

Jean-Pierre Danthine: Swiss monetary policy facts... and fiction

Speech by Mr Jean-Pierre Danthine, Vice Chairman of the Governing Board of the Swiss National Bank, at the Swiss Finance Institute Evening Seminar, Geneva, 19 May 2015.

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Introduction

I am very pleased to return to the Swiss Finance Institute almost six years after my departure for a final speech in my capacity as Vice Chairman of the Governing Board of the Swiss National Bank (SNB).

My soon-to-end tenure at the SNB has been marked by significant deviations from textbook monetary policy orthodoxies, both on conceptual and on operational levels. In many respects, it was a time that was anything but conventional: Central banks around the world stepped up their efforts and made use of increasingly expansionary measures, many of them new, to fight off the risk of a second Great Depression in the wake of the global financial crisis, and then to try and reanimate their economies in the troubled times that immediately followed.

The SNB, for its part, has taken exceptional measures as well, notably the minimum exchange rate of CHF 1.20 per euro in place from 6 September 2011 until 15 January 2015.

At the same time, central banks and financial regulators became increasingly vocal in stressing the overwhelming importance of a stable financial system, and took a more active role in strengthening their regulatory frameworks, both nationally and globally.

Inevitably, these substantial, unprecedented shifts in the design and operation of a key field in economic policy have raised fundamental questions and cast doubt on deeply entrenched beliefs.

Based on practical experience of making monetary policy in the last few years, I will try today to dispel four Swiss monetary policy “fictions” by contrasting them with established facts about Swiss monetary policy. These facts are not necessarily new, but rather took a back seat in more benign times; it took the crisis to amply demonstrate their considerable relevance.

Fiction I: Negative interest rates can't happen

First, I would like to address the belief that, because of the so-called “zero lower bound”, nominal interest rates cannot become negative.

This belief has clearly been proved a *fiction* by current developments, with the SNB lowering its policy target rate into negative territory.¹

Unsurprisingly, the measure has sparked intense debate in the public domain. This is partially due to fears that the costs incurred by banks holding sight deposits with the SNB will, at some point, be passed on to their clients. But there is a more fundamental issue here. At first glance, negative rates violate the intuition that savings must be remunerated. However, this intuition is misleading. The interest rate reflects the price of today's

¹ Negative interest rates have been implemented not just in Switzerland, but also in an increasing number of other advanced economies, such as Denmark and Sweden.

consumption in terms of consumption in the future. It is a relative price. There is nothing untenable in tomorrow's consumption being more valuable than today's.

Of course, while not untenable, negative nominal rates are not representative of a normal state of affairs. Rather, they mirror the current exceptional circumstances of the global economy and of Switzerland.

To understand why Switzerland is experiencing a period of negative interest rates, it is necessary to step back and recall three structural features that characterise the highly integrated Swiss economy: its "traditional" current account surplus, its globally traded, freely floating currency, which is commonly perceived as a "safe haven", and – as a result – its persistently lower interest rates, especially relative to the euro area.²

In "normal" times, Switzerland's traditional current account surplus is compatible with a stable currency, as it is compensated by net capital outflows of similar magnitude, with the negative interest rate differential providing the proper incentive for capital exports.

This "benign" equilibrium has been severely tested by recent financial market developments. The financial crisis has exacerbated the global appetite for Swiss franc investments because of their safe haven status. In addition, global interest rates have fallen to near zero levels, virtually eliminating any interest rate differential, and thus further reducing the incentives for Swiss investors to re-export their excess savings abroad.

Together, these developments largely explain the observed net *inflows* of private capital to Switzerland since the crisis, and, despite them being compensated by public sector capital exports through foreign exchange interventions by the SNB, the persistent strength of the Swiss franc.

These developments also highlight a first key *fact* of Swiss monetary policy: At any point in time, the attractiveness of the Swiss franc for both domestic and foreign investors is predominantly determined by the size of the interest rate differential and the safe haven status, with the latter being particularly important in times of heightened uncertainty.

In the current global environment of low interest rates, imposing negative rates is therefore a monetary policy necessity in order to re-establish a material interest rate differential vis-à-vis the major economies. The negative rate thus contributes to restoring the relative attractiveness of foreign currency investments for Swiss investors and corporates. At the same time, it reduces the incentive for foreign investors to invest in Swiss franc-denominated assets. Over time, this fundamental mechanism will contribute to reducing the current overvaluation of the Swiss franc.

