Thomas Jordan: The euro and Swiss monetary policy

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the Europa Forum Lucerne, Lucerne, 2 May 2016.

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The speaker would like to thank Tobias Cwik and Mathias Zurlinden for their valuable support in preparing this speech. He also extends his thanks to Petra Gerlach and Carlos Lenz, as well as to Communications and Language Services at the SNB.

When the euro was created almost two decades ago, there was considerable uncertainty about how the currency would impact Switzerland. My predecessors on the Governing Board of the Swiss National Bank regularly commented on subsequent euro developments in speeches and frequently voiced their expectations and concerns. Things ran fairly smoothly in the first few years; but the financial and debt crisis rocked the currency union and put the euro under pressure. The SNB has responded with a flexible and pragmatic monetary policy. As the difficulties have not yet been overcome, it is too early to draw definite conclusions. One thing is clear, however: getting to grips with the challenges we face has been – and remains – harder than the cartoon character in the picture suggests (cf. chart 1). From the SNB's point of view, the experiences of recent years have once again highlighted the importance and value of monetary sovereignty. Monetary sovereignty has its price, of course, but it remains true that the interests of our country are best served by retaining this independence.

Economic importance of the EU, the euro and the ECB

Ladies and gentlemen, as you all know, the EU is Switzerland's most important foreign trade partner. And within the EU, the euro area countries play a particularly important role for us. In 2015, exports to the euro area accounted for around 44% of total exports; the share of imports from the euro area was larger still. Although the share of exports to the euro area has fallen by around 10 percentage points since 2000 – we are increasingly diversifying our foreign trade towards the emerging markets in particular – overall, the euro area countries remain by far the biggest consumers of Swiss products (cf. chart 2).

The particular significance of the euro area for Swiss foreign trade means that the exchange rate to the euro is an important variable, both for our economy and for the SNB's monetary policy. The exchange rate influences the price of foreign goods in Switzerland – and thus also inflation, as measured by the national consumer price index; but it also impacts the price of Swiss goods in the euro area, which in turn impacts domestic inflation via production and employment effects.

Consequently, the monetary policy of the European Central Bank (ECB) is particularly relevant for Switzerland. This has become clear again in recent years. On the one hand, the ECB's expansionary monetary policy has encouraged the economic recovery and helped to promote cohesion in the euro area – which in turn has bolstered demand for Swiss products. On the other, the weakening of the euro has put Swiss producers in a bind versus their European competitors and presented problems for Switzerland's monetary policymakers.

Stability and instability in relation to European currencies

Over the course of several decades, the Swiss franc has appreciated against all European currencies. This applies not just to the nominal, but also to the real exchange rate (i.e. the exchange rate adjusted for the inflation differential between the Swiss franc and the relevant foreign currency), which is an important determinant of Switzerland's international competitiveness. So, while the appreciation we have witnessed in recent years is certainly very pronounced, it is not entirely new.

Our currency has frequently experienced upward surges – often in conjunction with short-term increases in exchange rate volatility. In the 1970s and 1980s, for instance, the Swiss franc appreciated substantially against all European currencies amid major fluctuations. The exchange rate to the German mark – which remained relatively stable – was an exception. This was due to structural similarities between the two countries' economies and to the fact that both the German Bundesbank and the SNB operated according to comparable monetary policy principles at the time. Both institutions were focused on money supply targets and pursued a policy geared towards maintaining price stability.

In the 1990s, monetary policy in most of the EU countries was dominated by preparations for the launch of the European single currency. As a result of the Maastricht convergence criteria, the central banks of these countries were increasingly aligning themselves with the Bundesbank. Exchange rates between the affected currencies, as well as exchange rates to the Swiss franc, consequently stabilised. This phase of low exchange rate volatility continued in the years immediately following the launch of the euro.

The most recent period of exchange rate volatility against the euro has its roots in the international financial and debt crisis, which rapidly evolved into a euro crisis. Doubts about the viability of some euro area member states' sovereign debts caused markets to lose confidence in the euro. As in past crises, the mounting uncertainty triggered substantial upward pressure on the Swiss franc.

