

Thomas Jordan: Reconciling Switzerland's minimum exchange rate and current account surplus

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the Peterson Institute for International Economics, Washington DC, 8 October 2013.

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Introduction

Ladies and gentlemen, it is a great pleasure to be here at the Peterson Institute for International Economics. Before we start, I would like to personally thank the President of the Peterson Institute, Adam Posen, for the invitation.

I will begin by asking two questions: First, is Switzerland's minimum exchange rate at odds with its longstanding current account surplus? Second, is such a policy undermining the adjustment of global imbalances? I will argue that, in both cases, the answer is no.

The Swiss National Bank set a minimum exchange rate of CHF 1.20 against the euro in September 2011. In so doing, it took action against an excessive strengthening of the Swiss franc that was threatening price stability and the Swiss economy. To illustrate the extent of the franc's appreciation, let's look at Figure 1, which shows the real trade-weighted exchange rate on a monthly basis. As we can see, right from the onset of the financial crisis in 2007, the Swiss franc strengthened significantly, and dramatically so in July 2011. Between early July and early August alone, the Swiss franc appreciated by roughly 20%.¹

With interest rates close to zero and inflation forecasts signaling deflationary risks, the minimum exchange rate helped us avoid a dangerous tightening of monetary conditions, in a situation where we had exhausted the options available under conventional monetary policy. It also provided the foreign exchange market with clear guidance at a time of enormous uncertainty.

The rationale for the introduction of the minimum exchange rate is internationally acknowledged. As I have seen over the last two years, particularly central banks and the IMF understand the difficult situation facing Switzerland in 2011. They also recognize that we set the minimum exchange rate at a level where the Swiss franc remains highly valued even today.

Over the last few years, exchange rate tensions between the major economies have flared up. In this context, some observers have criticized central banks for influencing exchange rates, either directly through foreign currency purchases, or indirectly through additional monetary easing measures such as the purchase of securities. It is claimed that these types of asset purchases generate spillover effects or constitute a beggar-thy-neighbor policy.² In recent weeks, it has been suggested that capital flows have again become highly volatile

¹ Based on daily data.

² There are several event studies which show that asset purchases by the Federal Reserve and the Bank of England weakened their domestic currencies. See the following references:

Bauer, M. and C. Neely (2013): "International Channels of the Fed's Unconventional Monetary Policy", Federal Reserve Bank of San Francisco, Working Paper 2012-12.

Glick, R. and S. Leduc (2013): "The Effects of Unconventional and Conventional U.S. Monetary Policy on the Dollar", Federal Reserve Bank of San Francisco, Working Paper 2013-11.

Neely, C. (2010): "The Large-Scale Asset Purchases Had Large International Effects", Federal Reserve Bank of St. Louis, Working Paper 2010-018C.

because asset purchase programs are expected to be scaled back, thereby unleashing a new round of currency tensions.

Against the background of currency fluctuations and weak global demand, the problem of global imbalances still lingers. In the debate on global adjustment, there have also been calls for countries with a current account surplus to let their currencies appreciate. For some observers, this includes Switzerland. Our country's large current account surplus – so the argument goes – is a sure sign that the Swiss franc is too weak. The SNB should therefore abolish the minimum exchange rate and allow the Swiss franc to appreciate further. This in turn would allow the current account surplus to diminish, thereby contributing to global rebalancing.³

I would like to point out that such a critique is not based on a full understanding of Switzerland's situation. For a comprehensive assessment of the Swiss current account and the Swiss franc, the following factors also need to be considered. First, large exchange rate appreciations have not resulted in external adjustment of the Swiss current account. Instead, key components of the Swiss current account are determined by structural factors that behave independently of the exchange rate. Second, there are good and legitimate reasons for countries to have current account deficits and surpluses to smooth their output and consumption. And third, independent central banks need to fulfill their mandate of price stability in an inter-dependent environment that constrains their policy choices. More specifically, the SNB has had to – and still has to – ensure that monetary conditions do not become restrictive for Switzerland in the face of extreme exchange rate appreciation and deflationary risks. The critique does not take these three points into account.

Structural factors and Switzerland's surplus

Let me first address the question of specific structural factors in the Swiss current account surplus, and why this surplus is not a reflection of Swiss franc weakness. In a nutshell, these factors are more closely correlated with external developments in real economic activity than with exchange rate movements.