The SNB is fully aware that, despite its established necessity, a negative interest rate policy does not come without detrimental side effects, notably for financial stability and the efficient use of capital, to name just two areas of concern. It therefore remains a policy instrument to be used with caution.

Fiction II: A central bank can expand its balance sheet without risks

The significant upward pressure on the Swiss franc due to its status as a safe haven and the collapsed interest rate differential could, arguably, be addressed differently, namely through foreign exchange interventions over a prolonged period.

As you all know, for the better part of my tenure at the SNB, Swiss monetary policy was focused on enforcing a minimum exchange rate of CHF 1.20 per euro. This exceptional policy measure was implemented as a temporary course of action to provide the foreign

² There are various further explanations for Switzerland's lower nominal interest rates, including, in particular, its track record of low and stable inflation.

exchange market with clear guidance. It aimed at, and succeeded in, counteracting excessive upward pressure on the Swiss franc in the aftermath of the financial crisis, which carried with it the risk of deflationary developments and severe disruptions to the Swiss economy.

The SNB enforced the minimum exchange rate for more than three years. The success of this measure was primarily founded on the credibility of the SNB, but also on outright interventions in the foreign exchange market. In consequence, the SNB's foreign exchange holdings surged from about CHF 220 billion in August 2011 to CHF 490 billion by the end of 2014, which corresponds to approximately 75% of Swiss GDP.

Why not persevere with the minimum exchange rate, instead of exposing the Swiss economy to the downsides of negative interest rates and the challenge of a stronger currency?

With this question in mind, let me turn straight to a second *fiction* regarding Swiss monetary policy, namely, that an unlimited lengthening of the SNB balance sheet would be riskless. This fiction flies against common sense and is mostly prevalent in academic circles.

I will try and clarify some misunderstandings with respect to central bank balance sheets by stressing three important *facts* that apply both generally and to the current Swiss monetary policy situation in particular.

First, a central bank balance sheet is never a target per se, but rather, its size and composition simply mirror monetary policy decisions.

Second, massive balance sheet expansions carry financial and economic risks.³ This is clearly the case when the policies underlying the balance sheet expansion comprise outright purchases of foreign exchange. This puts foreign exchange risk on the central bank's balance sheet.

Third, policy measures involving a significant balance sheet expansion should be taken only as long as the benefits in terms of the broader policy objective clearly justify the risks and cover the costs associated with the balance sheet expansion. It is important to note that the costs and benefits of a given policy measure may change over time, and must therefore be reassessed repeatedly.

A case in point is the SNB's decision to introduce the minimum exchange rate of CHF 1.20 per euro in September 2011, and then discontinue it earlier this year. As mentioned, in enforcing the minimum exchange rate, the SNB intervened heavily in the foreign exchange markets, and did not refrain from taking on significant balance sheet risks, particularly in 2012. At the time, interventions were necessary to counteract upward pressure on the Swiss franc resulting from substantial capital inflows and a lack of outflows due to flare-ups in the European debt crisis.

Towards the end of 2014, the minimum exchange rate again came under increasing market pressure, requiring renewed interventions by the SNB. This time, however, the international environment was very different. While expectations of an interest rate rise in the United States were mounting and the dollar was appreciating, from mid-year onwards there were signs in the euro area of further monetary policy easing, and the euro started to weaken across the board, pushing the EUR/CHF exchange rate close to the CHF 1.20 per euro floor. On the back of these developments – also reflecting the collapsing interest rate differential – Swiss franc investments again became relatively more attractive.

Given these circumstances, and in view of quantitative easing in the euro area, the continuation of the minimum exchange rate policy would have meant a permanent, potentially uncontrollable expansion of the SNB balance sheet. For at least the following two

³ In fact, removing tail risks from markets was a key objective of putting central banks' balance sheets to use during the crisis.

reasons, the risks associated with such a policy would have increased substantially, and were no longer justifiable.

The first reason is that the *policy risks* linked to monetary policy normalisation further down the road would have been substantial.

