Forex Focus: Swiss Franc Intervention Takes On A New Urgency

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LONDON (Dow Jones)--The battle on the Swiss National Bank's hands has just got a lot bigger.

Switzerland's export-led recovery is now at risk as the Swiss franc continues to rise rapidly, reaching a record high of CHF1.3785 against the euro, and the euro zone's growth prospects continue to deteriorate.

Also, with so many eastern European mortgages, including many in Hungary, denominated in the Swiss franc, further franc gains will only add to the instability already appearing in some of these markets.

However, as Tuesday's data from the SNB suggest, safe-haven flows supporting the franc have been much more than anticipated.

The central bank was forced to intervene much more than thought, to keep a lid on the franc's advance, with its reserves climbing by CHF79 billion to CHF232 billion last month.

But even as reserves have nearly doubled, the euro's slide against the franc has been almost continuous, with the single currency sinking steadily under CHF1.40 and showing little signs of stopping over the course of the month.

See the euro's fall against the franc:
http://www.dowjoneswebservices.com/chart/view/4105

If anything, support for the franc, at the cost of the euro, is only likely to increase as fiscal tightening across the euro zone increases the risk of a double dip recession. European politicians hinting that they are comfortable with this fall in the euro will only encourage the trend.

Additional downward pressure on the euro will also come from rising fears of a sovereign debt crisis. Although Hungary has insisted it isn't another Greece, there are still fears of a debt default that could trigger a wider selloff in euro-based assets.

For Switzerland, all this is only bad news.

With as much as 60% of Swiss exports headed for the euro zone, any slowdown in demand from the region means that Switzerland's export-led recovery will be hit.

There are already signs that price pressures are proving much more subdued than expected, with Swiss inflation easing to 1.1% from 1.4% in data released Tuesday. Expectations had been for a more modest drop to 1.2%.

Against this backdrop, the central bank is unlikely to become more tolerant of a strong franc, as appeared the case only a few weeks ago. Instead, the SNB will be swiftly losing its appetite for further franc strength.

The problem is that it could now face an even bigger battle to keep the franc down against the euro, especially if global uncertainties remain and safe-haven flows into the Swiss currency continue to increase.

There are signs that the SNB might have been back in the market late Tuesday but a sharp bounce in the euro could equally have been driven by choppy trading amid nervousness that the central bank may intervene again.

By 0645 GMT Wednesday, the euro was trading flat at CHF1.3780, unchanged from late Tuesday in New York, according to EBS.

The euro was a little higher elsewhere, helped by a general improvement in market sentiment after Japanese machinery orders came in much higher than forecast and the Nikkei index rose 1.0%.

Comments by Kansas City Fed President Thomas Hoenig that the U.S. recovery in now sustainable and that interest rates should start to rise, also helped boost the market's mood, especially as it came after upbeat comments from fed Chairman Ben Bernanke Tuesday.

The euro is up at $1.1959 and Y108.44 from $1.1952 and Y109.22.

The dollar rose to Y91.53 from Y91.44, helped by some disappointment that Japan's new prime minister, Naoto Kan, didn't express as much support for a weaker yen as he had previously.

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