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Unconventional policy measures in Switzerland

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I first present the key arguments for the introduction of the minimum exchange rate. Then I outline some operational aspects of its enforcement. Finally, I address another unconventional measure implemented in Switzerland: the countercyclical capital buffer (CCB).

1. Key arguments for the introduction of the minimum exchange rate

In summer 2011, the European sovereign debt crisis escalated as doubts about the solvency of Italy and Spain increased. In addition, financial markets were worried that the US Congress would not reach agreement on how to avoid hitting the debt ceiling. To make matters even worse, the global economic outlook turned noticeably gloomier.

As investors' fears sent jitters through financial markets, there was a surge in safe haven flows, which generated extreme reactions in terms of exchange rate movements.

The Swiss franc had already appreciated strongly between the onset of the financial crisis in August 2007 and spring 2011. Between early July and early August 2011, however, the development was exceptional in two ways. First, the yen, the US dollar and the Swiss franc have traditionally been regarded as safe haven currencies. But this time the franc appreciated against all other main currencies, that is, also against the dollar and the yen. Second, the appreciation of the franc accelerated dramatically, leaving our currency significantly overvalued.

This very substantial appreciation led to a sharp tightening in monetary conditions in Switzerland. This carried the risk of deflationary developments and posed a threat to the economy. Switzerland is a very small and open economy. Therefore, the exchange rate is a major driver of the price level, and annual inflation at that time was already very low and trending downwards. The exchange rate also has a substantial influence on the utilisation of production capacity.

As a result, the Swiss National Bank (SNB) had to act in order to fulfil its mandate. The SNB is required to ensure price stability, and in doing so, to take due account of economic developments in Switzerland.

While it was clear that we had to act to stop this appreciation, nominal interest rates were already close to zero. Lowering interest rates further to counter the strong appreciation was not possible. Moreover, given Switzerland's small domestic bond market, the purchase of domestic securities was not a viable option, either.

Therefore, in early August 2011, we decided to embark on an unprecedented liquidity expansion – that is, quantitative easing – through repo and foreign exchange swap transactions. Market interest rates entered negative territory, and the Swiss franc weakened as a result of these measures. Ultimately, however, these liquidity measures were insufficient. In early September, the franc came under renewed pressure after further negative news from abroad.

On 6 September 2011, the SNB announced that it would no longer tolerate a EUR/CHF exchange rate below CHF 1.20 and that it would enforce this minimum exchange rate through unlimited foreign currency purchases if necessary.

In a nutshell, by introducing the minimum exchange rate, the SNB countered an inappropriate tightening in monetary conditions for Switzerland. This tightening was the result of a dramatic appreciation of the Swiss franc. This appreciation did not reflect fundamental factors. It was caused by international developments which unsettled financial markets, transforming the Swiss franc into a safe haven.

Such a monetary tightening would have compromised price stability and had potentially serious consequences for the Swiss economy. The SNB had to act, and there was no real alternative to the minimum exchange rate.

It is easy to see that the SNB is not pursuing a beggar-thy-neighbour policy. We set the minimum exchange rate at a level where the value of the Swiss franc remains high. The introduction of the minimum exchange rate has not created a competitive advantage for companies operating in Switzerland. On the contrary, it has reduced a competitive disadvantage that had arisen as a result of adverse developments on the foreign exchange markets.

2. Some operational aspects of the exchange rate enforcement

With respect to the operational enforcement of the minimum exchange rate, I would like to address a few points: First, for a minimum exchange rate to work in a very volatile market environment with nervous market participants, it is absolutely crucial to give the market a very clear and unambiguous signal about the policy decision. Therefore, we determined a minimum exchange rate for the Swiss franc against one currency – the euro – rather than against a currency basket.

The introduction of the minimum exchange rate has indeed provided the foreign exchange market with clear guidance following a period of exceptional volatility. Nevertheless, the escalation of the euro area debt crisis in 2012 triggered another bout of intense upward pressure on the Swiss franc. As a result, we had to enforce the minimum exchange rate through extensive – unsterilised – foreign currency purchases. Overall, the SNB purchased foreign currency last year to the value of CHF 188 billion.

This leads me to the second operational aspect. The SNB was well prepared to purchase foreign currency if needed. We could count on our professional foreign exchange trading desk and an experienced asset management team, and we had the appropriate infrastructure in place. Moreover, with a network of well over 100 banks from around the world as counterparties, the SNB covers the relevant interbank foreign exchange market. Finally, order and execution process is highly automated.

The foreign currency purchases made in 2012 led to a significant rise in our foreign currency holdings. However, when managing its foreign currency assets, the SNB takes care to avoid its investments having any impact on financial markets, especially interest rates or exchange rates of other countries.

The increased volume in foreign currency holdings – and that is the last aspect I would like to mention here – also resulted in a considerably higher level of financial risk on our balance sheet. Yet these foreign currency purchases were necessary and we have to carry this risk. An appreciation of the Swiss franc would have compromised price stability.

3. The countercyclical capital buffer (CCB)

The minimum exchange rate is an important unconventional weapon in warding off an appreciation of the Swiss franc caused by investors' fears regarding the debt crisis. The minimum exchange rate was, however, not the only unconventional measure applied in Switzerland. The CCB, which can be used to target specific market segments, was another.

Persistently strong growth in both real estate prices and mortgage lending over the last several years in an environment of historically low interest rates has resulted in a build-up of imbalances on the real estate and residential mortgage markets. A sharp correction in property prices and an increase in mortgage defaults could impair financial stability in the medium term. These imbalances cannot be addressed by raising interest rates given the expansionary monetary policy stance in major advanced economies, the exchange rate concerns and inflation prospects.

Against this background, the Swiss Federal Council decided in February 2013 to activate the CCB following a proposal by the SNB. In Switzerland, the authorities are entitled to temporarily impose additional capital requirements of up to 2.5% of total domestic risk-weighted assets in the banking system, as imbalances in the credit market develop. At present, the buffer is activated to target mortgage loans financing residential property located in Switzerland and is set at 1% of the associated risk-weighted positions. The deadline for compliance is 30 September 2013.

When making its decision, the Federal Council took into account the fact that the imbalances are currently concentrated in this particular segment of the credit market and that, at the moment, they are still less pronounced than immediately prior to the onset of the real estate crisis in Switzerland in the early 1990s.

Conclusion

The two unconventional measures – the minimum exchange rate and the CCB – were not implemented as a direct result of unconventional monetary policies in other countries. The safe haven flows which led to the dramatic appreciation of the Swiss franc – and necessitated the imposition of the minimum exchange rate – are particularly related to uncertainty and financial stress. Due to these exchange rate concerns and inflation prospects, it is currently undesirable to raise interest rates in Switzerland. Thus, the imbalances in the real estate market have been addressed through the activation of the CCB for specific market segments.

The threat that the Swiss franc could suddenly come under upward pressure again has not been averted. In the current low interest rate environment, therefore, the minimum exchange rate remains the key instrument for ensuring appropriate monetary conditions in Switzerland.