Policy normalisation at some point in the future will inevitably require reabsorbing excess liquidity in order to contain potential inflation risks. In this context, it is worth remembering that at more than 90% of GDP, the SNB already has the largest balance sheet of all major central banks in relative terms. The challenges and the risks involved would have increased disproportionately in the event of a further massive expansion of the balance sheet. While the technical means to reabsorb even massive amounts of liquidity are at our disposal, such an expansion would have had put us in completely uncharted territory. Attempting policy normalisation with a balance sheet several times larger than GDP has never been done before, and is certainly not for the faint-hearted. A less than perfectly controlled exit carries very significant risks for price stability, as well as the potential for policy reversals which could be very costly for the economy.

Given these considerations, it is a *fact* that any significant balance sheet expansion amounts to what is called “exercising an option” in finance. Doing so at any point in time reduces the SNB’s room for manoeuvre in the future, precisely because it sets the bar even higher for the next time it wants to use the balance sheet for monetary policy purposes.

All in all, it is clear that an uncontrollable expansion of the balance sheet would have severely impaired the SNB’s ability to effectively conduct monetary policy and to fulfil its price stability mandate in the long term.

The second reason why the risks associated with continuing the minimum exchange rate would have increased substantially is because the larger the balance sheet, the larger the corresponding *financial risks* for the SNB and for the country.

Even at the current size of the balance sheet, situations of annual losses exceeding the SNB’s capital are already possible. An even larger stock of foreign reserves would further increase both the volatility of the income statement and the absolute size of potential losses. While in principle it is feasible for the SNB or any central bank to operate with negative equity, scenarios whereby expenses exceed income for a prolonged period of time are conceivable. Such extreme scenarios not only preclude any profit distribution to the Confederation and the cantons, but can also raise even more fundamental issues about the ability of a central bank to pursue a monetary policy oriented towards price stability.

To summarise, large-scale central bank balance sheet expansions are associated with increasing risks. At the current juncture, the longer-term risks associated with a massive, uncontrollable expansion of the SNB balance sheet would have been out of proportion to the benefits of continuing to enforce the minimum exchange rate. This does not mean that the SNB will refrain from expanding its balance sheet further, should it prove necessary. Rather, it clarifies that this policy option should be used only when the benefits clearly outweigh the costs.

Fiction III: The SNB has unlimited power

The drastic actions taken by central banks since the financial crisis – flooding financial markets with liquidity on an unprecedented scale, injecting billions to save banks from failing, or, in the case of Switzerland, intervening heavily in the foreign exchange markets – have led to the widespread perception that central banks have unlimited power.

On the one hand, this perception is based on the *fact* that central banks are entrusted with the note-issuing privilege, i.e. they can “print money”. In view of the current difficult debates about austerity and deleveraging, the tendency to overrate the power associated with this privilege is probably natural. Yet this view overestimates its *actual* power, for printing money

can only resolve short-term liquidity issues. In the long term, it creates no value and merely generates nominal price increases.

On the other hand, the perception that central banks are all-powerful is also based on the *fiction* that their independence renders them immune to democratic controls.

It is a *fact* that today, most central banks are granted significant independence. This holds also for the SNB, which, by law, is functionally, institutionally and financially independent, as well as with regard to personnel issues, from the Federal Council, the Federal Assembly and any other body.⁴

There are compelling reasons for this delegation of monetary policy power to an independent central bank: It is a *fact* both in theory and practice that an independent central bank better fulfils its mandate, namely, ensuring price stability and thereby contributing to sustained economic developments, than a central bank that is under the influence of political interest groups.

However, a further important *fact* in this regard is that the SNB's independence is far from unlimited.

First, our independence is not an end in itself. It applies only to the pursuit of a clearly specified mandate. This mandate is defined in the political realm. It is stipulated in article 99 of the Federal Constitution and set out in detail in the National Bank Act.⁵

Second, independence goes hand in hand with accountability. With the privilege and duty of conducting an independent monetary policy comes a particular responsibility. As bearer of this responsibility, the SNB is accountable to the Federal Council, the Federal Assembly and the public for the decisions it takes, the means it chooses and the results it achieves. The precise scope of this accountability is also clearly defined in the National Bank Act.⁶

Yet having a sound legal framework in place is clearly not enough. Just as important is how these rules are put into practice.

