Philipp M Hildebrand: Major challenges facing the Swiss National Bank

Speech by Mr Philipp M Hildebrand, Chairman of the Governing Board of the Swiss National Bank, at the General Meeting of Shareholders of the Swiss National Bank, Berne, 30 April 2010.

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Mr President of the Bank Council
Dear Shareholders
Dear Guests

I. The recession has run its course

A little over a year ago, we were still in the midst of the worst financial crisis in post-war history. True, we were able to discern the first tentative signs that the tide might be turning, but the outcome was still highly uncertain. Today, the worst is behind us. We can look to the future with a measure of optimism. Yet the challenges that the crisis has left in its wake are still substantial.

While 2008 will go down in history as an annus horribilis for the financial markets, 2009 was dominated by the gloomy economic environment. The global economy contracted for the first time since the Second World War. The huge loss of confidence on financial markets in autumn 2008 caused economic activity to nosedive. Indeed, one of the most striking features of this recession was the speed and severity with which economic growth dropped in a number of countries.

Faced with such a dramatic situation, governments and central banks across the world found themselves having to swiftly implement innovative support and rescue measures on an unprecedented scale, in a bid to stabilise the global financial system and limit the economic downturn.

The decisive economic policy intervention was a key contributor in calming the markets, halting the downward spiral and clearing the way for economic recovery.

As a small open economy, Switzerland could not avoid being drawn into the global recession. The sharp fall in economic activity, which had begun in the second half of 2008, continued in the first half of 2009. Around the middle of the year, the trough was reached and the economy began to grow again. Over the year 2009 as a whole, GDP dropped by 1.5%, the largest decline since 1975.

Nevertheless, Switzerland has so far weathered the effects of the financial crisis better than most industrialised economies. This may come as a surprise, given the importance of our financial centre. A deciding factor behind the comparative mildness of the recession in Switzerland was private consumption, which proved to be an important buttress of growth. Moreover, no major distortion was observed in the property market, and banks did not restrict access to lending. Last but not least, the rapid and decisive expansion of monetary policy also played a supporting role.

Despite this positive bill of health compared to other countries, the crisis has clearly left its mark on Switzerland too. For example, unemployment has risen markedly and manufacturing is suffering from the continuing low level of technical capacity utilisation. Finally, the events of the past two and a half years have shown exactly how vulnerable our country is in the event of a banking crisis, particularly one involving large banking institutions.

I would therefore like to begin by outlining a few of the Swiss National Bank's thoughts on the "too big to fail" issue. I will then briefly review our monetary policy in 2009, and describe the challenges facing the SNB in this area. In the final part of my speech, I will address the recent discussion surrounding the appropriate level of inflation.

II. The "too big to fail" issue

Without appropriate countermeasures, Switzerland would remain very exposed to any fallout from a banking crisis. True, the big banks have substantially cut their balance sheets, something which the SNB explicitly welcomes. Yet the size of those balance sheets still represents a multiple of our country's GDP. And the big banks continue to hold a dominant position in domestic lending and investment business. They are thus still "too big to fail".

In a comparable crisis, the government and the SNB would once again face an impossible choice: either they accept the devastating consequences of a big bank failure for the Swiss economy, or they take on the considerable financial risk of stabilisation measures. In the worst case scenario, it is even conceivable that the funds needed to provide such support would exceed our country's financial resources.

The lion's share of the burden from the measures taken to stabilise the Swiss financial centre was borne by the SNB. For this reason, it has been a staunch advocate of addressing and remedying the "too big to fail" issue. The SNB has always stressed the need for a political decision in this regard.

In November 2009, the Federal Council appointed a commission of experts, whose mandate is to formulate possible approaches for resolving the "too big to fail" issue. The SNB is represented by its Vice President, Thomas Jordan. The commission published its interim report last week. The report proposes measures in the areas of capital, liquidity, risk diversification and organisational structure. These measures are designed, first, to be preventative, reducing the likelihood of failure by a systemically important institution. Second, they should minimise the cost to the economy as a whole, in the event that a failure nevertheless occurs. The aim is to remove the need for renewed state intervention in the event of a crisis.

The report by the commission of experts represents an important milestone in the "too big to fail" debate. The SNB supports the direction proposed by the commission. It shares the commission's view that it is necessary to establish a legal basis which will allow special requirements to be imposed on systemically important banks. In the SNB's opinion, the draft legislation proposed by the commission is a good basis for alleviating the "too big to fail" issue. In our view it is important to launch the legislative process as soon as possible after the commission's final report has been completed. The key elements of these special requirements, such as minimum and maximum capital provisions or the permissible organisational restrictions, will have to be set out in detail in a Federal Council Ordinance.

It is essential that the capital requirements are designed to be progressive. This progressive nature should incentivise the banks to reduce their systemic importance. The capital requirements must be sufficiently strict to motivate the banks to bear the risks themselves which, up to now, they have been able to pass on to the general public.

