Bruno Gehrig: Moving among currency giants – a Swiss perspective

Speech by Prof Bruno Gehrig, Vice Chairman of the Governing Board of the Swiss National Bank, at the Swiss-American Chamber of Commerce, Zurich, 16 January 2001.

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First of all, I should like to thank you for the pleasure and delight of being invited to speak to you today. At the same time, I should like to emphasise how much I appreciate the exemplary and highly successful activity of the Swiss American Chamber of Commerce. Your organisation plays an invaluable part in the economic, political and - most important of all - in the personal relations between US and Swiss citizens.

In my speech entitled "Moving among currency giants" I should like to outline a few ideas under four different headings. I shall start out with a few remarks on the system of floating exchange rates, which we have more or less learned to live with since 1973, the time of the breakdown of Bretton Woods. This will be followed by some considerations on the always topical subject of short- and medium-term currency movements. After this bird's eye view of general developments, the frog perspective will be highlighted. I will deal with the special features of our small currency, and end by drawing a few conclusions for the SNB's monetary policy.

Floating exchange rates: perception and experience

Views on how floating currencies behave and what the implications of their implementation are have changed over the past 30 years, in the light of current experience. Early protagonists had fairly idealistic expectations with respect to floating. For example, Harry G. Johnson, one of the grand old men of international economics, when he stated hopefully 30 years ago: "a freely flexible exchange rate would tend to remain constant so long as underlying economic conditions (including government policies) remained constant: random deviations from the equilibrium level would be limited by the activities of private speculators…"[1]

This optimistic view was based on two convictions. For one, on the notion that exchange rate distortions are primarily triggered by inconsistent government policies oriented to short-term effects. In actual fact, the economic developments of the late sixties and of the seventies promoted the perception of a fundamental contrast between inherently stable private markets and a destabilising public policy sector. On the other hand, most economists were profoundly convinced that free exchange rate movements would be clearly dominated by inflation differentials with no lasting impact on real exchange rates. It must be borne in mind, however, that 30 years ago the play of global financial markets so forcefully driven by expectations was still in its infancy. At that time it was inconceivable what we witness today: namely, that a couple of sunny days on the stock market are able to produce a gain in wealth potentially several times the size of an entire years' deficit or surplus in the current account.

Thirty years later, the assessment of floating exchange rates is more differentiating. The system with all its advantages and despite its drawbacks is now firmly established and has even become increasingly widespread in the past twelve years. The number of countries which allow their currency to float more or less freely without a formal peg has risen from just over 30 to approximately 100.

By and large, the experience gained with floating exchange rates may be summarised in two statements:
First, the system occasionally generates large real exchange rate shifts that last longer than just a few days or weeks. They may extend over several quarters or even years, long enough to cause considerable harm to the real economy. Such distortions are not only observable in emerging economies but also between the currencies of the Big Three.

One of the most spectacular distortions in the past decade was the rise and fall of the USD against the yen: Up 80% from April 95 to August 98, then down 31% until the end of 99. More recently, the long-awaited appreciation of the euro in the past 12 weeks amounts to 13% against the USD and 20%

[1] **"The Case for flexible exchange rates", in: Further Essays in Monetary Economics, Cambridge (Mass.) 1973, p. 208**

against the yen. It took place in an environment where neither current nor expected inflation differentials have changed to any noticeable extent.

Second, the volatility of floating exchange rates by far exceeds the volatility of the fundamentals. It is impossible to explain short- and medium-term exchange rate fluctuations with the aid of traditional fundamental factors such as inflation and productivity differentials.
Against the background of such experiences, it is hardly surprising that two considerations characterise the ongoing discussion on currency regimes.
First: Floating versus pegging is not a question of right or wrong. What seems appropriate for one country may be a bad choice for another economy. Structural differences in trade flows, productive capacities, features of the financial sector and the credibility of the political process may result in different choices. Second: Even among ardent protagonists of floating the dogmatic position that central banks should take an attitude of benign neglect towards exchange rate movements is out of favour. The exchange rate is generally regarded as a core determinant of monetary conditions to be carefully taken into account when money market interest rates are set. This aspect of policy making is of particular importance in small and medium-sized, open economies.

Short- and medium-term adjustments – Muddling through in ignorance

Taking the Forex environment into account, however, does not mean actively steering exchange rates by fine-tuning. Such an endeavour would not only jeopardise stability goals. It would be bound to fail due to our poor understanding of the process of short-term exchange rate determination.

