The Swiss release the Kraken

John Mauldin | Mauldin Economics | 20 December 2015

If you want evidence that central bankers play by their own rules, regardless of what they say or what conventional wisdom tells us, last week's action by the Swiss National Bank should pretty much fill the bill. My friend Anatole Kaletsky, in a CNBC interview not long after the announcement, quipped (with a completely straight face) that just as James Bond has a license to kill, central bankers have a license to lie.

Swiss National Bank (SNB) Chairman Thomas Jordan had assured us just the week before that the Swiss would continue to "hold the peg" whereby the SNB kept the value of the Swiss franc from rising higher than €1.22. "The cap is absolutely central," he said. And SNB Vice Chairman Jean-Pierre Danthine said publicly only last Monday that the peg would remain a cornerstone of Swiss banking policy.

Early last Thursday morning, the Swiss abandoned that policy. Much of the press coverage in the (largish) wake of their surprise move has focused on the costs to banks and hedge funds around the world - but you have to realise that serious pain is being felt in Switzerland itself. Every bank and business that held non-Swiss-franc debt or investments took an immediate 15% to 20%+ haircut on its holdings. Swiss investors lost at least 10% on investments in their own stock market and more on shares they held in other stock markets. Forty percent of Swiss exports go to the Eurozone, and the Swiss franc is now over 30% higher than it was five years ago - with almost half that movement coming in one day. Those exporters just got hammered.

And this was not a painless policy decision for the SNB. Citibank estimates the SNB's losses to be close to 60 billion Swiss francs. Let's try to add a little perspective on that. The US is (very) roughly 40 times the size of Switzerland in both GDP and population. At today's conversion rate, the Swiss lost something like $70 billion, if Citibank is right. That's like the US Federal Reserve losing $2.8 trillion. That, my friends, will leave a red mark on any central bank's balance sheet. Not that the Swiss can't afford it, or that they're going to be out on the corner with a tin cup - but they do have a considerable quantity of euros that are now much less valuable. And dollars and yen and pounds and renminbi. But then again, they are in the privileged position of having a currency that the rest of the world wants, so much that in order to hold it, you will have to take a haircut on your deposits at the SNB, a haircut that is going to increase (more on that later).

There are also serious losses in the international banking community. We are just now beginning to learn how many funds and brokerages will have to close.

Do you think that SNB Chairman Thomas Jordan will be going into the local restaurants and getting high-fives and fist bumps? Exactly what do you think his reception was in Davos? Christine Lagarde, the managing director of the IMF, gave a somewhat frosty reply to my friend Steve Liesman at CNBC when he asked her only a few hours after Jordan's move (in what was clearly an already-scheduled interview) about her thoughts on the surprise announcement. She was not amused, but she kept her professional stage smile in place.

In Norse mythology, the Kraken was a sea monster that attacked ships unaware. In Greek mythology, it was a pet sea monster (of either Hades or Zeus) that would be released upon enemies that annoyed its master. It has been an iconic figure in comics and movies for the last 30 years. "Release the Kraken!" is the standard line prior all hell breaking loose.

In an era when central bankers are supposed to be more open, collaborative, and communicative, what would make the SNB decide to turn on a dime and shock the markets - to release the Kraken, as it were? Note, that in fact all hell did break loose. Rather than delivering hints accompanied by a few well-placed leaks, the Swiss decided it would be best to completely surprise the markets. It will be a long time before we get the full story on what must have been going through their heads as they reached the decision.

I have spent the last few days reading a great deal and talking with friends, trying to understand the "why" of the suddenness of the Swiss action. If we can get some insight into this question, perhaps it will give us a few clues as to upcoming global central bank policy changes in general and the problems facing Europe, in particular.

Not only are the Swiss not holding the peg, they have put out the "Not Welcome" mat, lowering their negative interest rates to -0.75%, with the implication that if that isn't enough, they will drop them to - 1.5%. You want a Swiss safe haven? It will cost you. And the irony is that many will pay it. Losing only 0.75% a year sounds really good if you are Russian. (The Danes moved their negative rates to - 0.2% this week just to make sure no one starts to see them as a rent-free safe haven.)