In normal circumstances, such as those before the crisis, this is a rather easy task, since the public and politicians understand "conventional" monetary policy quite well. People have a clear picture of how central banks act and communicate. In such times, the requirements of accountability and transparency are satisfied without undue controversy through a number of measures, namely, the annual accountability report submitted to parliament, regular

⁴ Cf. the National Bank Act (NBA) and Message concerning the revision of the National Bank Act.

Functional independence means, in particular, that the SNB fulfils its mandate without seeking or accepting instruction from any of these bodies.

Financial independence includes both the budgetary autonomy of the SNB and the prohibition against granting loans to the Confederation, thereby barring the state from using the banknote press.

The SNB's independence in personnel issues, finally, is ensured by the fact that Governing Board members and their deputies can only be dismissed during their term of office if they no longer fulfil the requirements for exercising that office or if they have committed a grave offence.

⁵ Specifically, art. 99 of the Federal Constitution states that "as an independent central bank, the Swiss National Bank shall follow monetary policy which serves the general interest of the country; it shall be administered with the cooperation and under the supervision of the Confederation."

Art. 5 of the NBA sets out in detail the SNB's constitutional mandate.

⁶ Accountability duties are specified as follows (art. 7 NBA): The SNB regularly discusses with the Federal Council the economic situation, monetary policy and topical issues of federal economic policy.

The SNB submits a written accountability report annually on the fulfilment of its tasks, and elaborates on its monetary policy to the respective committees of the Federal Assembly.

The public is informed through quarterly reports on the development of the real economy and of the monetary situation. At the same time, the SNB is obliged to publicly announce its monetary policy intentions.

meetings with the Federal Council and representatives of the relevant committees of the Federal Assembly as well as with representatives from different economic sectors, and the half-yearly media news conferences covering the current conduct of Swiss monetary policy.

This has changed with the crisis. Given today's circumstances and the SNB's monetary policy decisions over the last couple of years, public authorities, the general public and financial markets all require substantially more information and transparency from the SNB.

We are very aware of the legitimacy of these requests, and have responded in various ways. The SNB has strengthened its communication by significantly enlarging the scope of information available on its website.⁷ Furthermore, Governing Board members have appeared on numerous occasions before parliament committees, on public panels, as well as in print and electronic media, to explain significant monetary policy measures, such as the UBS bail-out, as well as the introduction and discontinuation of the minimum exchange rate.

However, transparency is not a goal in itself, but rather a means to achieve accountability, and it has its limits. It cannot be allowed to hamper the implementation or the effectiveness of monetary policy. An obvious example here is the discontinuation of the minimum exchange rate, when it was impossible for the SNB to give any kind of advanced warning of this decision without triggering speculative attacks on the EUR/CHF exchange rate.

In short, it is a *fiction* that the SNB has unlimited power. It is a *fact* that Switzerland has a well-developed system of checks and balances obliging the SNB to transparently account for its decisions.

Fiction IV: Financial stability is an impossible dream

With this, let me turn to another field in which the SNB has taken on a more prominent role recently, namely, financial stability. Substantial efforts are underway to improve the regulation of the financial system, both globally and nationally. Sometimes, these efforts are greeted with scepticism, based on the view – or the *fiction* – that financial stability is an “impossible dream”.

While I accept that there are conceptual and practical difficulties in fostering the stability of the financial system, I do not share this pessimism.

We have only to consider the substantial cost of the recent financial crisis to realise that we can and *should* do better!

In my view, two main prerequisites have to be fulfilled in tandem in order to sustainably achieve a higher level of financial stability.

The first is to continuously strive to improve our *knowledge* about the sources of financial instability. Clearly, the complex, continuously evolving financial system will never allow us to prevent all crises for all times. But, in general, the more information we have on the structure and dynamics of the system, the more accurately we can design its regulation, and the less uncertainty there will be about the “optimal” mix of regulatory instruments.

The second prerequisite for improving financial stability is to recognise that financial stability is a question of *will*, or more precisely, of *political* will. In other words, even perfect information on the sources of financial instability might prove insufficient if the collective will needed to translate this information into practical measures is not present. Conversely, even with imperfect knowledge, financial stability is attainable if we are willing to take precautionary measures commensurate to the extent of our ignorance.