Moreover, higher capital requirements can provide an important foundation for a future-oriented business model geared towards sustainability. In the fields of business in which Swiss financial institutions are traditionally strong, well capitalised banks certainly have a competitive advantage.

The SNB also takes the view that the organisation and legal structure of the big banks must be modified so that an orderly wind-down in extreme crisis situations is rendered possible. In particular, it must be possible for systemically important functions to keep running without the company as a whole having to be rescued.

At the international level, proposals are also being drawn up on measures to address the "too big to fail" issue. We need to take these international regulatory developments into consideration to ensure the global competitiveness of our financial centre. Yet, as the past two and a half years have shown all too clearly, in the event of a crisis each country must take responsibility for its own banks. The formulation and implementation of measures at the national level must take into account the specificities of the country concerned. Here in Switzerland, the “too big to fail” issue is particularly pronounced, hence the need for a “Swiss Finish”.

Reform of financial sector regulation and oversight is, without a doubt, a tough challenge. But the SNB is also faced with equally tough challenges in the area of monetary policy.

III. Review of monetary policy in 2009

In 2009, the SNB’s monetary policy activities were focused entirely on combating the financial and economic crisis and the associated deflationary trends. Price stability, which is not compatible with either deflation or inflation, remained the core objective.

As early as autumn 2008, the SNB had adopted an expansionary monetary policy stance as a result of the increasingly unfavourable economic outlook and the prospect that inflation would be low for the foreseeable future. Between October and December 2008, the SNB lowered the target range for the three-month Libor by a total of 225 basis points, to only 0.0–1.0%. The SNB also ensured a generous supply of liquidity to the money market.

The economic situation continued to worsen into the spring of 2009. In addition, the uncertainty engendered by the financial crisis had led to a strong appreciation of the Swiss franc against the euro. In view of the economic situation prevailing in Switzerland at that time, there was the risk of a pronounced deflationary trend, in particular if the Swiss franc were to appreciate further. This risk necessitated a further easing of our monetary policy.

The substantial monetary policy easing therefore continued, with a further 25 basis point reduction in the Libor target range in March 2009. This left the new range at 0.0–0.75%, where it has since remained. The SNB aims to keep the Libor in the lower end of the range, i.e. at around 0.25%; the one-week repo rate has been at practically zero since the end of 2008.

The room for manoeuvre using the traditional interest rate instrument was thus effectively exhausted in March 2009. To relax monetary conditions further, the SNB significantly increased liquidity. It did so via a number of unconventional monetary policy instruments. It concluded longer-term repos and purchased bonds issued by private sector borrowers. It also bought foreign exchange on the foreign currency market and acted to prevent the Swiss franc from appreciating further against the euro up to the end of the year.

Against the background of the economic recovery, following its monetary policy assessment in December the SNB is acting only to decisively counter an excessive appreciation of the Swiss franc against the euro. In addition, it has discontinued its purchases of Swiss franc bonds issued by private sector borrowers. Indeed, movements in the Swiss franc against the euro over the past few months have caused monetary conditions to tighten somewhat. Yet, overall, monetary policy is still expansionary. The three-month Libor remains at a low-water mark of 0.25%, and we continue to supply the banks with generous amounts of liquidity.

Let me now turn to the outlook for 2010 and the monetary policy challenges ahead.

IV. Outlook for 2010

The global economy has been in a phase of recovery since mid-2009. The SNB expects that this will continue, although the recovery is still exposed to risks and will vary greatly from region to region.

The greatest expansion will be seen in emerging Asia. The entire region will, in particular, benefit from the strong growth in Chinese domestic demand. In the industrialised economies, the recovery is still being driven by the expansionary monetary and fiscal policy measures adopted at the start of the crisis. At the same time, there are a number of factors weighing on growth prospects. High unemployment, growing sovereign debt and the deterioration in household wealth are likely to dampen private consumer spending in many economies. In addition, given the underutilisation of capacity and the tighter lending conditions, corporate investment seems unlikely to stage a strong recovery. Moreover, in a number of countries the situation in the real estate market, and hence the outlook for the construction industry, will remain difficult.

For 2010, the SNB is currently expecting real GDP growth of about 1.5%. On the one hand, our export industry is exposed to the relatively hesitant growth in European demand. On the other, Switzerland is well equipped for a recovery. Public finances are relatively healthy, the financial positions of both households and corporates are sound, and the labour market is flexible.

The risk of deflation has fallen in the wake of the economic recovery. The most recent SNB inflation forecast from mid-March shows that price stability is not threatened in the short term. The SNB has sufficient leeway to maintain its expansionary monetary policy for the time being. However, the forecast also shows that the current monetary policy cannot be maintained over the entire forecast horizon without compromising medium and long-term price stability.