I'd like to highlight these structural factors with the help of three figures. Figure 2 shows the current account surplus and the real trade-weighted exchange rate of the Swiss franc. I have two observations here: In the short run, when the franc appreciates in real terms, the surplus in the current account does not automatically decline. Nor does the surplus automatically increase when the franc depreciates. In the long run, both the real exchange rate and the surplus increase over time. Thus, the theory that a stronger real Swiss franc automatically leads to a lower current account surplus does not hold empirically for Switzerland.

Why is this? Let's look at Figure 3, which shows the trade account and current account balances for selected countries. If a country's current account surplus is primarily determined by its trade account in goods, then we might expect an appreciation to result in a smaller surplus, through lower exports and higher imports. The underlying assumption in many economic models is that current account adjustment comes about primarily through the trade-in-goods component. Switzerland is different to most other countries, in that its trade account balance in goods represents only a small fraction of the large current account surplus. This stands in stark contrast to other economies such as China, where goods trade makes up more than 80% of the current account surplus.

So, if the Swiss current account is *not* driven by the trade balance in goods, then what *are* the factors responsible for its surplus? As we can see from Figure 4, the large surplus in the

³ See, for example, Joseph E. Gagnon (2013): "[The Elephant Hiding in the Room: Currency Intervention and Trade Imbalances](#)", [Working Paper Series](#) WP13-2, Peterson Institute for International Economics.

current account is mainly attributable to two components: investment income and services. The figure shows just the net amounts for these components.

In Switzerland, there is close co-movement between investment income and current account balances. Historically, surpluses have been the norm for Switzerland. Our current account has recorded almost uninterrupted surpluses since 1960. Although official time series do not extend further back than 1947, unofficial current account estimates show that, even at the beginning of the 20th century, the Swiss were saving more than they invested domestically.⁴ So, already then, a savings surplus was being invested abroad, laying the foundations for today's international investment position, which is large by global standards. This took place against the background of an ever-appreciating Swiss franc during the post-World War II period.⁵ Most of the savings surplus is invested in securities, i.e. portfolio investment, and in production facilities abroad, i.e. direct investment.⁶ In this way, Switzerland has built up a strong net international investment position, most of which is held by multinational companies and pension funds.⁷

Let's now turn to income from services. Here, there are two drivers of the current account surplus: cross-border financial services and merchanting. Again, both activities are primarily driven by international financial markets and global demand for raw materials, and are not sensitive to movements in the Swiss franc.

I don't think I need to say much about receipts from cross-border financial services. The importance of the financial sector for our country is well known. Receipts from Swiss banks' and insurance companies' foreign customer business flow into the current account. In these cross-border transactions, banks' financial services are the largest contributor.

By contrast, merchanting – which is less well known but has a long tradition in Switzerland – has grown significantly over the past ten years.⁸ And since 2010, net income from merchanting has been higher than net income from banks' financial services in the current account. Merchanting refers to trade, denominated primarily in U.S. dollars, that does not cross the domestic border.⁹ The dynamics of Swiss merchanting can be partially explained by the relocation of commodity houses to Switzerland and the commodities boom before the financial crisis. Over the past five years, merchanting has accounted for almost one-third of the current account surplus.

Allow me to recap the main points regarding the Swiss current account. Switzerland's large current account surplus is determined by three structural factors: the strong net international

⁴ Already then, the savings surplus was based on net income from capital investment abroad and net receipts from trade in services with foreigners. See also T. Schlup, "Zahlungsbilanz", in *Historisches Lexikon der Schweiz*, electronic version (e-HLS).

⁵ See Figure 1 in Fratzscher, M., A.J. Mehl, and I. Vansteenkiste (2011): "130 years of fiscal vulnerabilities and currency crashes in advanced economies", *IMF Economic Review*, Vol. 59, Issue 4, 2011, pp. 683–716. It shows real exchange rates from 1890 to 2009 for Switzerland, and the major economies and emerging markets. Switzerland and the Netherlands are the only countries whose exchange rates have appreciated continuously and uninterruptedly since 1950.

⁶ In the case of portfolio investment and direct investment, Switzerland has high net assets abroad which, together, make up 84% of Swiss net wealth. However, in some years, the increase in the net international investment position attributable to current account surpluses has been cancelled out by currency-related losses on asset holdings abroad.

⁷ Since 2011, reserve assets have been a further important component of the net investment position. Switzerland has a net liability position in the "other investment" category, reflecting the strong linkages between the Swiss financial center and the rest of the world.

⁸ See "Merchanting in Switzerland", in *Swiss Balance of Payments 2012*, Swiss National Bank.