Given this state of ignorance, ongoing Forex dicussions inevitably suffer from a lack of analytical and systematic rigour. Reasons given for exchange rate movements remind us of a self-service shop offering all kinds of goodies that always fit the need of the moment: ice cream when the sun burns and hot coffee when it gets cold. The shopping list includes:

- trade imbalances
- cyclical leads and lags
- asset price bubbles
- events and announcements in politics
- a broad range of differentials, preferably in interest rates, productivity and inflation

and all this both effective and expected.

One chooses the story that best fits a specific situation in the hope that something is better than nothing. This opportunistic selection, reinforced by communicative herding, gives the Forex discussion the character of a sequence of scenes with different key subjects that influence expectations to a varying extent, thus also possibly causing exchange rate distortions. Exchange rate developments between the USD and the euro in the past two years once again are a good example in this respect.

I am not cynical, but humble. Day-to-day or month-to-month exchange rate movements seem to be a marvellously complex process, a highly unstable interaction of facts and expectations. The globalisation of capital markets has, if anything, added to this complexity by amplifying the impact of expectations.

Some old habits in explaining FX rates no longer make much sense. For example, the concept of fundamental factors that determine the current account, whose balance is then equilibrated by capital flows. This vantage point usually rests on the implicit assumption that trade flows are the "real" and causative side of the coin, while capital flows are a flexible gap filler, a sort of second round financial mechanism set off to match any given trade imbalance. In a world of integrated capital markets one may also have good reason to argue the other way round. Why are long-term capital flows, driven by perceived rates of capital productivity, less "real and fundamental" than trade flows? Would it not also be possible to argue - based on recent experience - that capital flows to the United States were, for a long time, the fundamental causative change which effected - as a consequence - the deterioration in the current account?

Be that as it may, traders, investors and central bankers would be well advised to accept the fact, and be prepared for it, that in the short- and medium-term surprises are always possible in the Forex markets. This was so in the past and will continue to be so in the future.

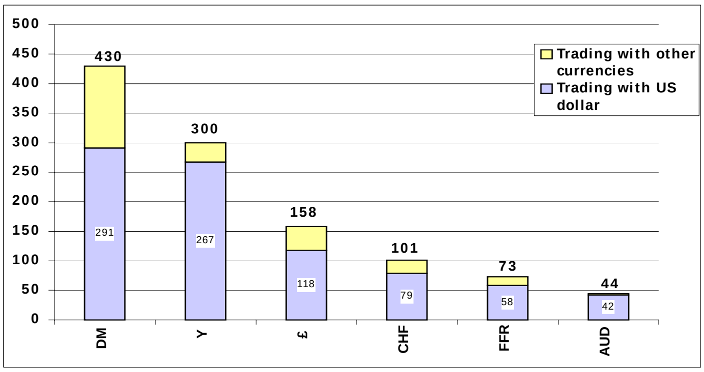
Smallness and connectedness: some facts

Let me now talk about the SFR, about its main features as a currency which is traded and held in international portfolios.

The SFR plays a minor part on the stage of the global currency game - it is a dwarf among giants, so to speak. Its position may be described by means of three indicators. First, by the SFR's share in the global turnover in foreign exchange trading.

Volume composition in Forex

(Daily foreign-exchange transactions, $ billion



This chart is based on data collected by the BIS in 1998, i.e. during the period prior to the introduction of the euro. The columns illustrate the composition of an average daily volume of approximately 1.5 trillion USD by currencies. The USD clearly predominates. This is shown by the size of the lower areas, which represent the respective trading volume vis-à-vis the USD. It seems very likely that the advent of the euro has not significantly changed the pre-eminence of the dollar. The new figures to be expected this year will be instructive in this regard.

The SFR accounted for USD 100 billion, i.e. approximately 7% of the total daily volume in 1998. This may seem modest, but relative to the size of our economy it is a very respectable figure. The Swiss franc is trading currency number 5, ranging behind the Big Three and Sterling, but well ahead of the currencies of much larger countries like Australia and Canada.

