Thomas Jordan: The Swiss National Bank's monetary policy after the discontinuation of the minimum exchange rate

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the 107th Ordinary General Meeting of Shareholders of the Swiss National Bank, Berne, 24 April 2015.

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Mr President of the Bank Council

Dear Shareholders

Dear Guests, dear School Students

Since 15 January, the Swiss National Bank (SNB) has once again been coming to terms with a whole new set of challenges. On that day, the Governing Board decided to discontinue the minimum exchange rate because the international environment for the SNB's monetary policy had changed dramatically. The end of the minimum exchange rate of CHF 1.20 against the euro has far-reaching implications for our economy. It is therefore understandable that our decision triggered strong reactions. Yet had we continued to maintain the minimum exchange rate for a certain period, the consequences for our country would have been much more severe.

In my talk today, I would like to explain to you in detail our reasons for discontinuing the minimum exchange rate. The SNB attaches great importance to clarifying its monetary policy decisions. This is, on the one hand, an important part of our statutory duty of accountability to parliament. On the other, it is a prime concern of ours that the general public and, in particular, you, our shareholders, should understand our monetary policy.

I will begin by talking about the prominent issues related to the discontinuation of the minimum exchange rate. This will be followed by our present assessment of the Swiss economy and price developments and an explanation of our current monetary policy. Alongside our willingness to intervene on the foreign exchange market as necessary, negative interest on SNB sight deposits plays an important role in monetary policy. I would therefore like to look at this subject in greater detail today.

Rationale for discontinuing the minimum exchange rate

Let us begin with the reasons for discontinuing the minimum exchange rate. In the course of 2014, there were growing signs that a US exit from a highly expansionary monetary policy was drawing closer. In the euro area, by contrast, there was increasing evidence that monetary policy would be eased further. Against this backdrop, the euro depreciated considerably against the US dollar. These diverging monetary policy stances in the major currency areas affected the Swiss franc in two different ways. Like the euro, the Swiss franc weakened against the US dollar. Against the euro, however, it gradually approached the minimum exchange rate of CHF 1.20. At that time, the weakening of the euro had not yet cast doubt on the sustainability of the minimum exchange rate. Consequently, at the monetary policy decision in mid-December, we made the decision to leave monetary policy unchanged.

Shortly after our monetary policy decision, the economic crisis in Russia escalated. Subsequently, the SNB had to make very substantial interventions in the foreign exchange market to enforce the minimum exchange rate. In order to support the minimum exchange rate, we introduced negative interest on sight deposit account balances at the SNB.

At first, the situation quietened down again. However, this proved to have been the calm before the storm. Due to growing expectations that there would be a further substantial relaxation of monetary policy in the euro area, the euro weakened again significantly in the first half of January 2015. In the wake of this downturn, pressure on the minimum exchange rate increased enormously. Unlike the situation in 2012, when the monetary policy stance in the US and the euro area remained unchanged, it became evident that this time the minimum exchange rate could only be enforced through permanent currency interventions of rapidly increasing magnitude. In other words, the minimum exchange rate of CHF 1.20 per euro was no longer sustainable.

Adhering to the minimum exchange rate would have led to an uncontrollable expansion of our foreign currency holdings and, thus, of our balance sheet, potentially to a level several times Swiss GDP. The risks associated with a balance sheet expansion of this scale would have been out of all proportion to the benefits of the minimum exchange rate for the Swiss economy. In particular, an expansion of the balance sheet would have severely impaired the SNB's ability to conduct monetary policy in future. Such a long balance sheet would have made further monetary policy measures substantially harder. At the same time, we would have jeopardised the fulfilment of our mandate in the long term, since reabsorbing such a huge volume of liquidity once monetary policy began to normalise would have been very difficult.