⁹ See the discussion in Beusch, E., Döbeli, B., Fischer, A., and Yesin, P. (2013): "Merchanting and Current Account Balances", Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute, WP 140.

investment position, the special role of our country as an international financial center, and merchanting business. Consequently, Switzerland's current account surplus did not arise because the Swiss franc was too weak. The real exchange rate does not play a decisive role in the structural factors responsible for this surplus.

Narrow current account ranges: a bad idea

In the context of resolving global imbalances, some would argue that each country's current account should lie within a narrowly defined range. The Geithner plan, for example, calls for a range of $\pm 4\%$; others say it should be even narrower.¹⁰ While these ranges serve as a reference for locomotive countries that should contribute to global absorption, this argument falls flat when a country of 8 million people is asked to adjust and take on such a role. Furthermore, these ranges are arbitrarily defined and are not considered to be flexible over time.¹¹

On a more technical level, it must be borne in mind that current account balances are not free from accounting biases. This is especially true for countries with large net investment assets and large portfolio investments in equity. For these countries – Switzerland included – the current account is overstated because of accounting procedures for the balance of payments. The time-varying bias, which in some years has been estimated at more than 5% of Swiss GDP, stems from the fact that income from foreign direct investment is fully attributed to domestic residents, rather than its corresponding proportion of domestic and foreign shareholders. In short, this accounting bias overstates our external wealth. A further statistical bias that overstates the Swiss current account surplus is cross-border shopping. It is unclear how current account ranges deal with such measurement issues.¹²

Besides country size and accounting issues, from the investment and savings perspective, too, there are good reasons to run a current account surplus that exceeds some predetermined range. An aging industrialized society, like Switzerland, needs to raise its national savings, perhaps by more than it invests domestically. In so doing, it exports capital abroad and runs a current account surplus, so that it can smooth its consumption in the future when the labor force shrinks. Similarly, a young emerging economy chooses to save less than it invests, attracting foreign investors, and running a current account deficit. It does this to increase its current consumption and its future output. Prescribing maximum levels for current account surpluses and deficits completely ignores the fact that countries operate within different structural environments. If we do not allow countries to smooth their consumption over time, why do we allow individuals to smooth their consumption by letting them take out loans or invest in foreign companies?

Certainly, it is a difficult question. What is considered to be a sustainable current account deficit or surplus? One thing is sure – forcing countries to adhere to an arbitrarily chosen range and ignoring their structural factors, the measurement biases, and their savings characteristics is not an appropriate strategy in an international economic order which is still based on the principle of free markets and free trade.

¹⁰ See www.bloomberg.com/news/2010-10-22/geithner-push-for-g-20-trade-gap-targets-opposed-before-g-20-talks-start.html.

¹¹ Between 1980 and 2012, the current account balances of the G20 countries were outside of the $-4/+4$ range 23.4% of the time, while for OECD countries the range was exceeded 34.9% of the time.

¹² For more information regarding accounting bias in the Swiss current account, see IMF (2011, 2012): Switzerland Article IV report.

Economic environment and the introduction of the minimum exchange rate

Now I'd like to discuss the motivation for introducing the minimum exchange rate. The rate was not implemented to stimulate exports, but rather to ensure that the appropriate monetary conditions prevailed and that the SNB could fulfill its mandate of price stability. The European sovereign debt crisis escalated dramatically in the summer of 2011. It became increasingly evident that, in addition to Italy and Spain being engulfed by the crisis, France also was potentially exposed. At the same time, the debt-ceiling negotiations in the United States and the consequent downgrade of the U.S. by Standard and Poor's added to the tension. During these months, the Swiss franc appreciated rapidly against all major currencies. This development is shown in Figure 5 for the exchange rate of the Swiss franc against the euro and the U.S. dollar. The increase in the value of the franc, which reflected market panic rather than economic fundamentals, drastically tightened domestic monetary conditions. With annual inflation already close to zero, Switzerland risked falling into a deflationary trap. What policy options were available?

The massive Swiss franc appreciation left the SNB with few options to combat the restrictive monetary conditions. As a result of the response to the global financial crisis of 2008/2009, our policy rate was already at the lower bound. In August 2011, in a first step to counter the excessively tight monetary conditions, we announced, almost on a weekly basis, an expansion of the monetary base, initially from CHF 30 billion to CHF 80 billion, then to CHF 120 billion and finally to CHF 200 billion. Even when the monetary base reached close to 40% of GDP, this was ultimately insufficient to halt the appreciation of the franc.

