

Which central banks matter?

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The start of 2015 has brought with it a flurry of central bank activity. The Swiss National Bank abandoned its policy of limiting the value of the Swiss franc against the Euro. The European Central Bank undertook to purchase sovereign government bonds (albeit using a slightly peculiar structure). The Canadians cut their interest rate. The Danes took their official deposit rate back into negative territory. Singapore unexpectedly eased its policy (via the currency markets). It is all dramatic stuff.

Does any of this matter beyond the boundaries of the monetary area governed by the relevant central bank? Does the ECB matter to Asia? Does the negative interest rate of the Danmarks Nationalbank have a bearing on events in the United States?

In most cases the international implications of central bank policy are limited. This is largely because the whole world of money, liquidity and thus central bank policy is a very parochial affair. The fact that the ECB plans to print more than a trillion Euros means that has increased the potential claims on Euro area goods and services, not on goods and services produced in Asia or the Americas. The idea that Euro liquidity, or indeed Japanese liquidity, could "replace" American liquidity is entirely erroneous. Try paying for a round of drinks in a bar in Dallas, Texas using Euro notes and coins, and you will soon discover the geographical limits of the ECB's liquidity. (It should be pointed out that if you do try and pay for drinks in Dallas using Euros, you do so entirely at your own risk.)

The main mechanism whereby these various national monetary policies have an international impact is via the currency markets. This is perhaps inevitable – the foreign exchange rate of a currency is the international manifestation of its domestic worth. However, foreign exchange markets are complex. There is no clear universal model for foreign exchange forecasting. Currency movements are not just a function of domestic monetary policies. At the very least the monetary policy of the other currency must be considered – if the Euro's value against the dollar is affected by the policies of the ECB, then logically it must also be affected by the policies of the US Federal Reserve, independent of whatever the ECB is doing.

The exception to the localised nature of central bank policy is the action taken by the Swiss National Bank, and potentially also the Monetary Authority of Singapore. This may seem odd at first: compared to the neighbouring Euro area the Swiss economy is relatively small. Switzerland's policy decision saw an appreciation of its currency and a move to more negative interest rates. Singapore as a city state is also a comparatively small economy in the global scheme of things, and MAS simply slowed the rate of currency appreciation. Why are these decisions so important?

The global relevance of the Swiss and potentially the Singaporean policy changes lies in the uncertainty that the moves have created. Swiss National Bank officials were declaring that the limits on franc appreciation were firmly in place only days before the peg was abandoned. There was no anticipation of the move in financial markets. The abrupt move in the currency (40% against the Euro at one point) testifies to the complete surprise of the decision. For Singapore the idea of an easing of policy at some point was expected, but the timing of the decision was a surprise to financial markets because it was outside of the normal policy cycle (the last time that happened was 2001).

Since the onset of the global financial crisis, central banks have generally been engaged in a policy of trying to minimise most forms of risk and uncertainty in the financial system. The



quantitative policies of the US, the UK and Japan were all aimed at reducing liquidity risk in the markets (liquidity risk is a powerful form of risk that will raise interest rates in the real world). What the Swiss and perhaps the Singaporean policies have done is once again inject an element of uncertainty, and with that risk, into global financial markets. Monetary policy may be a local concept but, with globalised financial markets, risk and risk aversion are global concepts. If the idea that "you cannot rely on what a central banker says" becomes common currency in the world's markets, then the global risk premium may increase.

This is why the ECB policy decision is not terribly important; it was generally anticipated, it does not change very much economically, and could be classified as a commitment as much as anything. The SNB and MAS have acted in a way to raise uncertainty, and uncertainty and risk have repercussions outside their borders. If financial markets are not ready for uncertainty, the consequences of these actions could be both long-lived and potentially disruptive.



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