Fritz Zurbrügg: Monetary policy and financial markets – is a return to normal on the horizon?

Speech by Mr Fritz Zurbrügg, Member of the Governing Board of the Swiss National Bank, at the Money Market Event, Geneva, 21 November 2013.

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Ladies and gentlemen

Welcome to the Money Market Event of the Swiss National Bank (SNB) in Geneva. It is a great pleasure for me to be able to address you here today for the second time. I am particularly delighted because I am able to talk to you today with a good deal more confidence than I could a year ago. The situation on the European financial markets has calmed perceptibly, and it is more than a year since the SNB has had to intervene in the foreign exchange market to defend the minimum exchange rate of CHF 1.20 against the euro.

But let us turn the clock back to 2012 for a moment. At that time, a great many market participants feared that the euro area would collapse. The upward pressure on the Swiss franc was immense. As a result, our willingness to defend the minimum exchange rate with all our resources was put to a severe test. In 2012, we purchased foreign currency for a value of almost CHF 190 billion. Consequently, my statements last year were devoted to the growth in foreign currency reserves and the associated challenges.

Today I would like to discuss the question of whether a return to normal is on the horizon either for monetary policy – initially in the US – or for financial markets. Although various signs on the financial markets point in this direction – including the calming of the bond markets in Europe's peripheral economies, record highs on stock markets and the rise in long-term interest rates since mid-year – other observations are less encouraging. Global economic recovery is merely sluggish and the risks for growth are still to the downside. Unemployment, particularly in the euro area, is very high and many structural reforms have been postponed. Against this background, financial markets are not expecting any of the major central banks to raise their reference rates before 2015.

In answering the question above, I will begin by talking about developments in financial markets, with a special focus on the Swiss franc. Then I will discuss monetary policy at the US Federal Reserve and its first attempt to bring about a restoration of normal conditions. Afterwards, I will give a brief presentation of the economic situation with a focus on Europe. In conclusion, I would like to draw your attention to the dangers associated with a prolonged period of low interest rates.

European financial markets calmer thanks to monetary policy

If you take a look at chart 1, you can follow the movements in both the euro/Swiss franc exchange rate and the average risk premium for the government bonds of five peripheral euro area countries (Italy, Spain, Greece, Portugal and Ireland). The risk premium is drawn on an inverted scale, in other words, a movement downwards signifies a higher risk. This chart serves as an illustrative example for two developments. On the one hand, it shows that uncertainty in the euro area has decreased greatly over the past twelve months. At the time of the last Money Market Event in Geneva, the risk premium was almost 1,200 basis points; it is now below 400. On the other hand, the chart illustrates the fact that the upward pressure on the Swiss franc has abated. Following a long period last year when the exchange rate stuck closely to the minimum exchange rate of CHF 1.20, it moved away in January and, since May, has fluctuated within a relatively narrow range of CHF 1.22–1.26 per euro.

Here, the situation has calmed in two respects. In order to reduce the risk of the euro area collapsing, the European Central Bank (ECB) resorted to an unconventional measure in late summer 2012, the outright monetary transactions programme. Market participants were persuaded, and since then the risk premium for peripheral economies in Europe has declined steadily. What is remarkable is how persistent this trend has been. The positive market sentiment on the European markets has defied both negative reports from the real economy and various political crises, even those in major member states such as Italy. The lower interest rates have improved the growth outlook in the euro area and opened up a time window for structural reform.

A certain degree of calming also occurred for the Swiss franc exchange rate. Demand declined for investments which were seen as safe havens, such as the Swiss franc, with the result that foreign currency purchases to defend the minimum exchange rate have not been necessary for over a year. However, investors remain cautious, as can be seen in chart 1. First, the exchange rate did not perceptibly move away from the CHF 1.20 level until January 2013, in other words, after many months of declining risk premia. Second, the Swiss franc has not weakened fundamentally against the euro during the course of this year, although risk premia have declined further. Nevertheless, many market participants expect a renewed depreciation in the Swiss franc in view of the progress in the euro area. The value of the Swiss franc is still high at present. As can be seen in chart 2, the trade-weighted, inflation-adjusted exchange rate for the Swiss franc, for instance, is currently about 10% above its long-term average. The minimum exchange rate continues to prevent an undesired tightening of monetary conditions should the upward pressure on the Swiss franc intensify once again in view of the current uncertainty.

Exceptional circumstances still apply for monetary policy

Clearly, exceptional circumstances still apply for monetary policy. This is the case not only for Switzerland and the euro area, but also for the US, Japan and the UK. As you know, the ECB reduced its refinancing rate by a further 25 basis points two weeks ago. In the US and Japan, current quantitative easing measures are giving rise to a further expansion in central bank balance sheets. The fact that monetary policy in the advanced economies is likely to remain exceptionally expansionary for some time to come can be seen in market expectations for reference rates (cf. chart 3). At the moment, the markets are assuming that the Federal Reserve will increase its key interest rate in the second quarter of 2015, the ECB in the fourth quarter of 2015 and the SNB in the first quarter of 2016.