As a consequence of these developments, on September 6, 2011, the SNB announced that it was introducing a minimum exchange rate of 1.20 against the euro. Since the announcement, the franc has never traded below this minimum. At the zero lower bound, the minimum exchange rate has become an important monetary policy tool for us. Yet despite the introduction of the minimum exchange rate, Switzerland has experienced almost two years of negative inflation. I just received the latest inflation data this morning: After having been at zero for two months, inflation turned negative again in September.

In this context, it is also crucial to note that the introduction of the minimum exchange rate is not a beggar-thy-neighbor policy. It must be remembered that Switzerland has always had a negative goods trade balance with the euro area. The trade balance was negative before the implementation of the minimum exchange rate, and continues to be negative today. Swiss exports in goods have not gained market share in the euro area at the expense of others.

Allow me to perform a simple thought experiment with you. Let's take the euro area perspective for a moment: What would have happened to euro area exports to Switzerland if the minimum exchange rate had *not* been introduced? Given that Switzerland is the euro area's fourth largest export destination, this is an important question. Moreover, European intermediate goods serve as an important input for Swiss exports worldwide. In the absence of the minimum exchange rate policy, the Swiss franc would have continued to appreciate strongly in an extremely volatile environment, and the risk of Switzerland entering a deflationary trap would have escalated. This would have depressed Swiss aggregate demand and European exports to Switzerland. In short, a policy of deflation avoidance had benefits for both sides in Swiss-European bilateral trade. In addition, given the broad use of the Swiss franc as a funding and credit currency in Europe, the introduction of the minimum exchange rate had a positive impact on financial stability beyond our country's borders.

Switzerland's economic stability is not just important in the realm of international finance and trade. It should be remembered that Switzerland is the second most important provider of international remittances, directly after the United States. Moreover, in terms of FDI, even the U.S. is a major beneficiary of Swiss investment. Over the past five years, Switzerland has

been the sixth largest FDI investor and eight largest job provider through foreign investment in the U.S.¹³

Conclusion: the current account and SNB monetary policy

Let me return to the question of Swiss monetary policy and the current account posed at the beginning of my speech. I have argued that the key components driving Switzerland's current account surplus – notably financial services, merchanting, and direct investment income – are not closely linked with either the exchange rate or the domestic economic situation. I have also argued that, historically, an appreciation of the Swiss franc has not led to a reduction in Switzerland's current account. Yet this disconnect between the exchange rate and the current account balance does not diminish the exchange rate's importance for the Swiss economy. Given the high degree of openness of our economy, the exchange rate – next to the interest rate – is the key definer of monetary conditions and thus has a strong impact on both prices and production.

The Swiss economy has shown in the past that it can handle volatility and appreciation in the real exchange rate when these are based on fundamentals. However, excessive and abrupt appreciations driven by financial market turmoil have a disruptive impact on prices and production, resulting in deflation and recession.

What, in practical terms, does this mean for the SNB's monetary policy? It means that we do not gear our monetary policy to the current account. The current account is not an indicator of Swiss capacity utilization; in particular, it is not an indicator of price stability. Consequently, the SNB has no target – and indeed should not have a target – for the current account. Rather, we need to take both the inflation outlook and capacity utilization into consideration, and must provide adequate monetary conditions in order to fulfill our mandate.

Despite recent turbulence on foreign exchange markets in emerging economies, the Swiss franc has settled against the euro since September 2012 at slightly above the minimum exchange rate of 1.20. Accordingly, the SNB did not have to enforce the minimum exchange rate for over a year now.

Yet the risks in the world economy are still to the downside and the Swiss franc is still high. Therefore, the SNB is maintaining the minimum exchange rate. It is the right tool for ensuring price stability in Switzerland in the foreseeable future. With short-term interest rates close to zero, the minimum exchange rate can prevent an undesirable tightening of monetary conditions in the event that upward pressure on the Swiss franc should intensify once again. Thus, as reiterated in our September monetary policy assessment, the SNB stands ready to enforce the minimum exchange rate and take further measures as required.

¹³ Source: U.S. Department of the Treasury.