Why Switzerland doesn't have the euro

Considering its close economic ties to the euro area, why didn't Switzerland ever seriously contemplate joining the single currency? Politically and legally speaking, the answer is simple: a country can only join the Eurosystem if it is already an EU member state. Swiss voters and cantons rejected accession to the European Economic Area in a referendum in 1992, and in 2001 followed this up by voting against a popular initiative favouring a "Yes to Europe". These decisions settled the question of whether Switzerland should join the EU for the foreseeable future.

Quite apart from these political and legal factors, the economic case for joining the euro had always been weaker for Switzerland than for many other European countries. Switzerland's inflation had always been relatively low, and the country thus saw no need to import monetary credibility by pegging the Swiss franc to a stable currency. Furthermore, it makes sense for Switzerland to pursue an independent monetary policy given the structure of its economy – particularly in view of its status as an international financial centre and the research-intensive nature of the industrial goods it produces.

Monetary policy between fixed and floating exchange rates

In 1973, when the system of fixed exchange rates established in Bretton Woods towards the end of the Second World War collapsed, Switzerland decided to adopt a system of floating exchange rates. Over the long term, this decision has proved its worth. However, there are pros and cons to both fixed and floating exchange rate policies.

The disadvantage of fixed exchange rates is that they prevent a country from pursuing its own, independent monetary policy; monetary policy in a given country cannot be geared towards ensuring price stability. Equally, the central bank is virtually unable to take account of economic developments or respond to the kind of special circumstances that typically arise during crises. Ultimately, under a fixed exchange rate system, monetary policy is delegated to the central bank of the country to whose currency one's own is pegged. In the long term, this leads to relatively high fluctuations in both production and inflation.

Floating exchange rates allow a country to pursue its own, independent monetary policy; however, the disadvantage of such an approach is that it can result in major (nominal and real) exchange rate fluctuations. A country's currency may thus be substantially under or overvalued – sometimes for considerable periods of time.

The problems associated with both fixed and floating exchange rates mean that, time and again, central banks have been on the lookout for compromises. Since the end of the Bretton Woods system, the SNB has twice introduced a temporary exchange rate floor in order to cap Swiss franc appreciation: first in October 1978 against the German mark, and latterly in September 2011 as a minimum exchange rate against the euro.

The minimum exchange rate as a monetary policy instrument

When a central bank announces a minimum exchange rate, it commits to enforcing a floor, if necessary by means of foreign currency purchases. Such a policy is designed to cap a currency's appreciation. The minimum exchange rate is not conceived as an instrument for fine-tuning the exchange rate. Rather, it is intended to give guidance to the markets in a period of extreme uncertainty and to reduce excessive appreciation.

However, a minimum exchange rate is not a long-term instrument. This is especially true in a country like Switzerland which has lower long-term average inflation rates than most countries and a currency that has appreciated consistently over the decades – both in real and nominal terms.

In normal times, if a country's currency appreciates to the point where it begins to jeopardise price stability, that country's central bank will react by lowering the reference interest rate. Lowering rates makes portfolio investments denominated in the relevant currency less attractive, thereby weakening it on the foreign exchange markets. However, when nominal interest rates reach their lower bound at or close to zero, central banks must take unconventional measures to prevent an undesired tightening of monetary conditions. A minimum exchange rate is one such measure.

In summary, a minimum exchange rate is first and foremost a temporary instrument for use in situations where foreign exchange markets are extremely unsettled, a country's currency is substantially overvalued against most other currencies, and nominal interest rates are at their lower bound, meaning that the exchange rate can no longer be influenced by cutting interest rates.

The introduction of the minimum exchange rate against the euro in September 2011

In summer 2011, the decision to introduce the minimum exchange rate undoubtedly made sense. We had already lowered the target range for the reference interest rate to between 0.0% and 0.25%, with the aim of reducing the three-month Libor to zero. Moreover, uncertainty on the financial markets was exceptionally high and the debt crisis had raised questions about the future of the euro. The acrimonious budget dispute in Congress was taking its toll and the US dollar was showing signs of weakening. This situation was compounded by weak economic data in the first half of 2011, which pointed to the risk of another global recession. Swiss franc appreciation accelerated in response to these developments, with the currency reaching historic highs against the euro and the US dollar and threatening to plunge Switzerland into a deep recession (cf. chart 3).