Last year, a number of central banks introduced the principle of forward guidance, in order to further increase the effectiveness of their expansionary monetary policy. Forward guidance involves the provision of information on the expected movement of short-term interest rates. To some extent, information of this kind has already been provided by central banks in the past. What is new with forward guidance is that some central banks give an explicit indication of how long they expect low interest rates to continue. For instance, the Federal Reserve and the Bank of England have tied the assessment of their respective reference rates to a threshold for the unemployment rate. At the moment, an intense debate is raging as to whether forward guidance can actually increase the effectiveness of monetary policy in a zero interest rate environment. What is crucial for the effectiveness of forward guidance is that it is transparent and credible.

In the case of the SNB, the inflation forecast provides implicit information about the expected interest rate path. At present, however, the minimum exchange rate against the euro is also in place. With short-term interest rates close to zero, the minimum exchange rate makes it possible, for the foreseeable future, to ensure monetary conditions that are appropriate for the Swiss economy.

Irrespective of any kind of forward guidance, international monetary policy is extremely expansionary. This has had a stabilising effect on international financial markets, as reflected by the situation in spring, when long-term interest rates sank to a historically low level and risk markets benefited from strong capital inflows. Various stock indices recorded new historical highs and risk premia for corporate bonds have steadily narrowed. This positive sentiment was also reflected in volatility measures which had returned to the levels prevailing before the financial crisis.

First attempt to normalise monetary policy in the US

Together with a revival of the economy in the US, this favourable environment resulted in the Federal Reserve making a first attempt to initiate the process of normalising monetary policy. On 22 May 2013, the Chairman of the Federal Reserve, Ben Bernanke, first mentioned the possibility that the ongoing third quantitative easing programme might be tapered off.

The possibility that the Federal Reserve might announce a reduction in the monthly bond purchase programme sparked an increase in long-term US interest rates, which had risen by over 100 basis points by the beginning of September (cf. chart 4). All other major markets reacted in the same way – this included interest rates in Germany – despite the fact that the course of monetary policy in the euro area actually pointed to sustained expansion. The tapering debate coincided with a more favourable economic outlook in the advanced economies. This, in turn, increased uncertainty with regard to the future monetary policy path of the major central banks, and term premia – which form part of bond yields – rose. However, at the same time, short-term interest rates stayed firmly in place. Despite the recent increase, bond yields in advanced economies are at a very low level in historical terms.

The impact on foreign exchange markets varied. The currencies of the emerging economies reacted particularly strongly, with capital outflows exerting very substantial downward pressure, as can be seen in chart 4. This shows that a number of emerging economies are still vulnerable to foreign portfolio investments, or hot money flows. The G4 currencies, by contrast, have been largely unaffected by the tapering debate (cf. chart 5). In trade-weighted terms, the US dollar has gained very slightly. The euro and the pound sterling also strengthened somewhat in the light of surprisingly favourable economic data. The Swiss franc is almost unchanged, with neither the tapering debate nor the ECB interest rate reduction two weeks ago triggering significant movements.

This first attempt by the Federal Reserve to normalise monetary policy has made a number of things clear. First, the very expansionary monetary policy has made a major contribution to the positive sentiment on financial markets. Paradoxically, stock markets are reacting to negative macroeconomic data with gains, since markets expect that expansionary monetary policies will be maintained as long as economic growth remains weak. If the data are good, the opposite will occur. Second, the hefty reactions of some markets point to the danger that an exit from the exceptionally expansionary monetary policy could prove to be bumpy. Uncertainty about future monetary policy direction is predominant in the current market environment, and it is therefore vulnerable to abrupt changes in expectations on the part of investors. Tapering represents a challenge for the Federal Reserve. However, we are working on the basis that this process can be conducted step by step, without major disruptions.

Growth momentum in the global economy remains moderate

Looking at the global economic outlook, there is little to substantiate the possibility that a return to normal for monetary policy has moved closer. The recovery in the economy is delayed and the International Monetary Fund (IMF) has repeatedly reduced the 2013 growth forecast for the global economy during the course of the year (cf. chart 6). The latest *World Economic Outlook* by the IMF reports that “Global growth is in low gear (…) and downside risks persist.” The IMF now anticipates global growth of 2.9% for 2013 and 3.6% for 2014.

A change in growth momentum is becoming evident at a global level. Chart 7 shows the purchasing managers indices (PMIs) for various countries. On the vertical axis we see the current level of PMIs and on the horizontal axis, movements over the past six months. Momentum in the emerging economies has declined recently (red ring). By contrast, the advanced economies are picking up, in particular in the euro area (green ring). Moreover, PMIs for most of these economies are above the growth threshold of 50 points. Growth in the US, especially, is very robust and, on this side of the Atlantic, the UK has exceeded expectations (blue ring).