Figure 1

CHF REAL TRADE-WEIGHTED EXCHANGE RATE

Index, January 1999 = 100



Source: BIS

Figure 2

CHF REAL TRADE-WEIGHTED EXCHANGE RATE AND CURRENT ACCOUNT BALANCE

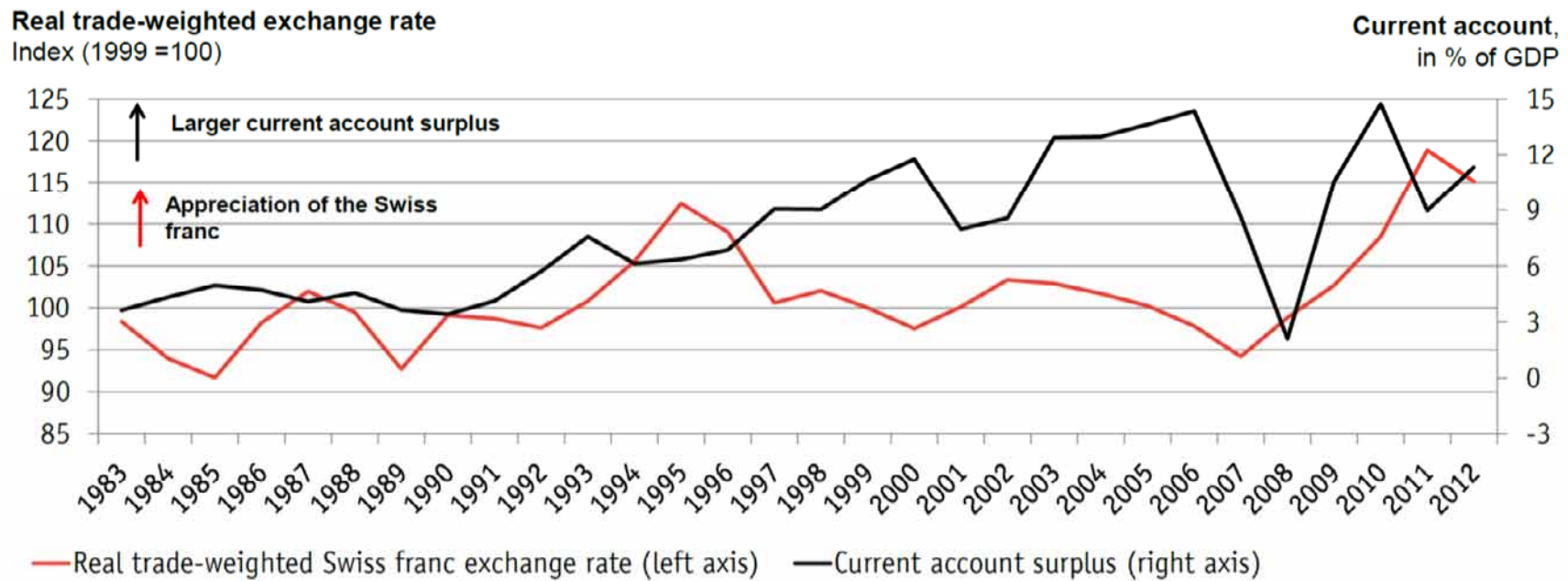
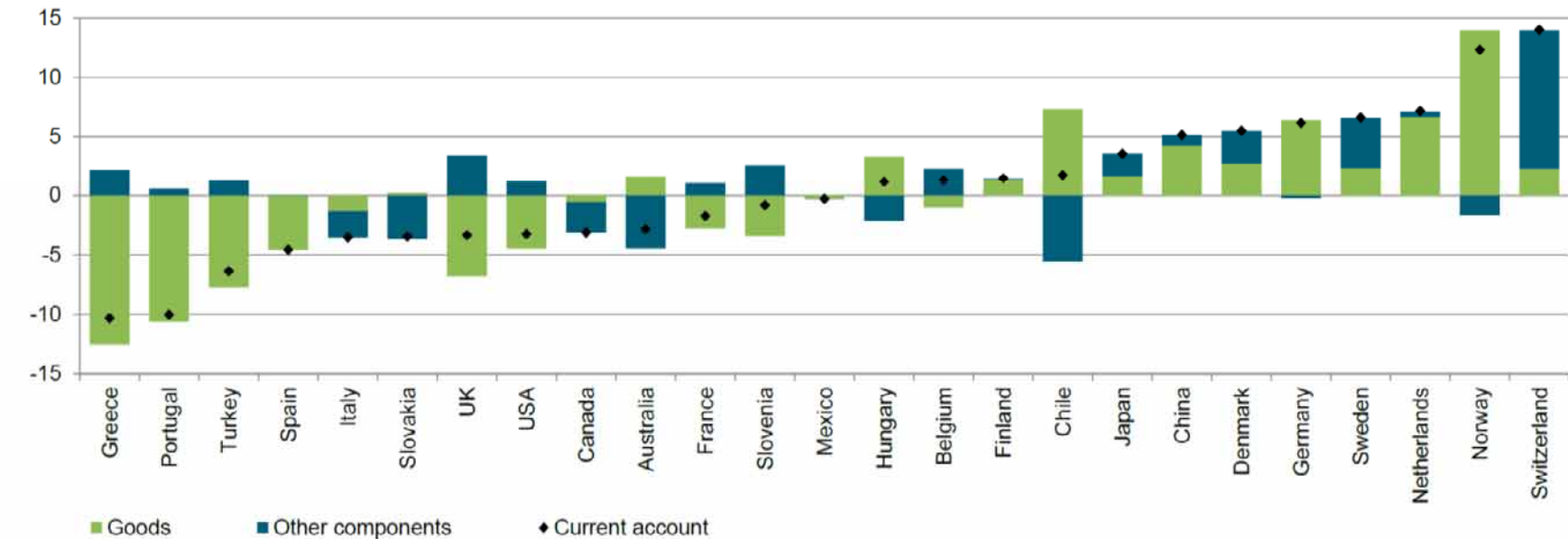