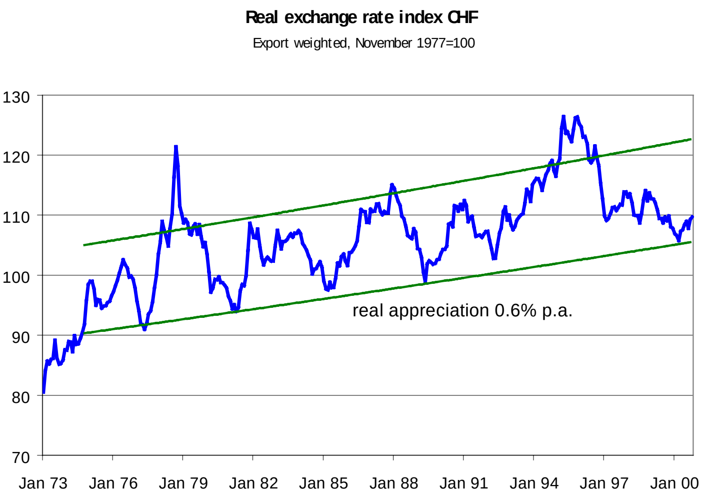
Economically more important than the trading volume is - second - the position of a currency held in international portfolios. Relative to the size of our country, the SFR occupies an unusually prominent position in international institutional and private portfolios. This position is the combined result of an above-average stability record, an efficient financial centre and the commitment to an independent monetary policy which lends the SFR special diversification characteristics in global portfolios. This certainly is a sign of strength, a sound basis for value creation, especially in our financial industry. At the same time, its strong position makes the SFR particularly sensitive to global capital movements.

Thirdly, due to relatively low interest rates, the Swiss franc - like the yen - periodically plays an important role in the short-term financing of trading positions. Currency and securities traders take short positions in our money market to finance long positions elsewhere. This is a rather volatile game, often reinforced by herd effects, which comes and goes with short-term exchange rate expectations. These so-called carry trades from time to time generate a significant amount of short-term exchange rate volatility. In the recent past, however, such strategies have lost their appeal, probably as a combined consequence of last year's increase in money market rates and the appreciation of the Swiss franc.

In a broader perspective which also includes impacts on the real sector, three points of view will be moved to the fore.

First and foremost, trade relations with Euroland have always been strong, on the export as well as on the import side. Under the new bilateral agreements, our connectedness with the EU may become even stronger in the years to come. Given these structural conditions, it is clear that our economy is highly susceptible to shocks in the SFR/euro exchange rate. In actual fact, this marked dependence is the strongest economic argument of all those wishing to substitute the euro for the Swiss franc as soon as possible.

A second relevant perspective for the real sector is to be seen in the trend towards a real appreciation of the SFR since the transition to floating.



The rising trend - measured by the index of the real trade-weighted SFR exchange rate - averaged 0.6% per annum. Its main causes seem to be two special features of our economy. One is the extraordinarily high external surplus of approximately 10% of GDP, which generates a steady net demand for SFR. Second, in Switzerland - as, incidentally, also in Japan - the so-called Balassa-Sammelson effect probably also plays a role. It rests on the fact that the productivity trend in the internationally active part of our economy proved to be much more vigorous than in the less competitive domestically-oriented sectors. It remains to be seen whether, and if so, to what extent, the deregulation of various formerly protected areas of our economy will cause this effect to disappear.

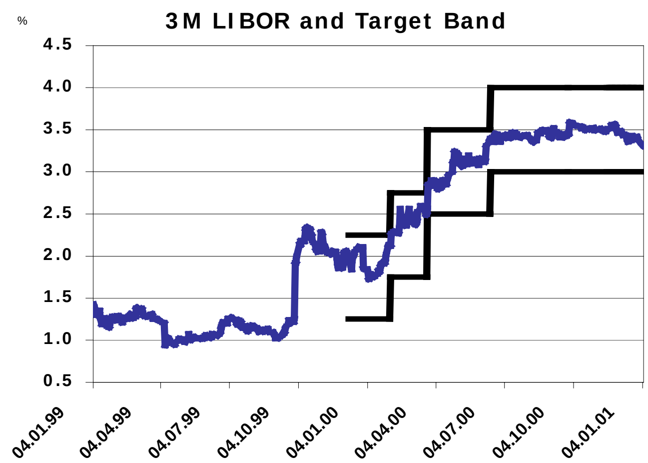
The upside trend of our exchange rate development, however, is not really a problem. This is evidenced by the remarkably strong performance of the export sector since 1973 as well as by the favourable trend of our terms of trade which showed an average improvement of 0.8% per year. On the contrary: the appreciation is a clear sign of the confidence placed in our currency. It has a positive effect on prosperity since the purchasing power of a given income in Swiss francs increases in the wake of falling import prices.

By contrast, the individual periods of massive and prolonged deviations from the trend proved to be a serious handicap for macro-economic development. No doubt, such shocks are a major stability risk for our open economy even if, fortunately, they are a rare occurrence.

Conclusions for monetary policy

Let me now turn to monetary policy, focusing first on recent developments followed by some long-term considerations.

The pattern of the 3-month Libor rate illustrates how we have proceeded since the euro was launched.