Particularly important for Switzerland were the surprisingly favourable economic indicators in Europe this summer. In the second quarter of 2013, the euro area reported positive growth for the first time in six quarters. There are encouraging signs from the peripheral economies, especially. Since mid-year, for instance, these countries have again been recording surpluses on their current accounts. Nevertheless, these signs must be put into perspective. The improvement in the peripheral economies is beginning from a very low base level and the unemployment figures are oppressive. The banking system is very fragmented and unhealthy bank balance sheets give rise to declining levels of lending. This hampers the monetary policy transmission mechanism. In addition, there are sustained high levels of public and private debt. All of these factors are likely to hold back economic developments in the peripheral economies for some time yet. Moreover, the euro area remains extremely heterogeneous. Chart 8 shows the level of real gross domestic product (GDP) in the euro area and its largest members, as well as for Switzerland. In Italy and Spain, GDP is just under 10% below the maximum pre-crisis level, while in Germany it has been above the pre-crisis figure since 2011.

Given the subdued developments in the euro area, it is surprising how well the Swiss economy has performed. In Switzerland, GDP is already almost 5% above the pre-crisis level. However, it should be borne in mind that, over the past few years, economic growth has been extensively supported by the increase in the population. In terms of GDP per capita, Switzerland has not yet quite returned to the pre-crisis figure, unlike Germany, for instance, where per-capita GDP is now almost 3% above the pre-crisis level. The growth driver in Switzerland has thus been the domestic economy, while the contribution provided by foreign trade has been relatively modest. There are substantial differences from one industry to another. In general, the services industries are growing and business remains very lively in construction. In manufacturing, by contrast, which is traditionally cyclical and export-oriented, developments have been less advantageous, and equipment investment has also suffered in Switzerland. The output gap remains negative, so that there is no pressure on wages and prices in the foreseeable future. The outlook is favourable, since we expect that the gradual recovery of the economy in Europe will stimulate demand for Swiss exports. We anticipate growth of 1.5–2.0% for the current year.

Dangers of a prolonged low-interest period

What do these tentative global economic developments mean for monetary policy? Most central banks maintained their very expansionary course and the various unconventional measures. These measures were largely uncontested as long as they served to stabilise financial markets and the banks and subsequently to stimulate the economy. However, the longer the current low interest rate period continues, the greater the associated risks can be. I would now like to talk about two of these risks – the increasing price distortions in various investment categories and the decreasing motivation to undertake structural reform measures.

Increasing price distortions: The very low interest rates affect aggregate demand in the economy both directly and also via the wealth effect. One of the effects which expansionary monetary policy abroad encourages is the quest for yield and, with it, the transfer of assets into more risky investments. However, low interest rates can result in misallocation on financial markets, particularly when they persist for a long period of time. It is possible that risks may be misjudged and, as a result, relative prices distorted. It is naturally difficult to establish the point at which price movements of this kind need to be considered as excesses. In the past, long periods of rising prices were always followed by corrections. The hefty reaction of risk markets to the tapering debate can be read as a sign of the instability of certain asset prices.

In Switzerland, for instance, the low interest rates have stimulated activity in the mortgage and real estate markets, where, for a number of years now, we have seen considerable momentum which can only be partially explained by movements in fundamental factors. As a result, imbalances have built up. For example, mortgage volumes have grown significantly faster than GDP for many years, as can be seen in chart 9. The SNB has issued repeated warnings about the risks for financial stability associated with these developments. This is the background to the Federal Council's activation of the countercyclical capital buffer (CCB) at the beginning of this year, upon the proposal of the SNB. The CCB has been in force since the end of September and its primary aim is to increase the resilience of the banking system against these risks and to combat excessive credit growth. Since low interest rates can be expected to persist in Switzerland for some time yet, we are keeping a very close watch on developments in the mortgage and real estate markets.

Waning motivation for reform measures: Lower interest rates mean more favourable refinancing costs for banks, companies and governments. Expansionary monetary policy following a financial crisis and recession can therefore open up a welcome time window for carrying out consolidation measures, cleaning up bank balance sheets and implementing structural reform measures. However, if decision-makers have reason to believe that low interest rates will probably remain in place for a long time yet, their motivation to undertake reform measures is likely to flag. This is particularly the case in countries where reforms have been under way for many years now, but are still insufficient, and where resistance at the political level is now on the increase. Here the temptation to depend on low interest rates – or even to increase political pressure on the central bank to keep interest rates low for longer than necessary – is especially pronounced.

In this context, it is important not to forget that central banks cannot do everything. They cannot restructure public sector budgets and they cannot carry out structural reforms. Nor can they provide substitutes for sensible fiscal policies. This area is the responsibility of other economic agents. A prosperous economy requires favourable conditions. In this respect, the contribution of central banks is to secure one of the major conditions – price stability.

And inflation?

