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As Switzerland Moves to Negative Rates, Finance Enters Uncharted Territory

By Michael J. Casey



Reuters

Having abandoned its policy of capping the Swiss franc's value versus the euros, the Swiss National Bank needs a Plan B for blocking the destructive, deflationary forces emanating from Switzerland's struggling neighbors in the eurozone.



Horizons

By Michael J. Casey

COMMENTARY

Most likely, it will consist of allowing Swiss banks to charge negative interest rates to foreign depositors in a bid to deter unwanted "hot money" inflows into the franc. It's an extreme measure that opens up uncharted territory and provides a test case for the limits of all central banks' ability to spur economic growth in a post-financial crisis era of stagnating economies and currency imbalances.

The SNB has not satisfactorily explained why it abruptly stopped intervening to keep the euro at a floor of 1.20 Swiss francs. But whether it was a response to political concerns over a ballooning portfolio of ever-depreciating euros or because of distortions in the domestic economy, it's hard not to imagine that some

SNB policy committee members are having pangs of regret. The Swiss franc's dramatic 20% surge after the announcement has immediately created the very problem that the euro floor was supposed to avoid, driving down the price of imported goods and making exporters' products more expensive overseas.

Another exchange rate fix is not a choice, however. Speculators, suspecting that the SNB can no longer be trusted not to cave in, would dump their unwanted euros for francs even more aggressively in a bid to again break the cap and pocket a big payoff. "Exchange rate pegs are always tested and a peg that was abandoned and then restored would immediately be tested," says Barry Eichengreen, a professor of international monetary policy history at the University of California at Berkeley.

Other options are off the table, too. As an economy founded on open trade and finance, Switzerland can't use limits on capital flows such as those in place for more closed economies like China. Neither is its sovereign bond market big enough for quantitative easing-style bond-buying like that employed by the U.S. Federal Reserve and likely soon by the European Central Bank.

That leaves negative bank deposit rates. Although this untested policy could be hard to implement and may have negative spillover international effects, the SNB may feel it has no choice.

Banks are already charged a negative rate to hold deposits at the central bank and that rate was cut further to -0.75% from -0.25% when the exchange rate cap was abandoned. With that policy, the SNB hopes to drive banks to lend out their excess funds and spur growth. But domestic demand for loans isn't big enough to accommodate the surfeit of funds and yields on Swiss government bonds are now also negative. Meanwhile, the charge for depositing at the central bank compromises banks' balance sheets if they can't turn around charge their own depositors.

The problem is that negative rates will likely drive domestic depositors to withdraw funds and hold them as banknotes in safety deposit boxes. The exodus, if big enough, could destabilize the Swiss banking system.

The trick is to limit the policy to those whose money Switzerland doesn't want — the safe haven-seeking foreigners fleeing the falling euro — by drafting laws permitting banks to discriminate between foreign depositors and Swiss citizens. "Negative interest rates [for foreigners] are reasonable because you are charging people a fee for the safety," says Adam Posen, President of the Peterson Institute for International Economics and a former member of the Bank of England's monetary policy committee. "You just make the fee as large as the market needs" to contain the franc's overvaluation.

Still, distinguishing between foreigners and locals is easier said than done. "In an open banking system like Switzerland's it is always going to be difficult to do, even though in principle they do have information about the residency of depositors," says Eswar Prasad, a Cornell University professor and former International Monetary Fund economist. Mr. Prasad says a generalized flight from banks right now would be tolerable because it would push money offshore and take pressure off the franc but ultimately it could threaten the stability of the banking system.

Then there's the international fallout as other countries feel compelled to respond in kind. Already, Denmark's central bank has pushed its benchmark rates deeper into negative territory as traders speculate that the krone's peg to the euro will be ditched.

Mr. Eichengreen notes concerns about losses for U.S. money-market funds that hold some of their cash on deposit in Swiss francs. They could seek returns in riskier or unprofitable investments elsewhere,

potentially squeezing profit margins to the point that it could again challenge the solvency of this vital sector of America's corporate cash management system.

"We are about to get a good test of the effectiveness of negative interest rates and of the question of how serious are its side effects," Mr. Eichengreen says.

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