Thomas Jordan: The Swiss National Bank's monetary policy and the Swiss financial centre

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the first meeting of the "Rencontres économiques de Genève", organized by Fondation Genève Place Financière, Institut National Genevois, Investment Strategists Association of Geneva, Geneva, 3 November 2015.

*   *   *

The speaker would like to thank Samuel Reynard and Rina Rosenblatt for their valuable support in preparing this speech, and Katrin Assenmacher, Petra Gerlach and Rita Kobel for their helpful comments.

Introduction

It is a great pleasure for me to be here with you tonight in Geneva, a key pillar of the Swiss financial sector. I also feel very honoured to be addressing you at the very first meeting of the "Rencontres économiques de Genève". Indeed, the financial centre of Geneva is also important from an international point of view. Its roots as a financial centre go back several hundred years. In the early 18th century, the minute Republic of Geneva was one of six major international financial centres, together with London, Paris, Amsterdam, Frankfurt and Brussels. It owed its ascent to its cosmopolitanism. Several factors bear witness to this, including the city's political neutrality and the fact that it welcomed protestant Huguenots who had been persecuted in France. In the 18th century, close personal relationships were established with the leading Parisian banks and the French court. In this way, Geneva bankers were eventually among the main financiers of France. Jacques Necker, who had been born in Geneva, was Minister of Finance under Louis XVI. After the French Revolution, Geneva began to evolve into an important wealth management centre.[1] In 1857, the first Swiss stock market was founded in Geneva, before those in Zurich and Basel. The Geneva stock market soon ranked fifth among European stock markets. Geneva remains one of the major world financial centres today, particularly when it comes to private wealth management.[2]

The financial sector in Geneva is an engine for the regional economy. In 2014, around 120 banks were based in Geneva. The financial sector creates a significant part of cantonal value added and is a major employer.[3]

A strong financial sector, such as that in Geneva, makes a substantial contribution to economic growth. It is therefore a crucial foundation, both for the regional economy and for the Swiss economy as a whole. A robust financial sector is also very important for the Swiss National Bank (SNB). The SNB interacts closely with the financial sector, and in particular with the banking sector. I will talk about this later.

In my presentation, I will begin by explaining how the SNB and the financial sector are interlinked. Then I will discuss the importance of an independent monetary policy in providing stability as a long-term asset. However, in the short term, this long-term stability may generate costs. I will then explain the SNB's current monetary policy and our reaction to international developments. Finally, I will place the challenges that face us within a long-term perspective.

---

1 Youssef Cassis, *Les Capitales du Capital. Histoire des places financières internationales 1780–2005*, Geneva (Éditions Slatkine, Pictet & Cie) 2005, 47–48.

2 Cf. www.ville-geneve.ch/histoire-chiffres/place-financiere/ and www.geneve-finance.ch/en-ch/overview/geneva-financial-center.

3 Cf. www.geneve-finance.ch/en-ch/overview/facts-figures.

Close interactions between the SNB and the Swiss financial sector

As an independent central bank, the SNB's mandate is to ensure price stability, while taking due account of economic developments in Switzerland. It also has the task of contributing to the stability of the financial system.

Banks, and the financial sector in general, contribute to the prosperity of our nation. On the one hand, financial intermediation, wealth management and the various other financial services provided by the financial sector are vital for an efficient economic environment. On the other hand, the same activities create employment and value added, both directly and indirectly. They are thus a source of economic prosperity.

The activities and goals of the SNB and the financial sector, apparently unrelated, are however closely interlinked. The connections between the two were particularly apparent during the recent financial and European debt crises. The SNB and the financial sector need one another, as I will now show (cf. chart 1).

