate in September 2011. *REUTERS*

"Central banks have been the heroes [of the global economy] the last few years, but there are costs to being heroes," said Charles Wyplosz, professor at The Graduate Institute in Geneva. "They're all in a bind" with official interest rates stuck near zero in many developed economies.

The SNB's decision to scrap the currency cap was accompanied by the immediate introduction of negative interest rates on overnight bank deposits. The negative rates are designed to lessen the attractiveness of the franc.

Abandoning the cap marks an abrupt about-face for the SNB, which has consistently defended the cap on the franc since it was introduced in September 2011. SNB President Thomas Jordan and some of the bank's other top officials had reiterated that the cap was a cornerstone of its policy.

In a news conference, Mr. Jordan said the cap had served its purpose, helping stabilize the Swiss economy stabilize and give exporters adequate time to adjust their businesses to the strong franc. But he said maintaining the policy wasn't an option.

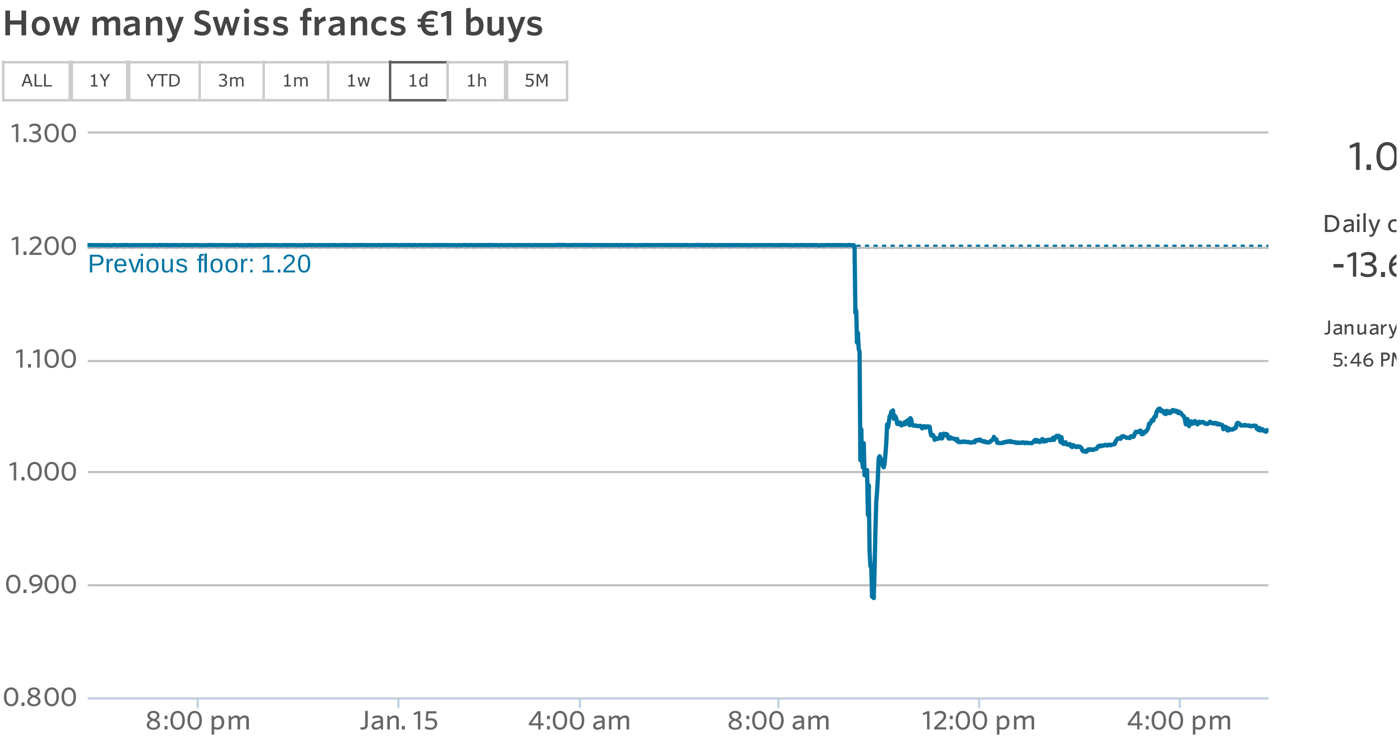
"We decided that due to international developments the time was right to discontinue the minimum exchange rate," Mr. Jordan told a news briefing. "The maintenance of the cap for the franc-euro isn't sustainable or sensible in the long term."

Mr. Jordan said the timing of the decision was meant to be a surprise. Indications that the SNB was planning a policy change might have encouraged improper trading, he said.

Mr. Jordan declined to comment on whether the SNB had consulted with the ECB or other central banks before making the move.

"The decision was taken without any outside influence," he said.

The efforts to rein in the franc have proved politically controversial even though the



In francs | Source: WSJ Market Data Group

central bank is widely credited for its sober stewardship of Switzerland's economy. In November, Swiss voters were asked to vote on forcing the central bank to hold a minimum amount of its assets in gold, a requirement some right-wing politicians felt was needed because the bank had purchased so many euros as it battled the relentless rise of the franc.

Voters rejected the measure but only after Mr. Jordan and other members of the governing board took the unusual step of staging interviews and lectures, a break with its custom of refraining to comment on political issues.

As well as abandoning the cap, the SNB said it would lower its target range for the three-month Libor rate—a key interest rate—to minus 1.25% to minus 0.25% from the existing range of minus 0.75% to 0.25%, effective immediately. Negative interest rates dissuade investors from buying a currency.

The SNB will also charge banks 0.75% on deposits that exceed an exemption threshold by 0.5 percentage point. The bank had planned to initially introduce a 0.25% fee on Jan. 22—the same day the ECB is expected to announce fresh stimulus.

The SNB justified the change in policy by saying the "overvaluation [of the franc] has

> *'It's a pretty extraordinary move, and there are going to be some massive repercussions in currency markets. The Swiss franc is a major currency, we're not talking about a rarely traded third-tier currency here. '*
>
> —Paul Lambert, London-based head of currency at Insight Investment. See related article: Swiss Franc Rockets

decreased" since the introduction of the cap more than three years ago, although it remains high.

"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," it said in a statement.

Following the decision, Mr. Jordan said the cap was an exceptional and temporary measure and was useful in protecting the Swiss economy.

The SNB is also lowering rates "significantly" to ensure the scrapping of the cap for the franc doesn't lead to tighter monetary conditions.

Analysts said Thursday's move was a surprise that could undermine the SNB's future credibility.

"This seems like a desperate move from the SNB," said Esther Reichelt, a currency analyst at Commerzbank . "It seems their willingness to intervene is not big enough."

A strong franc, which has benefited from haven buying and the malaise in the eurozone economies, raises the risk of deflation, a damaging spiral of lower prices and slowing spending, and creates headwinds for the country's exporters, many of whom depend on the European Union as an important market. A stronger currency makes exporters' goods sold abroad less competitive.

—Andrew Morse and John Revill contributed to this article.

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