Switzerland's Negative Interest Rate Dilemma

Keep On Paying Investors To Leave And Eventually They Will

Even the best-run companies can step in it unintentionally; such was the case with the venerable Procter & Gamble (PG). An unwinnable controversy regarding its former logo arose during the 1980s. I will not go into the details other than to note my sympathies for P&G's public relations people during the whole affair.

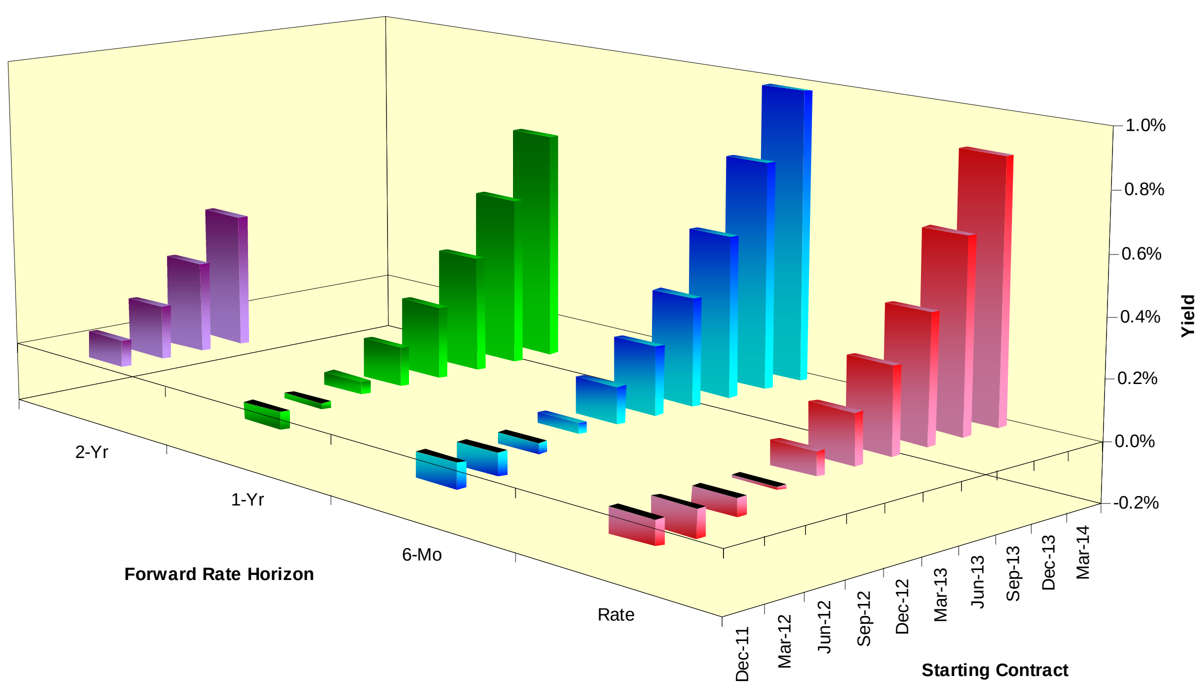
But, I thought, why not license company products to various countries in exchange for valuable advertising space? Let's take a certain Alpine country with a reputation for banking secrecy, one that is a favorite destination for flight capital coming out of the Eurozone elsewhere. You could plant a box of Tide detergent on their flag in celebration of all the laundering that has gone on there over the years and make everyone pledge allegiance thereto each and every morning. The possibilities are so endless in our flat and interdependent world you just want to burst out in a big campfire chorus of Kumbaya.

Negative Interest Rates

As I predicted in September's Swiss National Bank's Plan to Print Unlimited CHF Will End Disastrously, the imposition of a 1.20 CHF per EUR ceiling was a bet the SNB would have to lose someday. After all, if you make investors pay for the privilege of lending money to you and they still keep coming, you are in the same situation as the hunter who just blasted the charging elephant between the eyes and only managed to increase the latter's level of annoyance.