Then, you look around at the rest of Europe, and what you see, mostly, are problems. Where is the growth going to come from? Russian corporations and oligarchs have taken out massive Swiss-denominated loans, as has much of Eastern Europe. More than one million Hungarians are in dire straits - nearly 65% of the country's household mortgages are denominated in foreign currencies (mostly Swiss francs, according to the National Bank of Hungary). And, according to Bloomberg News, more than 40% of mortgages on the books of Poland's banks are denominated in Swiss francs. When the borrowed currency surges against the borrower's home currency, the effective cost of that debt balloons.

PITY THE POOR SWISS

To help us understand the mindset of the Swiss central banker, let's turn to a tongue-in-cheek analysis of the problems of the SNB by my friend Charles Gave.

> They [the SNB] didn't mind pegging the Swiss franc to the Deutsche mark, but it is becoming more and more obvious that the euro is more a lira than a mark. A clear sign is the decline of the euro against the US dollar.
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> Mr Draghi has been trying to talk the euro down for at least a year. This should not come as a surprise. After all, in the old pre-euro days, every time Italy had a problem, the solution was always to devalue.
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> But the Swiss, not being as smart as the Italians, do not believe in devaluations. You see, in Switzerland they have never believed in the "euthanasia of the rentier" nor have they believed in the Keynesian multiplier of government spending, nor have they accepted that the permanent growth of government spending as a proportion of gross domestic product is a social necessity. The benighted Swiss, just down from their mountains where it was difficult to survive the winters, have a strong Neanderthal bias and have never paid any attention to the luminaries teaching economics in Princeton or Cambridge. Strange as it may seem, they still believe in such queer, outdated notions as sound money, balanced budgets, local democracy, and the need for savings to finance investments. How quaint!
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> Of course, the Swiss are paying a huge price for their lack of enlightenment. For example, since the move to floating exchange rates in 1971, the Swiss franc has risen from CHF4.3 to the US dollar to CHF0.85 and appreciated from CHF10.5 to the British pound to CHF1.5. Naturally, such a protracted revaluation has destroyed the Swiss industrial base and greatly benefited British producers [not!]. Since 1971, the bilateral ratio of industrial production has gone from 100 to 175... in favor of Switzerland.
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> And, for most of that time, Switzerland ran a current account surplus, a balanced budget, and suffered almost no unemployment, all despite the fact that nobody knows the name of a single Swiss politician or central banker (or perhaps *because* nobody knows a single Swiss politician or central banker, since they have such limited power? And that all these marvelous results come from that one simple fact: their lack of power.)

> The last time I looked, the Swiss population had the highest standard of living in the world -another disastrous long-term consequence of not having properly trained economists of the true faith.

SO WHAT CAUSED THE SWISS TO ACT?

I think it was in part that they looked at the general weakness of Europe and its seeming inability to pursue reforms or to address its imbalances in any realistic manner. Many Eurozone leaders seem to think the European Central Bank has magic in its vaults and simply hope that the Germans can be persuaded to release some of that growth pixie dust. The Swiss look at their own experience and see the continued growth of debt and unfunded obligations in Europe as a real problem.

On top of all the other developments, the European Court of Justice issued a preliminary ruling on Wednesday that allows the ECB to employ quantitative easing. There are rumors that the ECB is going to propose a package that may run as high as €2 trillion [the ECB subsequently announced a €1.1tn QE plan on 23 Feb] - countered by "leaks" that suggest the total will be a fraction of that amount. Frankly, the market has priced in €500 billion already. If Draghi doesn't deliver a multiple of that, I think we will see a disappointed market.

Was the Swiss banking and business community given a heads-up? Were there phone calls from one desk to another? Clearly, there are communication channels. And the timing of the ECJ ruling and the announcement by the SNB the next day is more than suspicious. (Yes, I know it's a preliminary ruling, but do you really think it will get changed?)

I think the SNB looked down the road and saw the euro at parity to the dollar (which is where Draghi and the rest of Europe would like to have it), realised how much they would have to spend and ultimately lose to maintain the euro peg, and decided it simply wasn't worth the cost. That $70 billion loss could turn into a $150 billion loss before you knew it.

Simply removing the peg and taking that much buying off the table will in itself begin to reduce the value of the euro. Will the Swiss begin to move some of their rather large euro holdings to US dollars and other currencies? That move would seem the logical follow-on, and it would push the euro down even farther.