At its monetary policy assessments, the SNB had analysed the costs and benefits of adhering to the minimum exchange rate. On the basis of this kind of analysis, the Governing Board concluded, on 15 January, that a minimum exchange rate of CHF 1.20 per euro was no longer sustainable, and thus justified, from a monetary policy point of view. If it had ignored the changes in the international environment, the SNB would have jeopardised its credibility. It would have been irresponsible to maintain the minimum exchange rate even longer and thoughtlessly accept the high costs of this policy, without considering its sustainability.

Once we had reached this conclusion, swift action was necessary. Holding off any longer would have increased pressure on the minimum exchange rate because of mounting speculation. Had we delayed the discontinuation, the turmoil on the financial markets would have been no less severe. However, the impact on the Swiss economy would have been stronger and the losses on the SNB's balance sheet would have been greater.

Ladies and gentlemen, the decision of 15 January has far-reaching consequences and was anything but easy for me and my colleagues on the Governing Board. We were aware that discontinuing the minimum exchange rate would have significant effects on the outlook for the economy and inflation. However, as the Governing Board, we must be prepared to make decisions that may have negative effects in the short term. We are convinced that postponing a decision which was ultimately unavoidable would have caused far higher costs in the long term.

Review and appraisal of the minimum exchange rate

As mentioned before, the minimum exchange rate of CHF 1.20 per euro was the SNB's key monetary policy instrument for almost three and a half years. I will therefore begin my brief appraisal of this instrument in the summer of 2011, shortly before it was introduced. That summer saw a renewed deterioration in the outlook for the global economy, which was only hesitantly recovering from the worst recession since the 1930s. In addition, at that time, the European debt crisis was escalating again. In the US Congress, a protracted battle about raising the debt ceiling was under way. Given these developments, uncertainty on the financial markets was increasing very rapidly, and demand for Swiss francs soared. The Swiss franc appreciated very sharply against all major currencies, including the US dollar. In August 2011, the Swiss franc was, by any measure, massively overvalued. The SNB began by expanding liquidity on the money market to an extent that was historically unprecedented. However, the effect of this liquidity expansion on the exchange rate was only temporary.

Subsequently, on 6 September 2011, we decided to introduce the minimum exchange rate as an exceptional and temporary measure.

Through the minimum exchange rate, the massive overvaluation of the Swiss franc was partially corrected. In this way, the SNB countered the acute threat to the Swiss economy and the risk of a deflationary development. The minimum exchange rate served the Swiss economy well. It helped to see it through the turmoil of that period and bought some time so that the economy could adjust to the new conditions, at least to some extent. Production and employment recovered faster than in many other countries. Over the past two years, GDP has grown by approximately 2% on average. The Swiss economy is now better placed than it was in 2011.

New parameters for the economy: assessment and outlook

What is our current assessment of the economic outlook, given the changed situation? Before discontinuing the minimum exchange rate, the SNB was expecting growth of some 2% for this year as well. We now anticipate GDP growth of just under 1%. With the end of the minimum exchange rate, Switzerland faces more difficult times ahead. Overall, the Swiss franc is once again significantly overvalued. The sharp, and above all abrupt, appreciation of the Swiss franc represents a major challenge. Our economy has time and again demonstrated how adaptable and innovative it is, and it can certainly handle a gradual, long-term appreciation in the real exchange rate. However, the potential effects of the latest sharp Swiss franc appreciation should certainly not be underestimated. We have great respect for the businesses and their staff who are now having to make challenging adjustments. At this time, the Swiss economy must – more than ever before – build on its structural strengths and flexibility. Doing so will enable it to preserve its international competitiveness and, with it, the prosperity of our country.

Apart from the exchange rate, future economic growth will depend on further developments in the global economy. In this respect, the outlook appears more favourable than in 2011. The US economy is in better shape. In the euro area, the latest economic figures also give cause for more optimism. Nevertheless, considerable risks also exist now, with the Ukraine conflict and the debt problems in Greece.