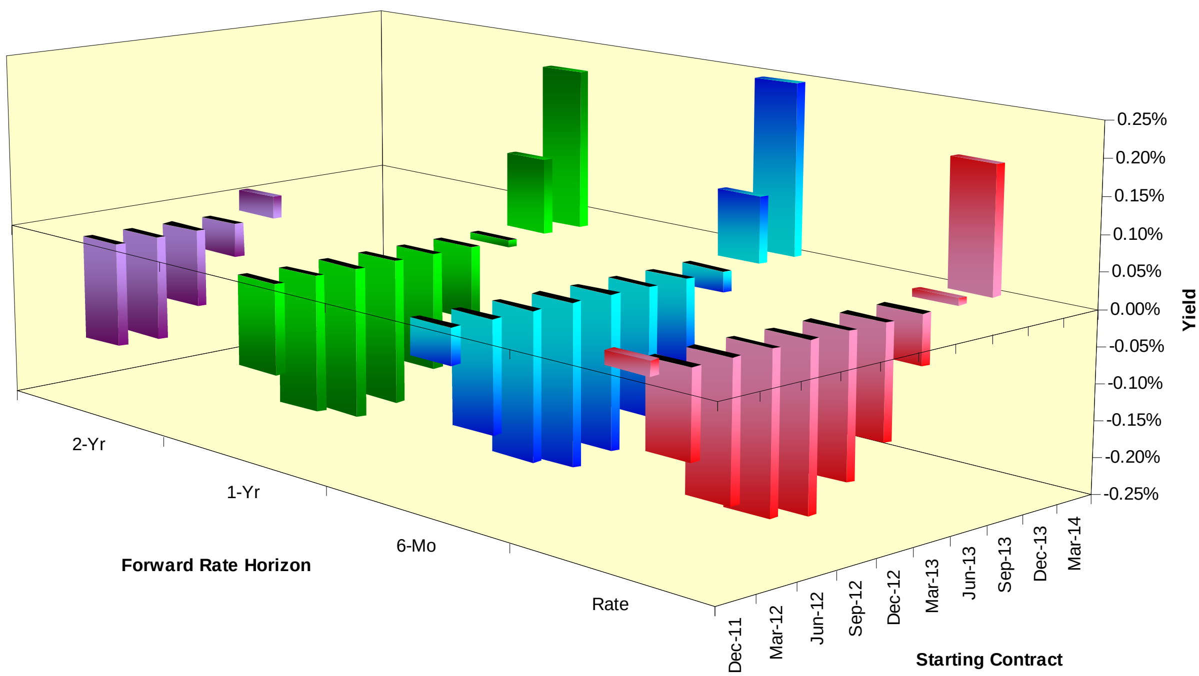
Let's see where our Swiss friends are these days on the interest rate front. First, here is what the synthetic forward rate matrix for Euroswiss deposits looked like right after the imposition of the franc ceiling in September:

Euroswiss Synthetic Forward Rates: September 7, 2011



Now let's advance the clock by three months and see what the same matrix looks like:

Euroswiss Synthetic Forward Rates: December 8, 2011



The same information could be depicted using a month-by-month chart for the Swiss tomorrow-overnight index swap (TOIS) rates. The conclusion would be the same: Lenders of short-term CHF are being forced into a worsening negative-rate situation and are willing to accept it. Why are they willing to pay this penalty? The answer is simple: They effectively are buying insurance against EUR depreciation, an unknown cost, by accepting a short-term interest rate penalty.

The bet for these lenders into the CHF is the eventual appreciation of the franc will compensate them for the interest rate penalties they are paying today. In the meantime, the SNB has to counter this inflow of funds by creating more francs itself to keep them from appreciating over 1.20 to the euro. You cannot flood a country with this much money and these negative rates and with this speculative fervor without destroying the entire concept of prices representing underlying economic value completely. Inflation will ensue eventually.