In 2002, I said the euro would rise to $1.50 and then fall back to parity. We do seem to be on that journey. This is not, of course, a one-way trip - and I would expect the euro to correct upwards at some point before resuming its downward journey.

The interesting question will be, if the ECB starts down the path of QE, at what point will it feel it can stop? Will it depend on an inflation-target number? It doesn't seem likely that QE can actually deliver inflation in a deleveraging world - and Europe must at some point deleverage. Thus, we could see QE in the Europe for a rather long time.

The Eurozone is simply unbalanced, and a monetary policy appropriate for Italy or Spain is not appropriate for Finland or Germany.

Unless and until its members create a fiscal union and come up with some formula to mutualise their debt, the Eurozone will remain imbalanced and will become increasingly likely to break up. Ironically, if they fail to pursue QE, there will be a crisis sooner rather than later – but a crisis is precisely what they need in order to address the present imbalances. They are not going to substantially reform their labor and budgetary processes except in the act of crisis resolution.

A significant QE package (on the order of €1 trillion or more per year) may be enough to postpone the crisis for at least several years. And perhaps that is all they intend to do, thinking that somehow they can all get a handle on their budgets and that growth will magically ensue in a world where debt has already overwhelmed the markets and governments have grown too large relative to the private sector that is necessary to support those governments. Stir into that mix healthcare and pension obligations that are even larger than those in the US, and you have a surefire formula for a major crisis at some point in the future.

Traders tend to act as if the current trend will never end. For some odd reason, they trust central bankers, when the truth is that central bankers will lie when they feel it is necessary. As Anatole said, they believe they have a license to lie. But one way and another, the current relative quiet in Europe will not hold indefinitely.

My friend Mohamed El-Erian has this to say about the SNB decision:

> Following the abrupt removal of the currency peg, Switzerland is now looking at a period of bumpy economic and financial adjustment. Being a relatively "open economy", in which trade and tourism play an important role, Swiss companies face a considerable competitiveness challenge ahead. The country will also have to deal with issues of currency mismatches, as well as having to battle larger, externally induced deflationary forces.
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> But the implications extend far beyond Switzerland. Countries with Swiss franc denominated liabilities, such as Hungary, now have to deal with a major adverse valuation shock.
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> More importantly in terms of global systemic effects, politicians in the core economies within the eurozone – including Germany, Austria, Finland and the Netherlands – will see the SNB's move as a reaffirmation of the dangers of substituting financial engineering for real economic reform. As such, they will be less willing to accommodate the hyperactivism of the ECB. And while this is

> unlikely to stop the ECB from doing more, it may increase the legal, reputational and unity risks it takes in doing so.
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> Then there are the consequences for a global economy which, in the absence of a comprehensive policy response in the advanced world, has ended up overly reliant on central bank interventions. Given that their tools cannot reach directly and sufficiently at what holds back growth and jobs, these central banks have been forced to use the partial channel of financial asset prices to influence real economic outcomes.
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> To this end, central banks have sought to repress market volatility as a means of encouraging risk taking that would then boost asset prices and thus encourage greater household consumption (via the wealth effect) and corporate investment (via animal spirits).

We are already in a currency war, where Japan and China feel the need to protect their competitiveness. Europe now feels compelled to follow. The furthering of various country's campaigns in this war is creating massive divergence among the major central banks and an environment in which the dollar is likely to become much stronger than it otherwise would.

If the ECB does deliver massive QE, that course has the potential to set off an even uglier set of events than followed on Japan's Halloween surprise. We could see a series of emerging-market crises, a rush to global risk aversion on top of divergence, and the USD carry trade might unwind quite forcefully, creating a very ugly feedback loop. The risk of financial shocks to the rest of the world – particularly to Europe's thinly capitalised banking system and China's questionably solvent financials – is enormous.

Trouble is, the "appropriate" measures needed to keep Eurozone risks at bay may be toxic for the rest of the world, and the "appropriate" policy for the rest of the world may be toxic for the Eurozone. Europe's grinding further into deflation until the EMU collapses – by the ballot or by the bullet – is an ugly scenario for the world, but a far less immediate risk than that of a violent unwind in the USD carry trade.

It's every central bank for itself. Stay tuned.

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