This raises the question of whether the exceptionally expansionary monetary policy will lead to inflation in the long term. In most financial systems, surplus liquidity has reached historical dimensions. Under normal circumstances, monetary developments of this kind would point to a rise in inflation. Yet at the moment, rates of inflation in advanced economies are trending downwards. As the recent reduction in the ECB reference rate shows, concerns about deflationary trends are more predominant in the euro area at present.

Neither can any inflationary threats be identified for Switzerland. The SNB's conditional inflation forecast from September (cf. chart 10) shows a very small increase in inflation to 2015, despite the assumption that the three-month Libor remains at zero over the entire period. Explanations for this low level of inflation include the fact that the output gap is still negative in Switzerland, the Swiss franc is strong, and commodity prices are stable or even declining. We are keeping a very close watch on price developments, and we have the necessary instruments to correctly assess any inflation or deflation risks and counter them with appropriate measures.

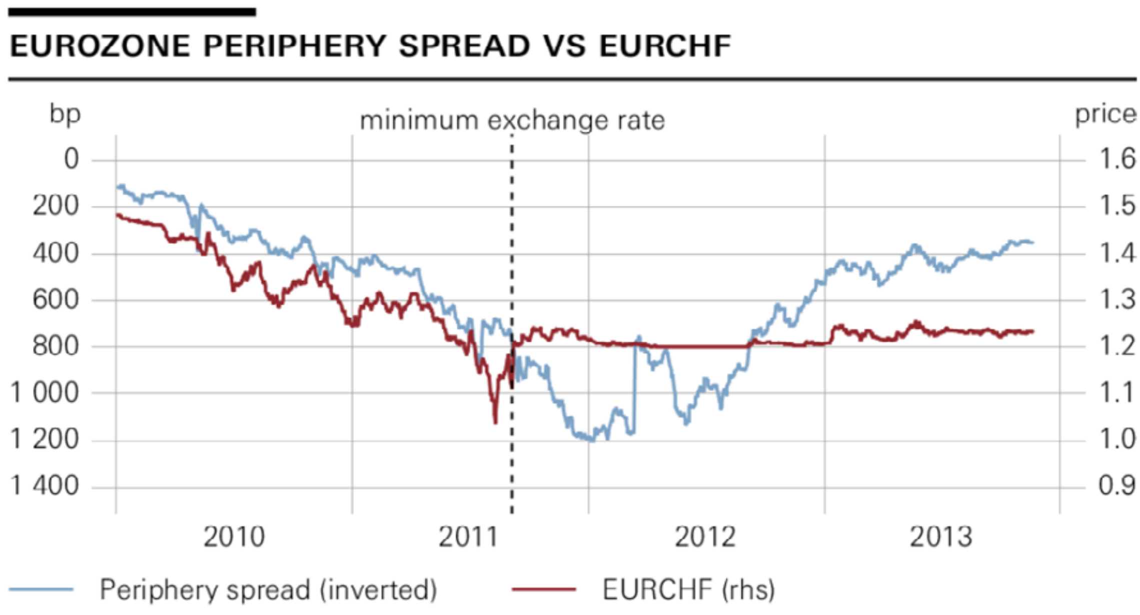
Concluding remarks

Is a return to normal on the horizon? Yes, but much more slowly than expected. Overall, financial markets have calmed and risk markets have strengthened considerably. The exceptional measures taken by the central banks made a major contribution to these developments, and in most cases, these measures are still in place. Thus it is clear that monetary policy is still far from returning to normal. The fact that international monetary policy is still very expansionary is not surprising, in view of the slow recovery of the global economy.

As far as Switzerland is concerned, the minimum exchange rate will remain a necessary instrument for the foreseeable future. Even today, the value of the Swiss franc remains high, and there are no inflation risks. With interest rates at zero, the minimum exchange rate prevents an undesired tightening of monetary conditions in the event that the upward pressure on the Swiss franc should intensify once again.

Thus we remain prepared to enforce the minimum exchange rate by buying foreign currency in unlimited quantities if necessary, and to take further measures as required. Consequently the monetary policy we have conducted to date will continue to apply without any restrictions.

