Swiss National Bank Shocks the World

By Simon Kennedy - Jan 15, 2015

The road to normal is proving to be bumpy.

Stunning monetary-policy shifts in Switzerland and India sent markets on wild rides, highlighting Federal Reserve Chair Janet Yellen’s November warning that “normalization could lead to some heightened financial volatility.”

Following today’s wake-up calls, the Swiss franc surged as much as 27 percent against the dollar, moving more like the Ukrainian hryvnia than the seventh-largest reserve currency. Mumbai’s benchmark stock index posted its biggest gain in more than a year.

In India, Reserve Bank Governor Raghuram Rajan cut his key interest rate for the first time in 20 months. Six hours later, Swiss National Bank (SNBN) President Thomas Jordan abandoned a three-year-old cap on the franc's gains. Both decisions were unscheduled and, in Switzerland’s case, unexpected.

Less Than Zero

The lessons for investors: central banks are no longer aligned and again a source of volatility rather than calm in financial markets. Also, forward guidance has its limits as policy can shift abruptly when economic conditions change and officials still like the odd surprise.

The risks were emerging even before today. Investors are bracing for the first U.S. interest rate increase since 2006 and the European Central Bank is set to decide it will buy government bonds for the first time. The euro has weakened 14 percent the past year against the dollar on the back of the divergence trade.

Before that came the “taper tantrum,” when hints of tightening from the Fed in 2013 roiled bond markets worldwide.

Ceiling Dismantled

Jordan dismantled the franc’s 1.20 per euro ceiling a week before the ECB’s expected announcement of quantitative easing. That move would intensify upward pressure on his currency, rendering the cap untenably expensive. Rajan acted after a weakening of inflation gave him room to support an economy growing half the pace of four years ago.
Since the financial crisis erupted in 2008 and the world tumbled into recession, major central banks have deployed ultra-easy policy in the form of near-zero interest rates and cheap cash that Deutsche Bank AG estimates totaled $10 trillion.

The unity and abundance of liquidity becalmed markets, yet now frictions are emerging that will likely roil them.

The SNB noted the end of solidarity was one reason to discontinue the cap, saying division is “a trend that is likely to become even more pronounced.” As the Fed readies to tighten monetary policy, deflationary forces mean the ECB is looking to ease anew. The Bank of Japan has already done so.

**BRIC Contrasts**

Rajan’s action also contrasted with recent rate increases in BRIC counterparts Russia and Brazil aimed at supporting exchange rates. Less noticed today, Indonesia’s central bank kept its rate unchanged.

As they grapple with turns in their economies, central banks also may struggle to control the message, something they’ve prided themselves on during the crisis. Forward guidance may need to be increasingly taken with a pinch of salt.

Just this week, the SNB indicated its cap was here to stay, with Vice President Jean-Pierre Danthine saying, “it must remain the pillar of our monetary policy.” A U.K. lawmaker called Bank of England Governor Mark Carney an “unreliable boyfriend” for sending mixed messages on rates.

In the end, central banks showed that they still have the power to stun. That may happen again at the ECB next week after markets sneered at the suggestion President Mario Draghi may limit quantitative easing to 500 billion euros ($586 billion).

The Fed could also wrong-foot investors as it stresses any shift will be data dependent. While Capital Economics Ltd. sees the Fed raising rates by June, Goldman Sachs Group Inc. is eyeing the third quarter. Morgan Stanley is looking into 2016.

“Volatility is back,” said Kit Juckes, global strategist at Societe Generale SA in London. “Markets now face opposing currents, more economic divergences and more monetary-policy divergences. All these things are going to be bumping against each other.”

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