SPECIAL FX

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The Visible Hand: Central Banks at Work

In recent days the actions of the European Central Bank and Swiss National Bank have had significant implications. There are also new signals from the US Federal Reserve. These events deserve closer scrutiny.

SNB

Let's begin with the Swiss National Bank. Recall that back in March the SNB acknowledged it faced a serious threat of deflation. It indicated it would engage in quantitative easing, but its bond market was too small, owing to fiscal conservativism, so it would sell Swiss francs and purchase foreign bonds.

Lo and behold the Swiss franc did not weaken and its strength contributed to the deflationary pressure. The franc appreciated against the euro and the few times it neared CHF1.50, the Swiss National Bank directly or indirectly intervened. But even that appeared to have reached a point of diminishing returns.

This week the SNB changed its tactics, becoming much more aggressive. If intervention is a ladder, it climbed a couple of rungs. It appeared to have chased the market higher. It was rumored to have increased the size and frequency of its operations, purchasing dollars as well as euros. This proved immediately and dramatically successful, even though the Swiss franc was not pushed below its March low.

It is possible that the SNB's actions have pushed the franc into a new and lower trading range, but it may not succeed in creating a downtrend in the Swiss franc per se, either against the euro or on a trade-weighted basis. Moreover, with oil and other commodity prices rising again, Swiss consumer prices (June figures are due July 3rd, and the consensus is for a flat reading and a year-over-year decline little changed from the -1.0% pace seen in May) appear to be stabilizing in any event.

The weaker Swiss franc may benefit other countries. Many households in Poland and Hungary had taken mortgages and other debt denominated in Swiss francs and this currency mismatch had been quite painful until March. Swiss franc weakness eases the pain and should be seen as positive for their currencies.

One step removed is the Swedish krona. Swedish bank exposure to the Baltics and especially Latvia has provided headwind to the krona. Currency gains in Poland and Hungary may spill over and help lift sentiment for the region, including the Baltics and subsequently diminish a source of pressure on the krona.

ECB

Even though officials have not confirmed the intervention, there is little doubt in the mind of market participants what happened and why, though reasonable people may differ over questions of its necessity and sustainable impact. There is little cost for the SNB, which may arguably be playing the curve too as it is believed to be using the proceeds of its intervention to buy intermediate term German bunds.

The ECB is a horse of different color. Many market observers appeared to get caught up in the gross actions and may be under-appreciating the finer points. Since the collapse of Lehman, the ECB has provided unlimited funds for up to six-months to member banks under a relatively liberal collateral regime. In May, ECB President Trichet indicated that in order to help banks renew lending and credit creation, funds would be available for up to a year.

The first such tender took place and the results on June 24th were spectacular. Over 1,000 banks participated and the ECB provided an unprecedented amount of €442 billion or roughly $615 billion. As Ralph Atkins at the Financial Times noted, this is equivalent to about €1,300 per euro zone citizen.

This is tantamount to some degree of monetary easing, though that sum probably is probably overstated because some banks appear to have simply replaced a portion of their shorter-term funding with this longer-term operation. There has been a decline in participation in recent short-term tenders. Still, it appears that the injection provided an additional €250-300 billion.

On the margins this may weigh on the euro through two channels. First, short-term interest rates have fallen, with overnight rates making new lows. In fact, some short-term euro rates are beginning to dip below US rates. The current 3-month swap rate is about 55bp, but in a year's time, it is trading flat and by the end of 2010, 3-month

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dollar rates will be 32bp above the 3-month euro rate. The US 2-year note yield is 18bp below Germany's. Before the German elections are held in September, the US rate will likely be above Germany's. It began the year near 100bp below.

The second channel is somewhat less significant. Some branches of foreign banks operating in the euro zone participated in the 1-year tender. They also managed to secure 1% funding for a year. Some of those funds may leak out of the region perhaps to the US, UK, Sweden, etc. To this extent it may be a marginal negative.

The bulk of the money will most likely stay within the euro zone, but where? Some will be kept in short-term deposits and this, or the anticipation of this, is what weighs on short-term interest rates. But there is another dimension that is perhaps as close to sublime as a central bank gets. Some of the funds will be used to buy government bonds. The incentive structure will be grasped to favor buying some higher yielding euro zone government bonds. Spreads may narrow here as well, though Ireland might be an exception.

However, the point is that to the extent that the banks buy government bonds, they are doing what the ECB cannot do itself—underwrite fiscal policy of the member governments. And to the extent that the government bonds bought are from the periphery of the euro zone, then the ECB is indirectly aiding their fiscal situation.

Federal Reserve

There is another element of the ECB's program that may be instructive. The preliminary signs that the financial and economic crisis is ebbing has led to the increased salience of exit strategies. The ECB's provision of funds is for a set time and then it will have to be unwound. The exit strategy is more intuitively clear than with the Federal Reserve, which committed to buying $1.75 trillion of long-term assets, including $300 billion of Treasuries.

The statement following this weeks FOMC meeting said nothing about an exit strategy, but defying the expectations of some, it did not expand its Treasury purchases program that will be completed by the end of the third quarter. The following day, it tightened the conditions, reduced availability and terminated some of it emergency credit facilities.

This largely formalized what was already taking place. The success in re-opening segments of the capital market means that the emergency facilities are no longer needed. At their peak, the emergency facilities provided around $1.5 trillion of support. Prior to the Fed's announcement, total usage had fallen by more than 50%.

Another part of the exit strategy was also suggested by the Fed. Some of the facilities that were set to expire at the end of October were extended to February 1st 2010. The statement made it clear that the bias, assuming the current improvement in financial conditions continues, is not to renew after that. Even though Chairman Bernanke's term expires at the end of January, a decision will be made before then under his watch. Predictive markets (e.g., www.intrade.com) and our own inclination favor Bernanke being reappointed. Sorry Mr. Summers. This is also then revealing of how Bernanke's exit strategy will work; Gradual and deliberate, like a general reclaiming territory vacated by an adversary.

The FOMC statement and the formalization of the declined usage also points to increased official confidence that the moderation of the contraction, likely experienced in recent months, is a prelude to a genuine recovery. Assuming that the US economy contracted here in the second quarter (by maybe a 1-1.5% at annualized pace rather than the 2% consensus), it is reasonable to expect the third quarter to snap a four-quarter contraction and expand by 1-2%.

If this is how events unfold taken separately and together, the dollar should get better traction over time.

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