The discontinuation of the minimum exchange rate in January 2015

The minimum exchange rate – which was to remain in place for almost three and a half years – halted the appreciation of the Swiss franc and helped to ease tensions. When we discontinued the measure in January 2015, the decision was criticised in some quarters. This is understandable, as the scale of the minimum exchange rate's negative side effects was not yet fully apparent. However, the discontinuation of the minimum exchange rate was unavoidable; conditions had changed and an analysis of the risks clearly favoured the decision to remove the floor.

The overall situation had improved significantly since the introduction of the minimum exchange rate. The economy had regained momentum, confidence in the US dollar had been restored and uncertainty had decreased considerably.

Then there was the issue of divergence: the monetary policies of the US Federal Reserve and the ECB were moving in opposite directions. As the markets were expecting the Americans to tighten and the Europeans to substantially loosen monetary policy, the euro had been weakening against the US dollar since mid-2014. Not just the euro, but the Swiss franc, too, had been losing ground against the US dollar. In contrast to summer 2011, when the Swiss franc had been significantly overvalued against all other currencies, by the time of the discontinuation, Swiss franc strength had given way to euro weakness.

The increasingly divergent monetary policy stances of the Federal Reserve and ECB were also putting pressure on the minimum exchange rate against the euro. The SNB was forced to intervene in the foreign exchange market on an ever larger scale. This was reflected in the monetary base (the volume of liquidity created by the SNB), which had expanded in several surges since 2009 and was now rising sharply again (cf. chart 4).

Given the changed international environment, the minimum exchange rate of CHF 1.20 per euro was no longer sustainable. The SNB could only have enforced it through ongoing foreign currency purchases of rapidly increasing magnitude – in an environment where there was no prospect of a long-term stabilisation on the exchange rate front. Delaying the decision to discontinue would not have mitigated the economic consequences, but the losses for the SNB would have been far greater. This would have compromised the SNB's ability to fulfil its mandate in the long term and would have undermined its independence in matters of monetary policy.

Monetary policy since the discontinuation of the minimum exchange rate

Developments since the minimum exchange rate was discontinued have confirmed our assessment at the time. The euro continued to weaken against the US dollar. The ECB also announced additional easing at the end of 2015 and again at the beginning of 2016.

Concurrently with the discontinuation of the minimum exchange rate, the SNB shifted the focus of its monetary policy. We moved the interest rate on sight deposits at the SNB deeper into negative territory. Money market interest rates have since settled at around −0.75%. We also underscored our willingness to intervene in the foreign exchange market as necessary. Both the negative interest rate and the willingness to intervene in the foreign exchange market were intended to cushion the effects of the discontinuation of the minimum exchange rate (cf. chart 5).

Once the currency floor had been removed, the Swiss franc appreciated sharply in the initial period; the euro fell to parity against the Swiss franc and the US dollar depreciated by a similar amount. Both currencies have since regained ground, however. In recent weeks, the euro has been trading at around CHF 1.10; and for some time now, the US dollar has been trading above the level posted on average while the minimum exchange rate was in place. Overall, though, the Swiss franc remains significantly overvalued.

At the last monetary policy assessment, which took place about six weeks ago, the SNB confirmed that the monetary policy it had been pursuing since January 2015 would remain unchanged. The target range for our reference interest rate, the three-month Libor for Swiss franc investments, thus remained unchanged at between –1.25% and –0.25%, and we confirmed the interest rate on sight deposits at the SNB of –0.75%. We also reaffirmed our willingness to intervene in the foreign exchange market as necessary. The SNB's policy of negative interest and foreign exchange market interventions – measures that are intended to relieve upward pressure on the Swiss franc – is helping to stabilise price developments and support economic activity in our country. The SNB thus continues to take account of the exchange rate situation in formulating its monetary policy.

Conclusion

The SNB – like the ECB and many other central banks – has been deploying unconventional monetary policy measures in recent years. These were prompted by the financial and debt crisis, which caused the central banks to reduce short-term interest rates to near zero and significantly expand the monetary base. In Switzerland, the crisis led to a very substantial appreciation in the Swiss franc, particularly against the euro. The SNB thus took targeted unconventional measures to ease upward pressure on the Swiss franc. Between September 2011 and January 2015, it maintained a minimum exchange rate against the euro. Since the discontinuation of this measure, monetary policy has been based on negative interest and the willingness to intervene in the foreign exchange market.