Due to the new exchange rate parameters, the SNB's conditional inflation forecast has also moved down significantly. For 2015, we anticipate inflation of –1.1% in Switzerland. As the stronger Swiss franc leads to a decrease in import prices. In addition, the very substantial fall in oil prices will move energy inflation deep into negative territory. However, both of these effects are temporary. According to our inflation forecast, the negative inflation phase will be short-lived. Sustained negative inflation or, indeed, a deflationary spiral, are not to be expected.

Nevertheless, neither inflationary nor economic developments are optimal. We would prefer slightly positive inflation and more economic growth. Due to the changed international environment, however, which we are unable to influence, we have no choice but to adjust to a leaner period, whether we like it or not.

Monetary policy of the SNB

With the end of the minimum exchange rate, the SNB has now returned to interest rate management. However, this does not mean that we have reverted to business as usual for monetary policy. In December last year, the SNB introduced an interest rate of –0.25%, to be charged on sight deposit account balances held by banks and other financial market participants at the SNB. On 15 January – concurrently with the discontinuation of the minimum exchange rate – we lowered this interest rate again, to –0.75%. This lowering of the interest rate makes it substantially more expensive to hold Swiss francs compared to other currencies. Over time it is intended to cushion the impact of the discontinuation of the minimum exchange rate and counter a tightening of monetary conditions.

Discontinuing the minimum exchange rate does not mean that the SNB will stop paying attention to foreign exchange market developments. We will continue to take account of the exchange rate situation in formulating our monetary policy in future.

Following the discontinuation of the minimum exchange rate, the Swiss franc initially appreciated sharply against all currencies. The appreciation diminished somewhat in the following weeks. However, as recent developments show, the Swiss franc may strengthen temporarily in response to the current phase of increased uncertainty surrounding the Greek debt problem. We are monitoring this development and its potential impact on Switzerland very closely. We will remain active in the foreign exchange market as necessary in order to influence monetary conditions. The Swiss franc is significantly overvalued overall. A correction of this overvaluation is to be expected over time.

Low interest rates worldwide and the difficulties they cause Switzerland

Not just in Switzerland, but in other countries, too, central banks are facing major challenges. After the beginning of the financial crisis, monetary policy was eased substantially across the board. As a result, interest rates worldwide are now very low or even, in the recent period, negative. Consequently, low or negative interest rates are not a purely Swiss phenomenon. They are a worldwide trend which Switzerland cannot escape. As a small open economy, Switzerland is closely linked to other countries through international trading and capital flows. The SNB has to take this into account when formulating its monetary policy.

Traditionally, interest rates in Switzerland are lower than in other countries, since Switzerland has long had low inflation and is also politically very stable. The Swiss economy benefits from this interest rate advantage in the form of low capital costs. This is expressed in a number of ways, including the high quality of infrastructure and high labour productivity.

During the financial crisis, interest rates abroad fell more sharply, overall, than in Switzerland. Consequently, the interest rate differential between investments in foreign currencies and those in Swiss francs had declined to almost zero towards the end of last year. This made the Swiss franc even more attractive for investors. The Swiss franc is equally attractive to both domestic and foreign investors. The upward pressure on the Swiss franc is not only due to the fact that foreigners want to invest in the Swiss franc, but also because Swiss residents invest less abroad or repatriate their international investments.

Allow me to explain this in more detail. For a long time, Switzerland has had a current account surplus, in other words, it exports more goods and services than it imports. In addition, the high level of international investments earns significant investment income. Due to the current account surpluses, Switzerland has built up considerable foreign assets over time. These asset holdings abroad were largely invested in foreign currencies, partly because of the more attractive returns.[1] The net revenue earned with the current account surpluses has to be “re-exported” in the form of foreign securities purchases or investments abroad. In the years before the financial crisis, inflows attributable to the current account surplus were more or less balanced by outflows in the form of private capital exports.

Following the financial crisis, the situation changed completely. Risk appetite in Switzerland reduced sharply. Investment of the proceeds from the current account surplus abroad by the domestic private sector has become increasingly restrained. Moreover, a portion of existing international investments is even being repatriated to Switzerland. This has very substantially increased private demand for Swiss francs, resulting in upward pressure on the currency.