Chart 1. Calming on European financial markets takes pressure off Swiss franc



Sources: SNB, Bloomberg

Chart 2. Swiss franc still high – minimum exchange rate remains necessary

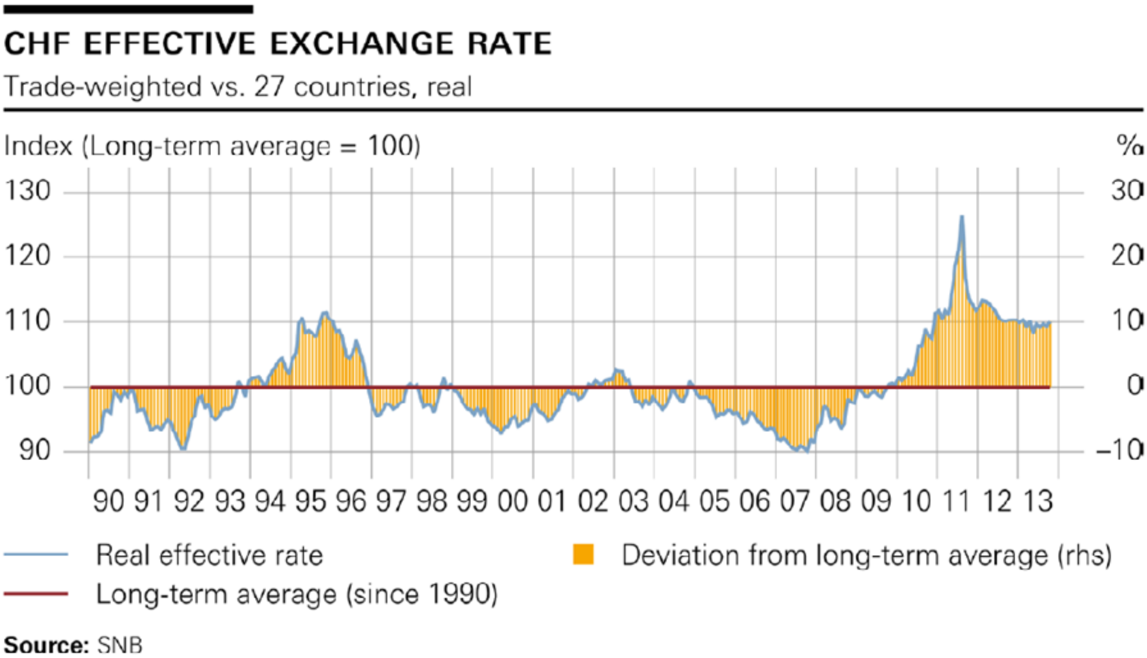


