



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Central Bank and Currency intervention

We do not wish to take part in the already ubiquitous debate about the franc. We would just remind the main elements which determine exchange rates and the instruments that a central bank has at its disposal in fighting currency appreciations and depreciations. Rates of exchange are influenced by many elements, both actual and psychological, linked to expectations and so on. Fundamentals consider the state of public finances, then debit and deficit levels, trade and payment balances, inflation, productivity... A key factor according to the financial theory should be the spread between the two involved currencies' yields, but today, when interest rates are at historical lows and mostly near zero, such element is no longer decisive. Other factors may include the overall system's reliability, the standing of political and central bank's governances (which currently fail to rate very high indeed !). The forex market discounts that all and investors act consequently, so selecting some currencies rather than other ones. A strong currency takes advantages and handicaps with it, mainly linked to the export, but history indicates that on the long run, strength is more rewarding than weakness. If the central bank, as is the current case for Switzerland, engages in fighting a presumed excessive appreciation, it has several options. Apart from doing nothing, so being often the best choice, according to the rule that "fighting the market is always painful", the central bank may inject Swiss francs and buy foreign currency. However, should the latter devalue, it causes losses and does not take to any solutions. The market proceeds straight on, although in its aim of weakening the home currency the central bank has unlimited funds at its disposal, if compared to stopping excessive losses, in which limited foreign reserves are to be carefully used. Secondly, the central bank may set a peg, that is a fixed rate of exchange, so to give up an independent monetary policy: that is a very disputable choice in both political and technical terms, and may take to huge risks should the pegged currency devalue. The third option is to set exchange limits and act consequently with a coherent mixed policy of rates, reserve levels, targeted interventions, in order to stay within such limits at any costs. In both cases however inflation risks are high, particularly if liquidity in excess is not timely drained from the market. *Historia docet.* - GLT

The views expressed are not necessarily those of the Swiss Association of Asset Managers