Banks need the SNB to conduct their various business activities, since the SNB acts as the bank of banks. First, banks use the currency issued by the SNB as the numeraire in their daily business. The credibility that the SNB has acquired over decades guarantees a stable currency. This constitutes a perfect numeraire for banking activities. Second, the money issued by the SNB, i.e. deposits that banks hold at the SNB and banknotes, is the Swiss legal tender. It represents the anchor of the Swiss monetary system. If their customers wish, banks exchange the money in customers' deposits against banknotes issued by the SNB. Third, banks use the SNB's infrastructure, the Swiss Interbank Clearing system, for their payment transactions. And fourth, the SNB provides liquidity to the banks, which they hold in the form of deposit accounts or banknotes. In this way, the SNB ensures that the payment system functions well and the demand for banknotes can be satisfied. By fulfilling its mandate, the SNB thus provides fundamental services for the operations of banks and the financial sector.

At the same time, the SNB needs the financial sector in order to fulfil its mandate. The financial sector transmits the SNB's monetary policy actions to the Swiss economy through its lending and borrowing decisions. Based on short-term money market conditions set by the SNB, banks adjust the cost of borrowing for households and firms. Through their core business, banks thus contribute to monetary policy transmission.

More generally, the financial sector transmits changes in the short-term policy interest rate to other assets of different maturities. The resulting change in overall yields on Swiss assets influences their relative attractiveness. This also affects Swiss franc exchange rates. Both exchange rates and interest rates then determine monetary conditions in Switzerland, and thus eventually output and inflation.

Although short-term interest rates are the main monetary policy instrument, the SNB has, in recent years, been using exchange rate interventions as an additional tool. Due to the safe-haven status of the Swiss franc, the SNB has been active on the foreign exchange market. We are also willing to intervene, as required, as part of our current monetary policy. Once again, banks have been at the heart of monetary policy transmission. They have acted as intermediaries of the SNB's foreign exchange interventions.[4]

With depressed international demand and a strong Swiss franc weighing on GDP, credit availability has been crucial for the domestic economy. Low interest rates and ample liquidity provision by the SNB have facilitated banks' intermediation activities. In short, the SNB's

---

[4] For further details, cf. Lukas Altermatt and Romain Baeriswyl, The effect of the monetary base expansion on the balance sheet of domestic banks, *SNB Quarterly Bulletin*, 1/2015, and Raphael Auer, A safe haven: international demand for Swiss francs during the euro area debt crisis, *SNB Quarterly Bulletin*, 2/2015.

policy has supported the banks' provision of credit to the real economy. The banking sector, which is traditionally procyclical, has in turn benefited from improved economic conditions.

In order to fulfil our mandate we need a stable banking system. Financial stability is key, both for the SNB and the whole economy. Without it, Switzerland as a financial centre and a leader in wealth management would lose its attractiveness. Moreover, only a stable and healthy banking sector can transmit the SNB's monetary policy to domestic monetary conditions effectively. Overall, our economy could not prosper with impaired financial intermediation.

That is why, in addition to being responsible for monetary policy, the SNB also has the task of contributing to the stability of the financial system. The financial system itself should not be a source of excessive risk for the rest of the economy. Failures resulting from excessive risk-taking can affect the whole financial system and prove extremely costly for the economy. Stringent capital and liquidity requirements and self-regulation by the banking industry are essential for enhancing financial stability.

There is also a broad consensus that macroprudential tools are required to address systemic risk. We therefore analyse sources of risk to the financial system continuously, and identify areas where action is needed.[5] In addition, we help design and implement a regulatory framework for the financial sector. We also oversee systemically important financial market infrastructures.

Our aim is to increase the resilience of the financial sector by mitigating systemic risk. To ensure this, we work closely with the Financial Market Supervisory Authority (FINMA), the Federal Department of Finance and various international standard-setting bodies. The adjustment of the "too big to fail" regulations approved by the Federal Council on 21 October is an example of such cooperation. The new capital requirements will strengthen the resilience of the Swiss banking system considerably. In a crisis there should not be any need for systemically important banks to be bailed out by the state.

Monetary policy and macroprudential measures are closely linked. Sometimes monetary policy demands a low policy interest rate in order to ensure price stability and support economic activity, especially if the Swiss franc is overvalued. However, low interest rates can translate into a build-up of imbalances on the mortgage and real estate markets. To increase banks' resilience to the correction of these imbalances, macroprudential measures are needed. The countercyclical capital buffer, for which the SNB may propose changes, is one such measure.