Chart 3. No interest rate increase for 2014 expected by market

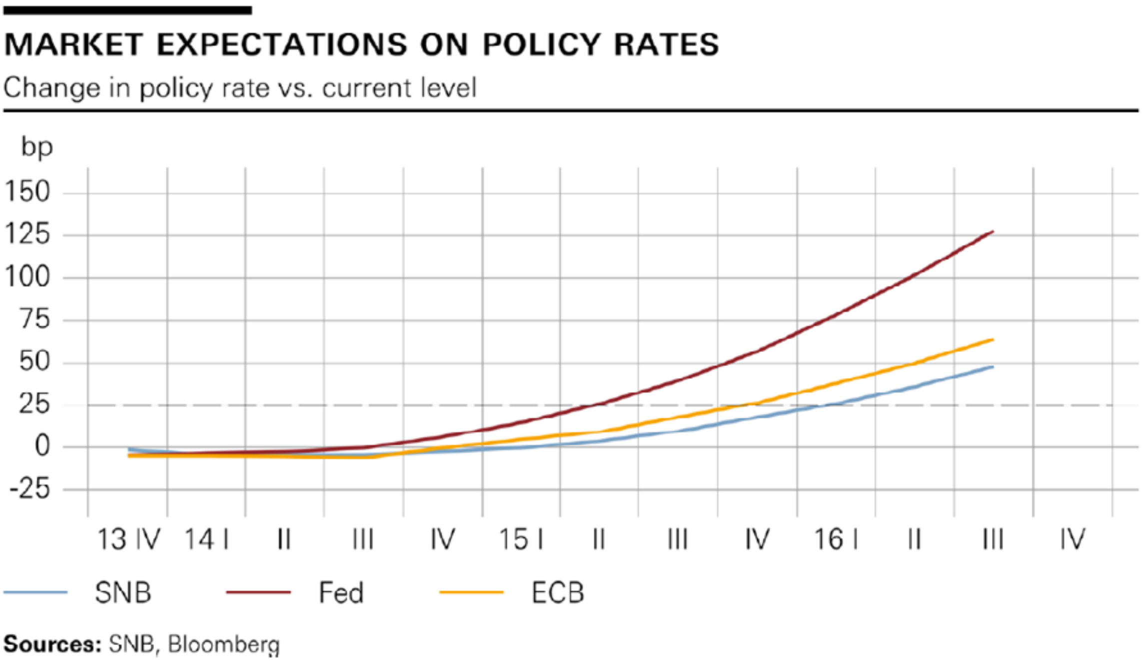
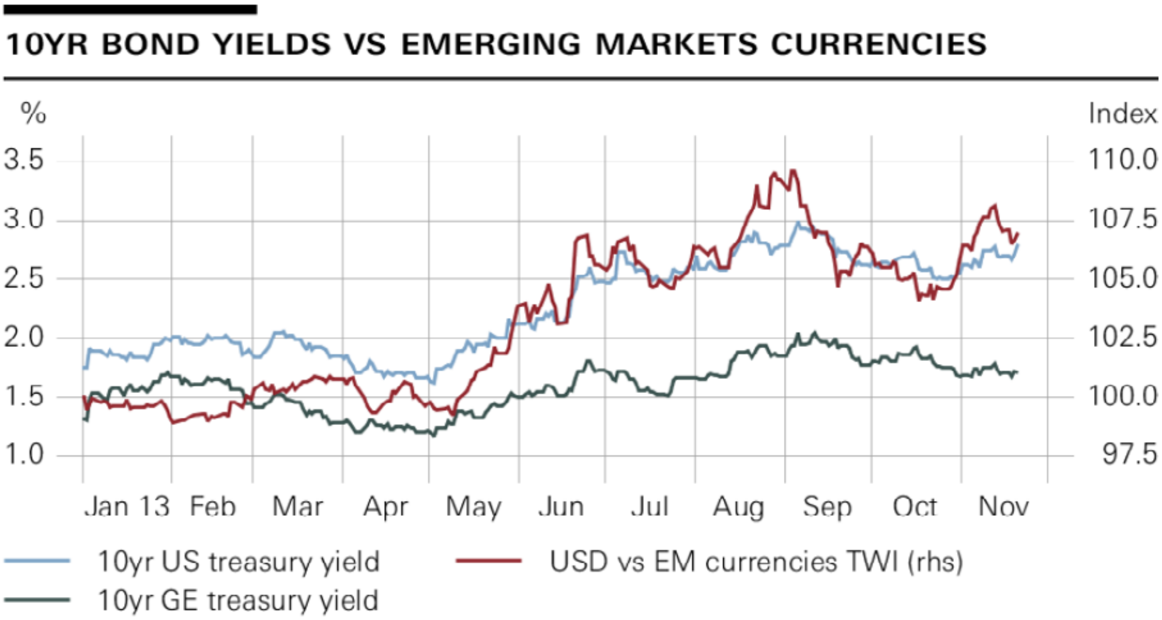
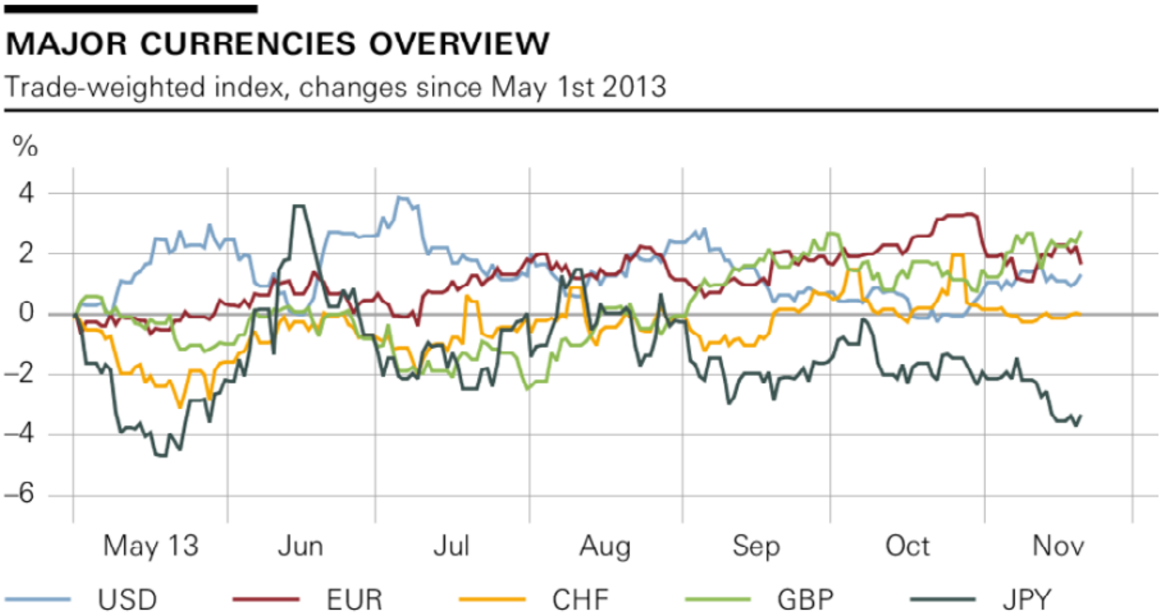


