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Swiss Pledge Unlimited Currency Purchases

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The Swiss central bank imposed a ceiling on the franc for the first time in more than three decades and pledged to defend the target with the "utmost determination," prompting a record drop in the currency.

The Swiss National Bank is "aiming for a substantial and sustained weakening of the franc," the Zurich-based bank said in an e-mailedstatement today. "With immediate effect, it will no longer tolerate a euro-franc exchange rate below the minimum rate of 1.20 francs" and "is prepared to buy foreign currency in unlimited quantities."

The franc plunged the most ever against the euro after the SNB announced the measure last introduced in 1978 to stem gains versus the Deutsche mark. While the central bank in August boosted liquidity to the money market and lowered borrowing costs to zero to protect the economy, investor concern that governments may struggle to contain Europe's worsening debt crisis continued to push the currency higher.

"The SNB has committed itself to creating unlimited amounts of francs and selling them versus the euro to defend the currency's level," said Fabian Heller, an economist at Credit Suisse Group AG in Zurich. "They will follow through on their commitment as otherwise their credibility would be clearly damaged and speculation would start again, most likely leading to renewed franc gains."

The franc snapped four days of gains versus the euro, dropping as much as 8.7 percent. It traded at 1.2025 at 5:46 p.m. in Zurich and was at 85.82 centimes versus the dollar.

Economic 'Damage'

SNB President Philipp Hildebrand said in an e-mailed statement that while costs "might be very high," doing "nothing would almost certainly inflict tremendous long-term damage" to the Swiss economy.

"With today's decision, the SNB sets foot on a challenging journey," he said. "Even at a rate of 1.20 per euro, our currency is still at a high level. It should continue to weaken over time. If the economic outlook and deflationary risks demand it, the SNB will take further measures."

Before today's move, the currency surged more than 13 percent against the euro this year as investors turned to find a haven from turmoil provoked by the debt crisis. It reached a record of 1.0075 against the euro on Aug. 9, trading close to parity. As of yesterday, the franc was 40.5 percent overvalued against the euro, based on a measure of purchasing power as calculated by the Organization for Economic Cooperation and Development.

'Ridiculous' Gains

Jim O'Neill, chairman of Goldman Sachs Asset Management in London, said the SNB had the "utmost justification" for its decision, calling the franc's appreciation "ridiculous."

"The Swiss are forcibly saying don't put all the stresses on us," he said. "Once a central bank puts a misaligned currency at the center of policy making, you go with it. Simply intervening in the franc won't solve all the world's problems but it might help markets be more balanced in their herd-like panic about some of these issues."

Fears of a new global recession have prompted investors to pile into currencies such as the franc and the Japanese yen which are seen as havens in a time of crisis. That's forced policy makers into action to protect their exporters.

Japan last month intervened again to stem a rising yen and Finance Minister Jun Azumi today said he will use this week's meeting of Group of Seven policy makers to highlight the danger the currency poses to his economy. Brazil's authorities have also sought to weaken the real.

'Currency Wars'

The Swiss step is nevertheless the boldest single move by a central bank to restrain its currency since Brazilian Finance Minister Guido Mantega said in September 2010 the world faced a "currency war."

"The currency wars are heating up," Kit Juckes, head of foreign exchange research at Societe Generale SA in London, said in a note to clients today.

The SNB's foreign currency holdings jumped to a record 253.4 billion francs ($299 billion) at the end of August from 182.1 billion francs in the previous month after it used foreign exchange swaps to weaken the franc. At the end of the second quarter, the euro made up 55 percent of reserves.

Companies from watchmaker Swatch Group AG (UHR) to ABB Ltd. (ABBN), the world's largest maker of power-transmission gear, have said the currency's strength is weighing on earnings. A slump in exports was among the reasons why the Swiss economy slowed in the second quarter, expanding 0.4 percent from the previous three months, when it grew 0.6 percent.

The SNB abandoned efforts to weaken the franc in June 2010 after quadrupling its currency holdings. The intervention policy sparked a record loss of $21 billion last year and prompted calls by lawmaker for Hildebrand to resign.

“The SNB has just drawn the ultimate weapon,” said Alexander Koch, an economist at UniCredit Group in Munich. Still, “the central bank’s problem is that the franc is a hostage to outside events.”

The SNB is scheduled to hold its next monetary policy assessment on Sept. 15.

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