Stability: a long-term asset with potential short-term costs

Ladies and Gentlemen, price stability and financial stability are indeed important long-term assets for the financial sector and the entire economy. As an independent central bank with its own currency, the SNB has been successful in providing long-term stability. Switzerland has had significantly lower and more stable inflation rates than most other countries (cf. chart 2). Our long history of price stability, a reliable political and legal environment, and efficient institutions have resulted in an interest rate bonus. This is more pronounced for the long-term part of the yield curve than for the short-term part. Ten-year government bond yields have typically been lower in Switzerland than in Europe and the US.

In addition, having its own currency plays an important role in Switzerland's attractiveness. It makes it possible for us to conduct our own monetary policy, with monetary conditions adapted to the Swiss economy. It enables us to create long-term stability. And this in turn is an asset for the whole economy and the financial sector in particular.

---

[5] Cf. SNB annual *Financial Stability Report*, in which the SNB presents its yearly assessment of the Swiss banking sector's stability: www.snb.ch/en/iabout/pub/oecpub/id/pub_oecpub_stabrep.

Due to Switzerland's stability, domestic and foreign investors find it attractive to invest or have their wealth managed here. Of course, high-quality services provided by banks are an additional factor making Switzerland attractive for investors. Price stability is also an advantage. It makes the future more predictable and decreases the uncertainty of investments. Customers of Swiss banks are not investing exclusively in Swiss assets or Swiss francs. But part of the reason why they want to have their wealth managed here is because of the stable political, economic and monetary conditions.

These stable conditions have supported the development of a strong and globally attractive financial sector. Swiss banks are global leaders in managing cross-border assets and wealth management. At the end of 2014, roughly half of the assets under management at banks in Switzerland were foreign customer assets.[6] The Swiss franc plays an important role in the international financial system. Measured by foreign exchange turnover, the Swiss franc was the sixth most important currency worldwide in 2013.[7]

The banking sector is also an important part of the Swiss economy. The Swiss banking sector currently generates about 6% of GDP (cf. chart 3). With close to 120,000 employees[8] in 2014, the banking sector is a major employer. The size of the banking sector, as measured by the ratio of total assets to GDP, is high by international standards.[9]

Macroeconomic stability is thus a long-term asset for Switzerland. Low interest rates make borrowing conditions for firms and households cheaper. This leads to higher investment and supports the real sector. Macroeconomic stability is not only a precondition for sustained economic growth, but has helped to build a stable and robust financial sector. It is the long-term stability, combined with high quality work, which has helped create 'brand Switzerland'. The Swiss financial sector has not only benefited from this brand but also contributed to its international propagation.

However, long-term stability can sometimes be associated with short-term costs. As a small open economy, Switzerland can be subject to short-term exchange rate volatility resulting from the safe-haven status of its currency. The costs of this volatility are substantial at times. Strong fluctuations in the Swiss franc have had major effects on the Swiss economy in the past. For example, in the early 1990s, during the European Monetary System crisis, the Swiss franc appreciated strongly against European currencies. The entire economy had to adjust to a strong currency.

More recently, Switzerland has been particularly heavily affected by international disturbances since the beginning of the financial crisis. The Swiss economy and its inflation outlook have been subject to strong downside pressures, due to massive exchange rate appreciation, weak international demand, and volatile financial markets. The Swiss franc remains significantly overvalued.

The financial sector has also suffered from the effects of the recent crisis on Switzerland and its currency. For instance, the current account shows that exports of banking commissions have diminished markedly since the financial crisis. Indeed, the entire Swiss economy has had to adapt to new international monetary conditions. At the SNB we have geared monetary policy towards this new and difficult situation.

---

6 Swiss Bankers Association, *Banking Barometer*, September 2015.

7 BIS Triennial Central Bank Survey 2013.

8 Full-time equivalents.

9 Cf. Final report of the group of experts for the further development of the financial market strategy, dated 1.12.2014; Annex to the Review of the Swiss TBTF regime by international standards – Basis for an evaluation in accordance with Article 52 of the Banking Act, p. 55.