Chart 4. Tapering debate – emerging market currencies under pressure



Sources: SNB, Bloomberg, JP Morgan

Chart 5. Tapering debate – Swiss franc and G4 currencies largely unaffected



Sources: SNB, Bloomberg, JP Morgan

Chart 6. Economic recovery delayed – forecasts reduced

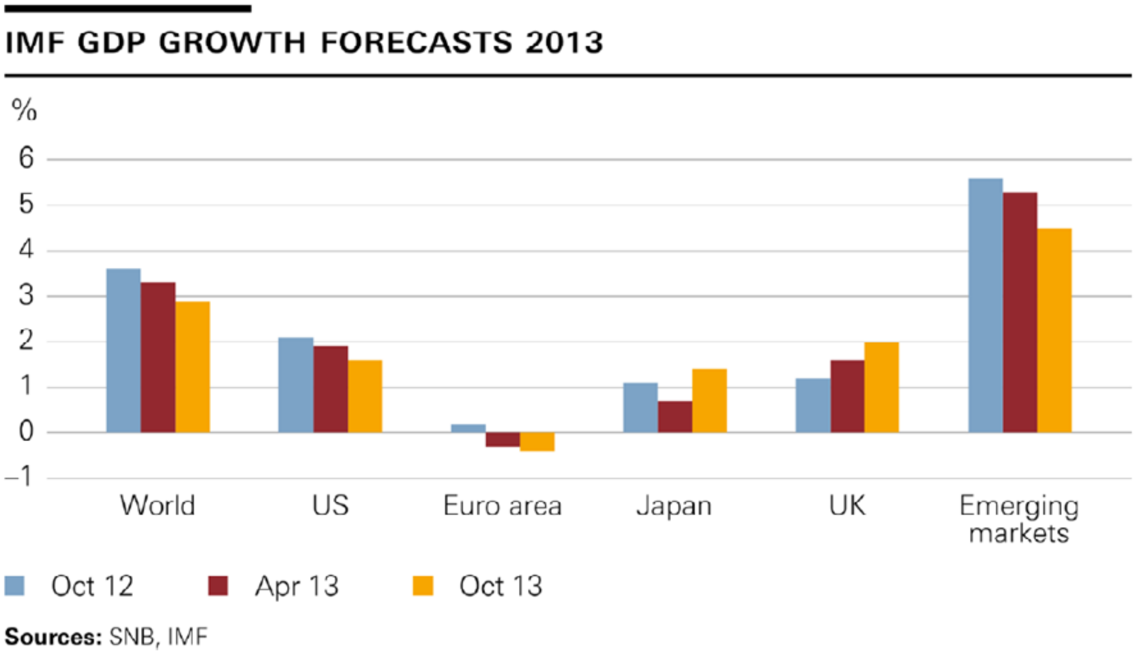