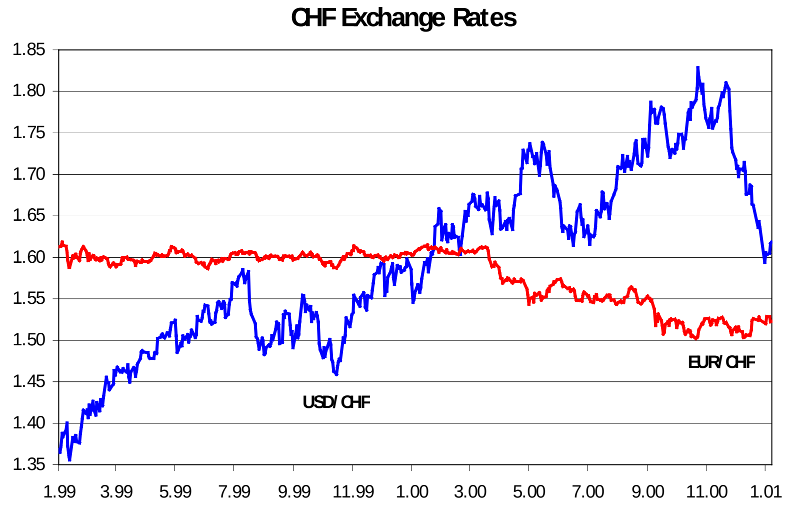
Until the latter part of 1999, the interest rate path was shaped by our concern about the economic downside risk. We aimed at a generous setting of the monetary conditions by means of very low money market rates. We were therefore not unhappy that during this time the Swiss franc remained consistently stable vis-à-vis the euro, while weakening against the USD. During the - surprisingly vigorous - recovery that set in in winter, we increased the 3-month Libor rate in several steps from around 1% to 3.5% in June 2000. In this phase, we pursued a more restrictive course than our colleagues at the European Central Bank. We considered this course to be adequate because our economy was practically back at full employment.

Since June 2000, we have not adjusted interest rates. In retrospect, that was an adequate policy. Even though, in August and September, there was still frequent talk of an imminent overheating and markets were expecting a further increase in interest rates, we did not become active. It seemed likely to us that the signs of a slowdown would soon become more marked both in Switzerland and abroad. This stance was not without risks. In monetary policy, as elsewhere, one occasionally needs some good luck.

In the current environment, we consider the position of the target band to be appropriate. The Libor rate has sufficient leeway in the 3% to 4% bracket to reflect current fluctuations driven by the market. Of course, we will carefully observe and analyse ongoing developments and take action if necessary. Our mission is clearly oriented towards achieving a high degree of price stability in the medium term while taking into account the economic development.

Two years of experience with the euro has taught us that living as a dwarf moving among giants is a reasonable strategy. It has allowed us to implement our own policy and at the same time to retain our traditional interest rate bonus, a significant economic advantage. Rather than obstructing our monetary policy during this time, the floating exchange rate has facilitated, even supported it.

When we wanted to pursue an expansionary course in 1999, the Swiss franc remained weak. And when, in the first quarter of 2000, we took corrective action by adopting a more restrictive course, it appreciated against the euro without overshooting. Without this exchange rate support, we would undoubtedly have had to impose bigger changes in interest rates. Prior to the launch of the euro, we made it abundantly clear that in the event of a massive exchange rate distortion, which would have posed a serious threat to internal stability, we would be ready to take action in the foreign exchange market. We have not had to make use of this measure of last resort at all.



Finally, not even the marked decline of the USD in the past months has led to any undesirable tremors. The effect, registered fairly regularly in the past, that a weakening of the USD is reinforced by an appreciation of the SFR vis-à-vis the DM, has been almost absent. It remains to be seen whether this undoubtedly destabilising "coffee cup effect" has disappeared for good with the advent of the euro. Do we want to maintain our own currency even in 10 or 20 years' time? That is certainly a good question. In economic respects, it seems advisable to remain noncommittal for the time being. Not only on the financial markets do available options have a positive value. They should not be given away lightly. That, however, is precisely what those are doing who are pressing for an early - as early as possible - decision: adopting the euro as the country's currency as soon as possible or a commitment to run our own currency system for ever. These two radical alternatives, however, are fraught with considerable uncertainties. It therefore seems much more rational to adopt a wait-and-see attitude during which experience is gained, and to delay the decision until such time as its implications may be assessed with greater accuracy than is possible today.

If you don't yet know where Berne is and whether you will like it there or not, don't take a non-stop intercity train. Rather board a train that will stop once in a while, giving you a chance to make up your mind. Perhaps you will want to leave the train in Olten and go on to Basel instead, or you may prefer to get off in Lenzburg and return to Zurich. With this little side leap into option theory - or should I say common sense? - I shall close my remarks.

I thank you for your patience.