Monetary policy during the financial and European debt crises

The Swiss economy is currently being hit by external shocks. In such a context, the SNB aims to dampen short-term costs without jeopardising the long-term goals of monetary policy. The challenge for monetary policy in recent years has been to react to sudden developments in international markets and geopolitical risks that have endangered Switzerland's real economy and price stability in the medium term. The goal has been to steer policy responses in a way that reduces short-term costs while preserving the stability achieved over the past four decades of independent monetary policy. In order to meet these challenges, we have had to use unconventional instruments for the implementation of monetary policy.

Our current monetary policy is based on two pillars. These are designed to dampen upward pressure on the Swiss franc. The first pillar is the negative interest rate on sight deposits at the SNB. The second pillar is our willingness to intervene on the foreign exchange market as required. The SNB monitors developments in the foreign exchange market and their potential effects on the Swiss economy very carefully.

At a global level, interest rates have been on a downward trend for more than two decades (cf. chart 4). This development reflects, on the one hand, an overall decrease in inflation. On the other, quantitative easing programmes implemented by various central banks in response to the financial crisis have brought global interest rates close to zero. In an interconnected financial world, it was impossible for Swiss interest rates to diverge from this strong and persistent downward trend. Very low global nominal yields have reduced the interest rate differential between foreign and Swiss interest rates.

By the end of last year, the spread between short-term interest rates on assets denominated in euros and those denominated in Swiss francs had almost vanished. As I mentioned earlier, interest rates have traditionally been lower in Switzerland than abroad. However, during the financial crisis, foreign interest rates decreased to a greater extent than their Swiss counterparts. With both foreign and Swiss interest rates close to zero, the spread between euro and Swiss interest rates disappeared.

This created upward pressure on the Swiss franc. A narrower interest rate differential acts like a bonus on Swiss franc holdings. The appetite for Swiss franc assets increased among both foreign and Swiss investors. In the context of a financial and debt crisis, and in a world of high geopolitical risks, a narrower interest rate differential makes the Swiss franc particularly attractive for investors.

At the same time it is important to recognise that the current situation cannot be compared to that of 2011. At that time, the Swiss franc was appreciating strongly against all currencies, and, as a response, we introduced the minimum exchange rate. Now the situation is characterised by a general weakness in the euro. Thus, at the end of 2014 and the beginning of 2015, the euro lost substantial value, not just against the Swiss franc but also against other important currencies such as the US dollar and the pound sterling (cf. chart 5).

In this new environment, we introduced negative interest rates to partially restore the traditional differential between interest rates on euro and Swiss franc assets. Monetary conditions were adjusted, as the monetary policy stance relative to that abroad had changed. With short-term interest rates in the euro area at zero, negative Swiss interest rates helped restore, at least partially, the pre-crisis interest rate differential. The decrease in Swiss interest rates makes the holding of Swiss franc assets more expensive relative to other currencies. This makes the Swiss franc relatively less attractive and counteracts the upward pressure.

Introducing negative interest rates on sight deposits at the SNB is designed to allow interest rates to take on an important role in monetary policy transmission again. Since 2000, the short-term interest rate at which banks borrow and lend liquidity to each other has been the SNB's main policy instrument for fulfilling its mandate of price stability. Negative interest rates on sight deposits at the SNB affect interest rates of different maturities and the economy as a whole through financial markets and the banking sector. This change in overall yields on Swiss assets influences their attractiveness and thus exchange rates against the Swiss franc.

The current policy of negative interest rates differs from the exceptional measures taken by Swiss authorities in the late 1970s. At that time, negative rates were levied directly on deposits in Swiss francs made by non-residents. Moreover, private persons or companies residing in Switzerland were not allowed to sell domestic securities to non-residents. These measures and restrictions – directly targeted at foreign customers – were, however, not very effective since too many loopholes existed. Moreover, they created serious distortions and had a negative impact on Switzerland's position as a financial centre and on its international wealth management. Our current negative interest rates are more effective since they impact overall macroeconomic conditions without loopholes and because they do not interfere with trading freedom.