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[1] At the end of 2012, Switzerland’s foreign assets amounted to some CHF 3.5 trillion, of which approximately 85% were invested in foreign currencies.

Some of this was absorbed by the high levels of foreign currency purchases by the SNB in recent years.

Thus, responsibility for upward pressure on the Swiss franc cannot be attributed to foreign investors alone. Swiss franc investment must therefore be made less attractive for all investors. As I have just explained, it is inappropriate to differentiate between domestic and foreign investors from a monetary policy point of view. Since foreign interest rates are close to zero or negative, Swiss interest rates cannot remain at zero. They have to move into negative territory in order to restore the traditional interest rate differential.

Criticism of negative interest

Let me now discuss negative interest in more detail. As I have explained, negative interest helps to make investment in Swiss francs less attractive and thereby limit net inflows into our currency. This reduces upward pressure on the Swiss franc and eases monetary conditions.

We are aware that the current low interest environment is very challenging for investors, especially pension funds. Acceptable investment options are limited. For institutions that are legally or contractually obliged to attain specific returns it is difficult to comply with these requirements at the moment. The current low interest rate environment is a temporary phenomenon attributable to the severe economic turmoil resulting from the financial crisis. We expect that the economy will continue to recover, and that interest rates worldwide will increase again. The first signs of this are evident in the US. However, looking at the international situation, it is also clear that the interest rate in Switzerland cannot be higher than in the rest of the world, because otherwise we would be threatened with major inflows into the Swiss franc.

Some claim that negative interest goes against human nature and deprives the economy of an important yardstick. However, that is not the case. The interest rate is the reward for forgoing consumption. The resources saved in this manner are basically available for investment. Investment, in turn, must generate a return that allows the interest to be paid. When uncertainty is high, savings increase, on the one hand. On the other hand, however, the increased uncertainty or the lower potential for returns causes businesses to postpone investment. Under these conditions, therefore, the interest rate falls; in extreme circumstances, it may even move into negative territory. Low or negative interest rates are an expression of the fact that, in the current situation, there is a very high supply of savings capital worldwide and a relatively low demand for investment. As soon as the global economy has recovered sufficiently, interest rates will rise again.

With all the concern about negative interest it is important to remember that when inflation is negative, real interest rates are higher than nominal interest rates. This is the case in Switzerland at the moment. If inflation is lower than the nominal interest rate, the end result is still an increase in purchasing power, even if an investment is not earning a nominal return. In the past, the rate of inflation has often been higher than the nominal rate of interest. In other words, in terms of real returns, there have certainly been times when saving was even less worthwhile than it is now; times, in fact, when savings lost value in real terms.

Concluding remarks

Ladies and gentlemen, I come to my concluding remarks. As you will have gathered from my comments today, the international environment remains extremely challenging for the Swiss economy and the SNB's monetary policy. Interest rates worldwide have been very low for a long time. The after-effects of the financial crisis persist and are hampering global economic developments. At the same time, the Swiss franc is significantly overvalued and presents major difficulties for our economy.

Nevertheless, I will venture to make two forecasts. First, that our economy will overcome these challenges successfully. Second, that negative interest will not become the "new normal". If the global economy recovers further and growth in the euro area increases again more robustly, this unsatisfactory situation will change as well. Until then, negative interest in Switzerland will fulfil a very important role – that of reducing upward pressure on the Swiss franc, thereby supporting the Swiss economy.

Thus, eight years after the beginning of the financial crisis, the SNB is still facing considerable challenges. In order to do our job well, we still require the full commitment of our staff, whom I would like to thank – also in the name of my colleagues, Jean-Pierre Danthine and Fritz Zurbrügg – for their hard work and support. We thank our shareholders for their solidarity with the SNB. And I thank everyone, including in particular our young guests, for taking such a great interest in the activities of the SNB.

Thank you for your attention.