Figure 3

CURRENT ACCOUNT BALANCE OF OECD COUNTRIES AND CHINA IN 2010

In % of GDP

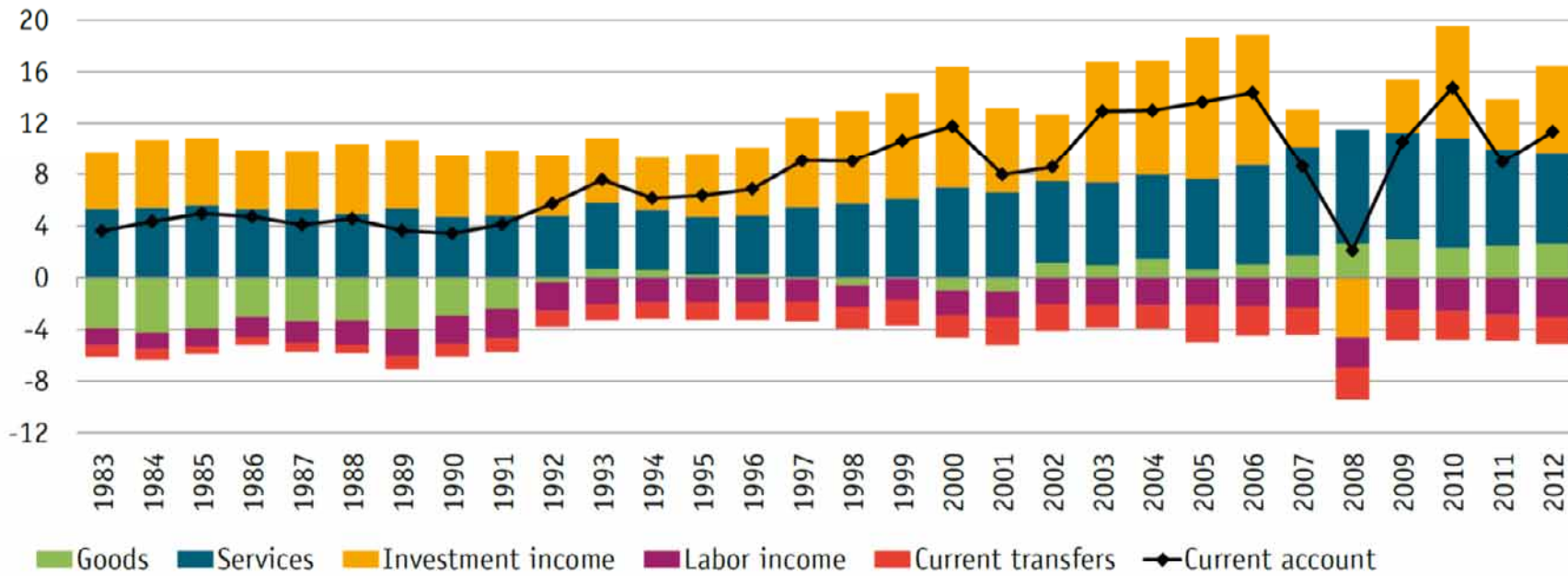


Source: IMF BOPS BPM5 (CA), and WDI (GDP)

Figure 4

COMPONENTS OF THE SWISS CURRENT ACCOUNT

In % of GDP



Source: SNB

Figure 5

DAILY NOMINAL EXCHANGES RATES

Index, 01.01.2010 = 100



Source: BIS