⁷ For instance, a regularly updated Q&A section covering relevant topics around SNB and Swiss monetary policy.

My optimism that financial stability is achievable rests partly on the *fact* that, in the case of Switzerland, identifying the main sources of potential financial instabilities is rather straightforward. A first source is the “too big to fail” (TBTF) problem – that the Swiss banking sector has several banks with balance sheets that are large in relation to GDP. A second key source of risk resides in the substantial imbalances that have been building up in Swiss real estate and mortgage markets and the high exposure of domestically focused banks to these markets.

Let me mention here that other possible system-wide sources of risk discussed on the global level, in particular those in the “shadow banking” sector, are considered less of an issue in Switzerland. One reason is that shadow banking assets in Switzerland carry low to moderate bank-like systemic risks. Another reason lies in the fact that bond funds and other investment funds, which make up 60% of shadow banking assets in Switzerland, are supervised by FINMA.⁸

Switzerland has made considerable progress in addressing its two main sources of risk to financial stability.

With respect to the risks stemming from the real estate and mortgage markets, a countercyclical capital buffer (CCB) has been introduced. The CCB was activated on a sectoral level in early 2013 and increased in 2014, as a complement to further administrative and self-regulatory measures aimed at increasing the resilience of the banking system and preventing excessive credit growth.

Experience with this policy mix has so far been encouraging, and has flowed into the preliminary assessment indicating that these measures have contributed to a recent dampening of corresponding market dynamics.

Despite this, it is still too early to give the all-clear. Imbalances in the housing markets have stabilised at high levels only, and the risks of a further build-up remain substantial, not least given the current environment of negative interest rates.

Should there be renewed signs of a further build-up, I am confident that we could contain the problem.

With respect to the TBTF issue, the knowledge and awareness of the risks stemming from our systemically important banks have improved significantly. As early as in 2011, Switzerland adopted a package of measures to address the core problems in this area.⁹

On behalf of the Federal Council, the effectiveness of the Swiss TBTF framework was assessed by a group of experts in 2014. Overall, the assessment indicated that the chosen approach was appropriate to address the TBTF problem. At the same time, the experts concluded – rightly in the view of the SNB – that even the full implementation of the framework in its current specification would not solve the Swiss TBTF problem entirely. Therefore, supplementary measures have been proposed.¹⁰

⁸ FSB (2014). This FSB report states furthermore that “compared to the country’s banking sector, the size of Swiss shadow banking is considerably smaller – by more than five times.”

⁹ The package consists of four complementary measures, namely, significantly more capital of better quality, larger liquidity buffers, rules imposing sufficient diversification to reduce counterparty risk, and organisational measures. The package aims to reduce both the likelihood of crisis occurring at a systemically important bank and the costs to the economy in the event of such a crisis.

¹⁰ Group of experts on the further development of the financial market strategy (2014). The proposed supplementary measures include a quantitative and qualitative recalibration of the capital requirements, a review of the method for calculating risk-weighted assets (RWA), a timetable for the implementation of workable recovery and resolution plans, and the introduction of binding Total Loss Absorbency Capacity (TLAC) requirements.

Uncertainties regarding optimal regulation are likely more important here than in the case of the real estate and mortgage markets, as the probability of a big bank failing and the macroeconomic cost of such a tail-risk event may be less clear or not “objectively” measurable ex ante. Such fundamental uncertainties imply more substantial tensions with respect to the choice and design – size and scope – of further measures to contain the TBTF issue. Going too far could theoretically entail a cost to society that may not be warranted from a cost-benefit perspective. Not going far enough, however, creates the risk of ending up in a very costly crisis.

Let me conclude: Sustainably improving the stability of the financial system is a difficult task. But it's not an impossible dream. It is a *fact* that improving the regulatory framework entails a delicate trade-off between knowledge and prudence. There will always be risks about which knowledge will be lacking; even worse, there may be risks we don't know about ex ante. This speaks for the willingness, collectively, to accept the price of precaution. However, it is also a *fact* that we will be able to make tangible progress towards a sustainably more stable financial system only if this view is widely shared in society! The last couple of years of work in Switzerland leads me to be cautiously optimistic. But this must not be misread as a reason to be complacent or give up midway.

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