Chart 7. Change in growth momentum of global economy

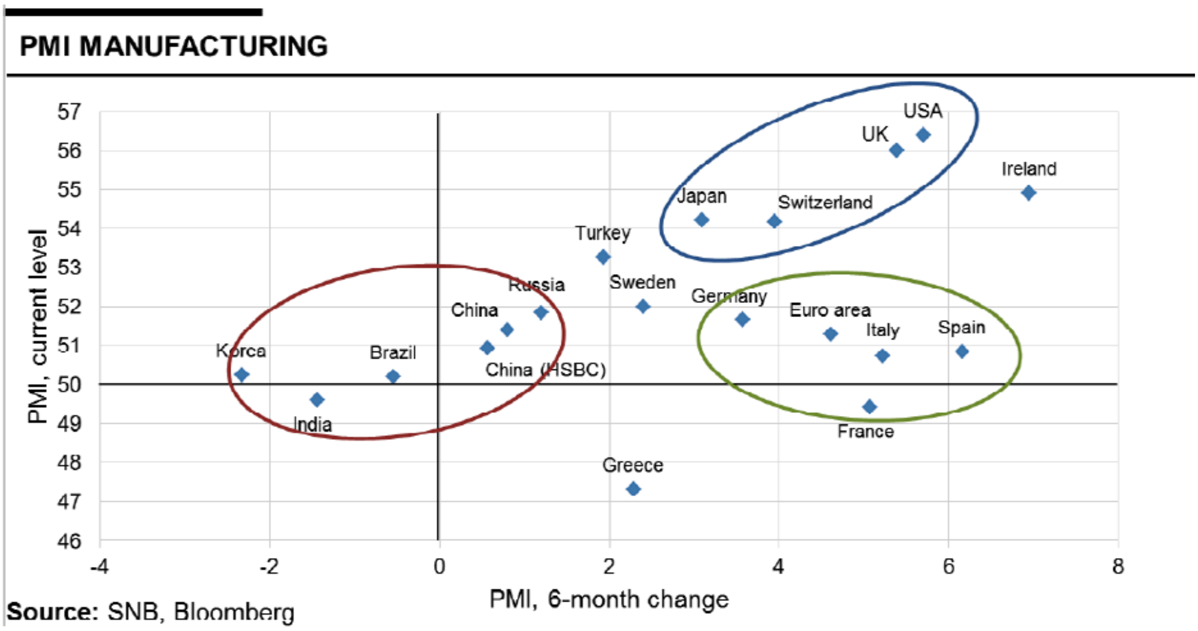


Chart 8. Heterogeneity in euro area persists

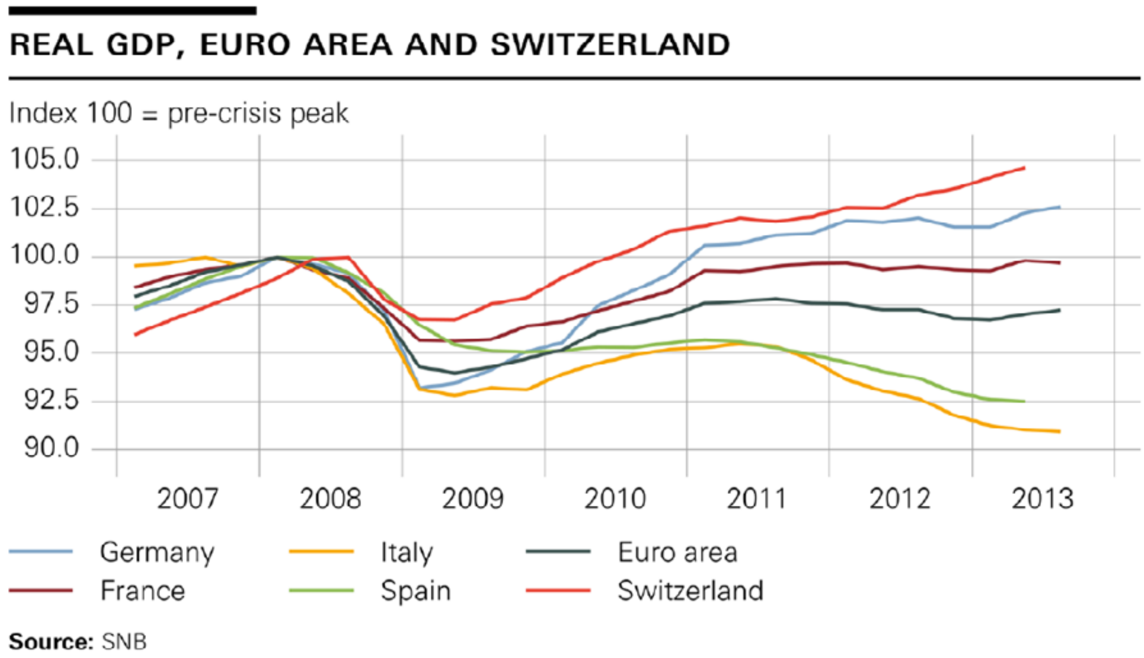


Chart 9. Imbalances in Swiss mortgage and real estate markets further increased

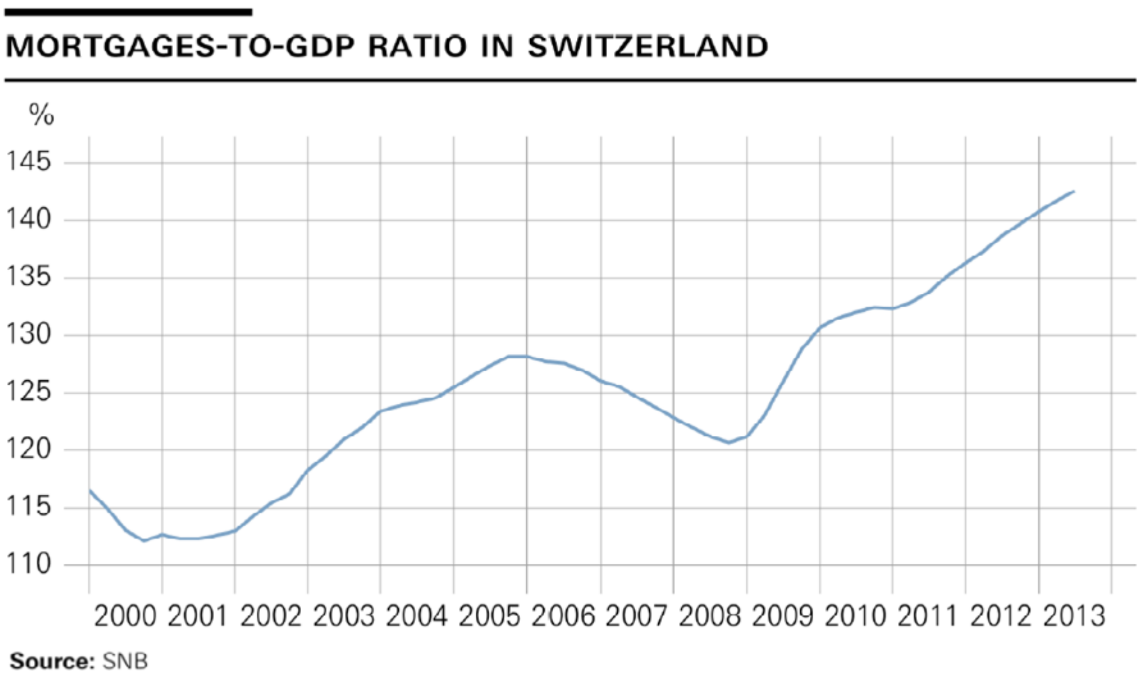


Chart 10. No signs of inflation risks in Switzerland