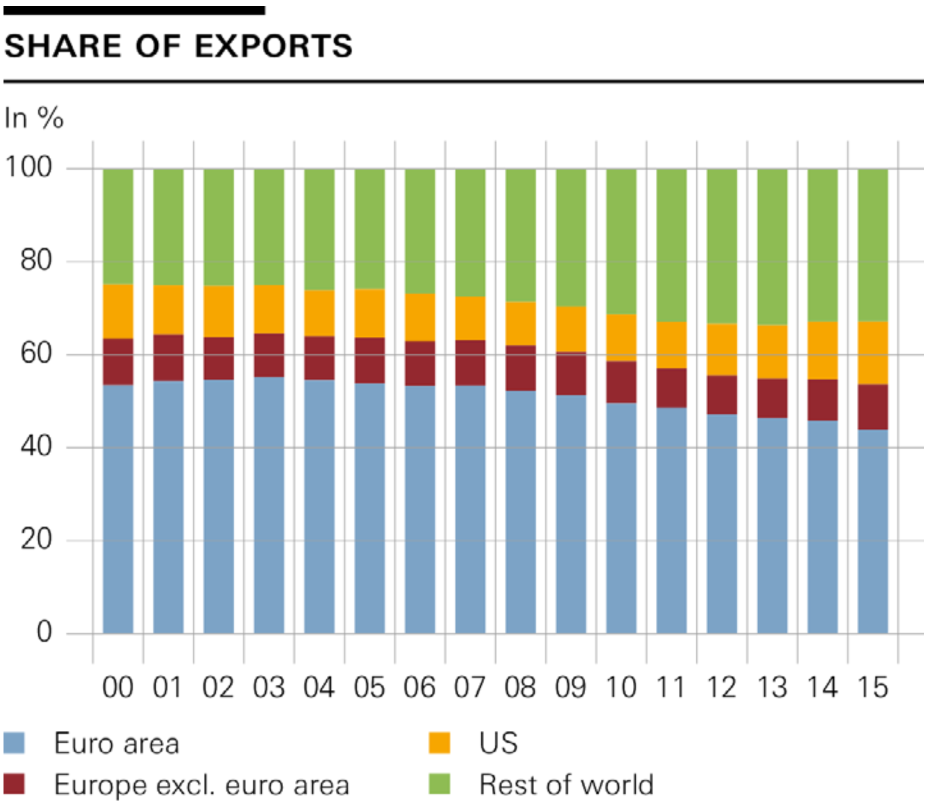
Logically and quite rightly, the central banks were major economic protagonists during the financial and debt crisis. However, in the intervening period, they have continued to play this role. This state of affairs is not without risks. Ultimately, monetary policy alone cannot remedy all economic ills, especially those of a structural nature. It is therefore important that all the powers involved play their part in solving the problems we face.

Ladies and gentlemen, today's topic focused on the challenges for Swiss monetary policy with regard to the euro. Anything that affects the EU or the euro also affects our country. Consequently, it is very much in our interest that solutions for the structural problems in the EU be found and that economic recovery continue. Having said this, Switzerland should not simply stand idly by and rely on Europe. As a small open economy, we must 'do our homework' and adapt to a changing landscape. It is important for companies to continue operating with a high degree of flexibility, and for economic policymakers in all fields – in this country, too – to ensure good business conditions. The SNB will continue to make the most of the latitude afforded by its monetary sovereignty to respond pragmatically to the challenges ahead.

