

Thomas Jordan: Comments on Swiss monetary policy

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the 106th Ordinary General Meeting of Shareholders of the Swiss National Bank, Berne, 25 April 2014.

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Mr President of the Bank Council

Dear Shareholders

Dear Guests

The Swiss National Bank (SNB) has a mandate to ensure price stability, while taking due account of the development of the economy. The monetary policy decisions needed to fulfil this mandate have a direct impact on the size and composition of our balance sheet. As a result of the current size of our balance sheet and the nature of our investments, it can be assumed that the annual results will continue to fluctuate significantly in the foreseeable future.

Since summer 2007, the global economy has experienced a series of crises. At times, it was on the brink of the abyss, and the threat to the Swiss economy was correspondingly great. In order to fulfil our statutory mandate, we have been obliged to resort to unconventional measures, rather than operating solely with the familiar monetary instruments. The most exceptional measure was certainly the introduction and enforcement of the minimum exchange rate against the euro. However, the creation of the stabilisation fund to take over illiquid assets from UBS was also a special measure. In 2013, this episode was successfully concluded. By contrast, the minimum exchange rate remains the SNB's key monetary policy instrument. This remains true even though we have not had to enforce the minimum exchange rate with foreign currency purchases since autumn 2012.

In my comments today I will explain the reasons why we are maintaining the minimum exchange rate. I will begin with a brief look at global economic developments. Then I will present our forecast for the global economy and the Swiss economy. Based on this, I will follow with an examination of the outlook for price stability. As you know, in our view, developments on the Swiss mortgage and real estate markets represent a risk for financial stability. I will therefore use this opportunity to follow up with a brief presentation of our considerations on this topic. I will round up my remarks with two examples which illustrate the link between monetary policy decisions and our balance sheet.

Global economic developments in 2013

First, let me begin by reviewing the events of 2013. On the one hand, there was a certain feeling of renewed confidence last year. This can be mainly attributed to the ebbing of the European financial and debt crisis. The alleviation of the crisis is likely to have made a significant contribution to Europe's emergence from recession. Meanwhile, economic growth in the US firmed and the economy in Japan picked up perceptibly. On the other hand, concerns about a number of emerging economies increased. One of the factors resulting in more difficult financing conditions for emerging economies with structural problems was the announcement by the US Federal Reserve that it intended to reduce its securities purchases.

Overall, growth in the global economy in 2013 was weak and uneven, and remained marked by uncertainty. Will this situation change in the current year? Probably only to a limited extent. According to our assessment, although the cycle has probably bottomed out, the challenges remain formidable. I will now outline the international economic position in more detail.

Global economic outlook for 2014

In 2014, growth in the global economy is likely to be stronger than in 2013. Nevertheless, regional differences will remain substantial. While relatively robust growth can be expected in the US, the signs are pointing to a modest and uneven recovery in the euro area. A slightly stronger economic momentum than in 2013 can be expected in the major emerging economies, but they will not attain former growth rates. We therefore anticipate that expansion in the global economy will be no more than moderate. However, the recovery remains subject to significant downside risks. This is still largely due to the European debt crisis.

You may be wondering whether the debt crisis is not already over. The extreme risks have indeed been eliminated. Reform programmes introduced in some euro area countries, progress achieved in creating a banking union and measures taken by the European Central Bank (ECB) have clearly brought about an alleviation of the crisis. But the crisis has not yet been overcome – which is hardly surprising, since structural reforms are also required if this is to be achieved.

It is important to acknowledge the efforts that have already been made in this respect in the affected countries, and as an onlooker one should be cautious when making recommendations. Yet there is broad consensus that additional structural reforms are needed and should be implemented consistently. Such reforms should increase the growth potential of the countries affected and allow them to significantly and sustainably reduce their high level of unemployment and debt. Additional efforts are also required in the banking sector. Consequently, the bank review to be carried out by the ECB is extremely important. Only a healthy banking sector is capable of supplying the economy with sufficient credit.

However, risks also exist outside the euro area. The global recovery could be held back by political tension in several regions as well as structural weakness in major emerging economies.

A further source of potential turmoil is uncertainty about the future path of monetary policy in the major currency areas. In particular, the divergence in the monetary policy direction could increase. Overall, monetary policy in the advanced economies is likely to remain very expansionary since production capacity is underutilised and inflation is low. But while in the US the Federal Reserve is preparing the ground for a gradual normalisation of monetary policy, the ECB is considering whether it should undertake further monetary policy easing. By contrast, interest rate increases could become necessary again in a number of emerging economies, to prevent further depreciation of their currencies and counter high inflation.

As you can see from this list of items, unfortunately the risks for economic growth have not diminished. The European crisis may have become somewhat less virulent, but it has not been overcome. Moreover, additional uncertainties have emerged and the Swiss franc is still high. Overall, the environment remains extremely challenging for both the Swiss economy and our monetary policy.