Moreover, this forecast is still associated with considerable uncertainties. The most recent financial market concerns that have arisen about the public finances of individual euro area countries represent a considerable risk in this regard. Over the past few years, Switzerland has benefited from the advent of the euro and the associated increase in European currency stability. Any threat to this currency stability would, by definition, have a negative impact on Switzerland, above all if the Swiss franc were to appreciate sharply due to its role as a safe haven currency. The SNB will not, however, allow such a development to turn into a new deflation hazard for Switzerland. For this reason, it is acting decisively to prevent an excessive appreciation of the Swiss franc.

As part of its measures to combat the crisis, the SNB supplied large amounts of liquidity to the banks. Liquidity created via repos and currency swaps is temporary: it flows back automatically when the transactions are not renewed. Since the volume of these transactions has declined sharply over the past few months, the amount of liquidity resulting from repos and swaps has already decreased substantially.

The liquidity that we created by purchasing foreign exchange or Swiss franc bonds is, however, of a more permanent nature and must be reabsorbed in good time, to ensure price stability in the medium and long term. The SNB has at its disposal the requisite instruments for rapidly absorbing large amounts of liquidity as and when necessary. Foremost among these are the SNB's own debt certificates, SNB Bills. We can also use reverse repos.

Thus, absorbing excess liquidity is technically not a problem. The challenge lies in selecting the right moment for a normalisation of monetary policy. A major factor in this decision will be the further development of the inflation outlook. The inflation forecast is the main indicator used in monetary policy decision-making by the SNB. The SNB monetary policy strategy does not, however, foresee a mechanical reaction to the forecast on the part of the Governing Board. Aspects such as uncertainty about economic development and the situation on the financial markets are also factored into the monetary policy decision.

V. Maintaining price stability

In concluding my remarks today, I would like to reaffirm that maintaining price stability is the SNB's utmost priority. We equate price stability with having average annual inflation below

2% while avoiding deflation. The reason why I am emphasising this is because the financial crisis has also sparked a debate on the appropriate level for inflation. In particular, it has been suggested that central banks should target a higher inflation level in normal times. The argument goes like this: if central bank reference rates are low, there is also little freedom for reducing interest rates, as the nominal rate cannot fall below zero. In turn – so runs the argument – a central bank's ability to react to a severe crisis is also limited. In contrast, higher inflation would lead to higher nominal interest rates. These could serve as a buffer in the event of a major shock. Monetary policy would then have scope for larger interest rate cuts, and a reduction in deflation risks. In other words: there would be more leeway for a relaxation of monetary policy in a crisis.

This argument is severely flawed. First, it is very doubtful that further interest rate cuts alone would have been enough to deal with the crisis. Second, this line of argument implies that monetary policy is ineffective once the zero lower bound has been reached. However, as I mentioned earlier, our experience shows that there is still room for monetary policy manoeuvre even at the zero lower bound. Using the unconventional measures I have described, the SNB certainly was able to relax monetary policy even further and thereby successfully ward off the risk of deflation.

So in times of crisis, the apparently greater monetary policy freedom with a higher inflation rate would be illusory. Moreover, a higher rate of inflation in normal times would create costs and threaten macroeconomic stability. Costs would arise even if the central bank were successful in keeping inflation constant at the desired level, and thus enabled households and companies to correctly anticipate the inflation rate.

Experience shows, however, that the inflation rate cannot be fine-tuned and a higher level of inflation often goes hand in hand with large fluctuations in inflation rates. It then becomes almost impossible to correctly factor inflation into calculations, leading to the misallocation of resources, as well as random and undesirable income and asset redistributions. In addition, it is generally the most disadvantaged members of society who bear the brunt of inflation, as they have only limited means of protecting themselves against it.

But, above all, higher and fluctuating inflation rates would undermine public confidence in the central bank. Credibility, built up painstakingly over decades, would quickly be eroded. The central bank would lose control of inflation and inflation expectations. Moreover, as inflation rose higher, pecuniary benefits such as salaries would increasingly be indexed, which would amplify the stickiness of inflation. But indexation, combined with a failure to anchor inflation expectations, would lessen the effectiveness of monetary policy and lead to greater fluctuations in interest rates, economic activity and employment.

We are therefore convinced that allowing higher inflation rates would be the wrong lesson to draw from the crisis. Price stability, i.e. neither inflation nor deflation, is a key public good. It is a decisive factor in achieving sustainable economic growth and prosperity, and not least social stability.

Switzerland has had a long and positive experience with low inflation and low nominal interest rates. The SNB is, and will remain, committed to price stability. Its monetary policy strategy gives it the necessary leeway to act decisively against both inflation and deflation.

VI. Conclusion

Ladies and Gentlemen, the worst of the financial and economic crisis that erupted in summer 2007 is now behind us. But we will be dealing with the fallout for some time to come. Hopefully, the Swiss economy will return to a sustainable growth trajectory. Until then, the SNB will continue to face major challenges. The Governing Board will approach them with great respect, but also with confidence and conviction. To achieve this, we will once again need to count on the exceptional efforts of each and every SNB staff member. We thank our shareholders for their continuing support and for their interest in the activities of the SNB.