Chart 1

Chart 2

Switzerland's foreign trade, 2000−2015



Source: Swiss Customs Administration

Chart 3

Interest and exchange rates, 2008−2011

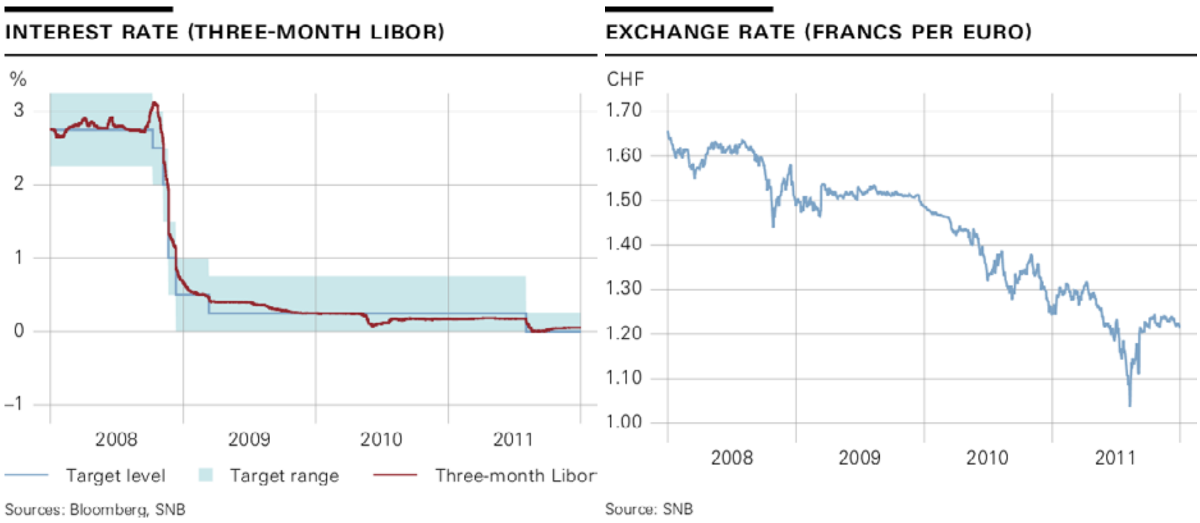


Chart 4

Monetary base from 2008 to the present day

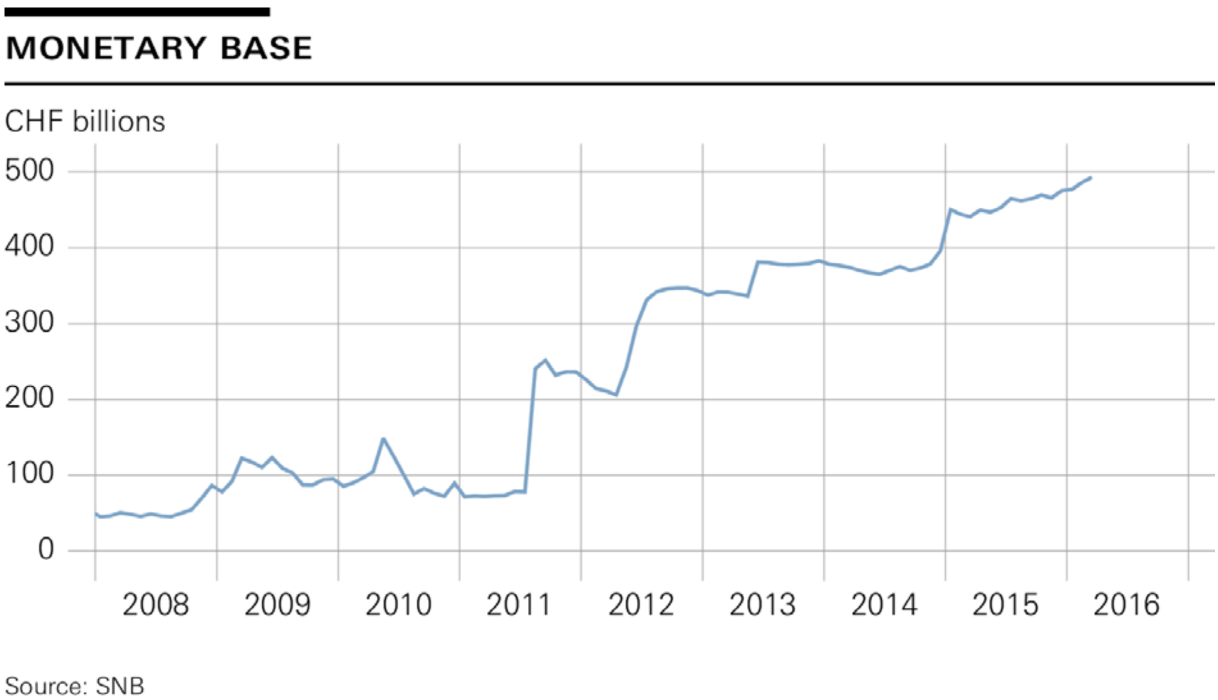


Chart 5

Interest and exchange rates from 2012 to the present day