Outlook for Switzerland in 2014

I will now look at developments in Switzerland. In 2013, our economy did quite well, primarily as a result of stable domestic demand. This year we are expecting the economy to maintain a similar momentum, driven by domestic demand as well as, increasingly, by foreign demand. Thus the global economy will supply positive growth impetus, which will assist export industries, in particular. Accordingly, production capacity utilisation is expected to be higher and companies should see further improvement in their financial situation. Given this situation, investment looks set to regain momentum. During the months ahead, unemployment is likely to decline slightly.

However, this essentially positive scenario is associated with external risks which I have already outlined. Furthermore, the popular federal initiative approved in February to curb

immigration represents an additional element of uncertainty as far as the economy is concerned. We do not know yet how the initiative will be implemented and what effect it will have on our relationship to the EU. Consequently, the economic impact of the popular decision cannot really be properly quantified at the moment, and this is why it has not been included in our forecast. For 2014, we continue to expect economic growth of around 2%.

Inflation in Switzerland and the SNB's monetary policy

The greater economic momentum which we are forecasting will gradually lead to a better utilisation of production capacity. The underutilisation which still prevails continues to restrain consumer prices in Switzerland. Declining inflation abroad and the slightly stronger Swiss franc are having a similar impact by dampening imported inflation. Thus the SNB's inflation forecast shows that there is no risk of inflation in the foreseeable future. In 2014, inflation in Switzerland is likely to amount to only 0%.

In addition, the international environment is still giving rise to high levels of uncertainty. Consequently, the danger that the Swiss franc, as a safe haven, might suddenly be subject to further upward pressure has not been averted. Short-term interest rates are practically zero. For this reason, the minimum exchange rate is the right tool to avoid an undesirable tightening of monetary conditions, since an appreciation of the Swiss franc would lead to a further decline in import prices and a renewed threat of deflation. Given this situation, the SNB is maintaining the minimum exchange rate of CHF 1.20 per euro. We remain ready to enforce the minimum exchange rate, if necessary, by purchasing foreign currency in unlimited quantities, and to take further measures as required. I would like to take this opportunity of stressing, once again, that the minimum exchange rate does not represent a peg to the euro. The Swiss franc is able to move freely above CHF 1.20 per euro. As I said, it is high, and should weaken with time.

For many years, interest rates have been at a low level due to the overall economic situation. However, the danger of a longer period of low interest rates is that imbalances can build up, and we can indeed observe such a development in the Swiss mortgage and real estate markets. Allow me therefore to give you our assessment of this situation.

Mortgage and real estate markets and countercyclical capital buffer

The Swiss residential mortgage and real estate markets have been growing strongly for some time, giving rise to imbalances. Some time ago, these reached a level, in the view of the SNB, that poses a risk to the stability of the banking system and hence the Swiss economy.

Why does the SNB not simply increase interest rates in order to slow down the mortgage and real estate markets? Although an increase in the interest rate would have a dampening effect, it would, at the same time, intensify upward pressure on the Swiss franc and, given the current situation, threaten price stability. Consequently, an interest rate increase is not an option. Given this situation, in 2013, the SNB made a proposal to the Federal Council, after consultation with the Swiss Financial Market Supervisory Authority (FINMA), that the sectorial countercyclical capital buffer (CCB) be activated for the first time, at 1% of risk-weighted mortgage loans financing residential property located in Switzerland. The Federal Council acted on the proposal. Since last September, banks have therefore been required to provide more capital backing for residential mortgage loans in Switzerland.

Certainly, momentum on the mortgage and real estate markets was dampened somewhat in 2013. However, the measures introduced by the beginning of 2013, such as the activation of the CCB as well as those taken by the industry itself, were insufficient to prevent a further build-up of imbalances. Therefore, the volume of mortgage lending was still rising at a substantially stronger pace than national income. As a result, in Switzerland as a whole, debt was increasing significantly faster than people's capacity to offset this debt with income. This

development is particularly critical because the correlation between mortgages and national income is very high, both in historical terms and compared with other countries. In addition, in an environment of persistently low interest rates, coupled with banks' undiminished appetite for risk, the danger remained considerable that imbalances would build up further unless additional countermeasures were taken.

In January 2014, therefore, acting on a proposal by the SNB, the Federal Council increased the CCB from 1% to 2% of risk-weighted positions financing residential property in Switzerland. The deadline for compliance is 30 June 2014. As part of its proposal, the SNB drew attention not only to the cyclical risks but also, once again, to the high risks in mortgage lending, especially in the area of affordability.

Some three months have passed since the CCB was increased. Based on the data currently available for the first quarter of 2014, the all-clear still cannot be given, in our view. In the first quarter of 2014, momentum in real estate prices was similar to that in the previous year and therefore has not further diminished. However, for an idea of the overall picture we are still lacking important data. A definitive assessment of the latest developments would therefore be premature.

So we will continue to monitor developments on the mortgage and real estate markets closely. Any decisions on further measures must be made in the light of these observations. The SNB therefore regularly examines, first, whether the CCB needs to be adjusted. Depending on how the situation develops, this might need to be an upward or a downward adjustment. Second, the authorities are working on the specification of measures that would target risks in the area of affordability.

Monetary policy and the SNB balance sheet: Flexibility as the key factor

In the case of the CCB, the SNB plays an important role because it can make proposals for its activation, alteration or deactivation. However, this instrument does not have any impact on our balance sheet. By contrast, our monetary policy decisions as well as other measures aimed at stabilising the financial system are reflected in the composition and size of the balance sheet. Accordingly, it is of key importance for the effectiveness of our measures in the fields of monetary policy and financial stability that we have the option of making flexible use of our balance sheet. There are therefore no statutory limitations with respect to the size or composition of our balance sheet.

This flexibility played a major role in ensuring that we remained capable of acting during the crisis, even in very difficult conditions. It enabled us to fulfil our mandate of ensuring price stability and also of making a contribution to financial stability as part of this mandate.

Let me give you two examples of the way in which we make flexible use of our balance sheet. For topical reasons, I would like to start by talking about the creation of the stabilisation fund. The stabilisation fund, as we called it, was an undertaking which commenced in 2008 and was successfully concluded last year.

What was involved? You will recall that in October 2008 a Swiss big bank, UBS, was in substantial difficulties. Financial stability was threatened and intervention by the authorities was absolutely necessary. Consequently, the Federal Council, the Swiss Federal Banking Commission (predecessor of FINMA) and the SNB decided on measures to stabilise UBS and thereby strengthen the Swiss financial system. The core element in the package of measures was the stabilisation fund, which took over illiquid assets from UBS totalling almost USD 40 billion. The SNB funded 90% by granting the stabilisation fund an interest-bearing loan. For its part, UBS provided the stabilisation fund with equity corresponding to 10% of the

transferred assets.¹ Moreover, to strengthen UBS's equity, the Swiss Confederation subscribed to mandatory convertible notes in the amount of CHF 6 billion.²

By April 2009, the illiquid assets had been transferred to the stabilisation fund from UBS. Subsequently, the portfolio was managed and reduced. The main goal was complete repayment of the loan to the SNB. Sales as well as principal repayments and interest payments did indeed result in a gradual repayment of the SNB loan. By mid-August 2013, the loan had been fully repaid. Finally, in November, UBS purchased the stabilisation fund by reimbursing the SNB its contractual share in the fund equity. At this point, the stabilisation fund assets were entirely liquid.

The conclusion of this transaction was a major and exceptional achievement. To strengthen the financial system, the SNB had stated, in autumn 2008, that it was prepared to finance the takeover of assets up to a value of USD 60 billion by the stabilisation fund. For the success of this undertaking it was important that we could handle our balance sheet flexibly. This package of measures enabled both investors and savers to regain confidence in UBS.

The second example I would like to mention here is the introduction of the minimum exchange rate in September 2011. This rate was introduced to correct a massive overvaluation of the Swiss franc arising from adverse developments on the foreign exchange market, and thereby avert the threat of a deflationary trend. I have explained to you why this instrument is still needed and is being enforced by us without any restriction. A measure like the minimum exchange rate can only succeed if the central bank is totally credible, in other words, if people believe it will actually defend the rate, if need be. Words can certainly achieve a great deal in the financial markets. But this only holds true if they are followed up with deeds when necessary. In the case of the minimum exchange rate, the deeds in question are unlimited foreign currency market interventions. In 2012, we were required to enforce the minimum exchange rate with extensive foreign currency purchases, and our balance sheet total increased significantly. If there were statutory restrictions on our balance sheet we would be unable to introduce and enforce a measure of this kind. The financial markets would call into question both our resolve and our ability to see the measure through.

Concluding remarks

Ladies and gentlemen, I come to my concluding remarks. Even seven years after the onset of the financial crisis, the environment remains very challenging for our economy and for Swiss monetary policy. With interest rates close to zero and a high Swiss franc, the minimum exchange rate is still the key monetary policy instrument for the SNB.

Our monetary policy decisions have caused the SNB balance sheet to increase considerably. Due to the size of the balance sheet and the uncertainty on the capital markets, annual results are expected to be volatile in the foreseeable future. That is why we cannot provide you with any forecasts of the SNB's future annual results.

We are certainly very aware that the lack of a dividend is painful for many shareholders. However, as you know, the SNB is obliged by constitution and statute to act in accordance with the interests of the country as a whole. Its primary goal is to ensure price stability, while taking due account of the development of the economy. The SNB is required to gear its

¹ Overall, illiquid assets totalling USD 38.7 billion were taken over. The funding was as follows: The SNB granted a loan of USD 25.8 billion and UBS provided 10% or USD 3.9 billion in the form of the purchase price for the option to repurchase the stabilisation fund at a later date. The difference between the funds paid into the stabilisation fund and the total sum of transferred assets was made up of contingent liabilities which, at that point, did not require any financing.

² In 2009, the Confederation sold the equities arising out of the conversion of these notes to institutional investors, thereby ceasing its involvement.

monetary policy to this goal alone, and not to making profits. I would therefore like to thank you, our shareholders, also on behalf of my colleagues, Jean-Pierre Danthine and Fritz Zurbrügg, for your loyal support of and understanding for the activities of the SNB. The Governing Board thanks the SNB staff for their untiring service to our institution. Thank you all for your attention.