Although negative interest rates may be painful for banks and investors in general, they are important measures for guaranteeing long-term macroeconomic stability under the current circumstances. They make the holding of Swiss assets relatively more expensive. In this way, they dampen the upward pressure on the Swiss franc and reduce the adjustment costs for the Swiss economy. They thereby also support the financial sector. Negative rates are thus a fundamental pillar of our current monetary policy. It is, however, also important to recognise that negative interest rates are a response to the current international environment and do not represent a long-term equilibrium.

Challenges ahead and long-term perspective

Ladies and gentlemen, I am coming to my final comments. Looking ahead, a robust and well-functioning financial sector will remain of utmost importance to Switzerland. It makes a major contribution to national GDP and provides vital financial services to the economy. These functions are also required during business cycle troughs and at times of exceptional policy measures. It is therefore important that banks remain resilient in difficult circumstances.

It is crucial that the Swiss financial sector adapts to the new environment and meets the current challenges. The macroeconomic cyclical headwinds in the recent crisis were followed by changes in the regulatory environment such as Basel III, the 'too big to fail' measures for systemically important banks and the countercyclical capital buffer. These measures are necessary to increase resilience. Banks also need to adjust to changing customer needs and to a more competitive and global environment.[10] This process of adaptation is challenging for the financial sector, but will be beneficial in the long term.

The SNB also faces challenges. The current significant overvaluation of the Swiss franc implies macroeconomic costs in terms of lower growth and employment as well as negative inflation. While these costs must be set against the long-term benefits of macroeconomic stability, they engender painful adjustment processes in the economy. Our current monetary policy therefore reflects this difficult economic environment. Its two pillars, i.e. negative interest rates and foreign exchange interventions as required, serve to reduce the significant overvaluation of the Swiss franc and to guarantee price stability in the long run.

To conclude, I would again like to emphasise that in order to achieve the goals of the financial sector and the SNB, we both need one another. On the one hand, the SNB acts as the bank of banks, providing a stable currency, liquidity and a payment system on which banks rely. By ensuring price stability and contributing to financial stability, the SNB helps create the conditions in which the financial sector can flourish. Banks benefit from a strong

---

[10] See also Geneva Financial Center, *Economic Survey* 2015–2016, October 2015, which sets out the challenges Geneva, as a financial centre, is facing.

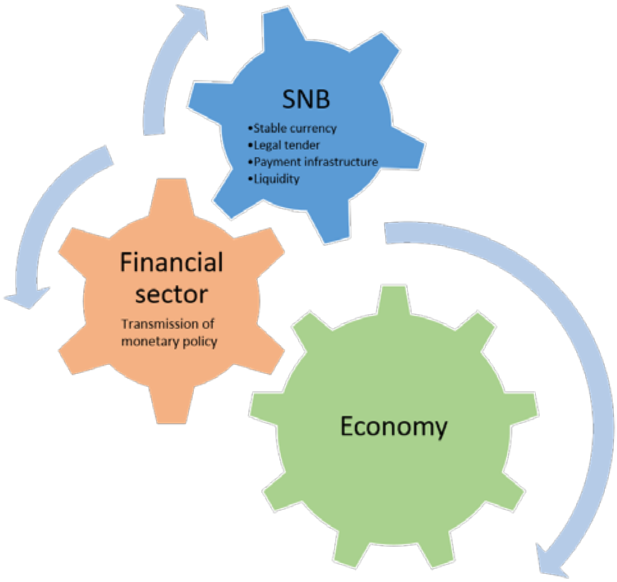
economy and long-term macroeconomic stability. On the other hand, the financial sector acts as an intermediary between monetary policy decisions and the overall economy. It contributes to an efficient economic system and to the prosperity of our country. The SNB thus needs a competitive and stable banking system to fulfil its mandate.

The long-term goals of the SNB and the banking sector usually go hand-in-hand. Monetary stability and a strong financial sector are in our common interest. They represent long-term assets for the whole economy and for Switzerland as a country.

Ladies and Gentlemen, thank you very much for your attention.

Charts

Chart 1



Source: SNB

Chart 2

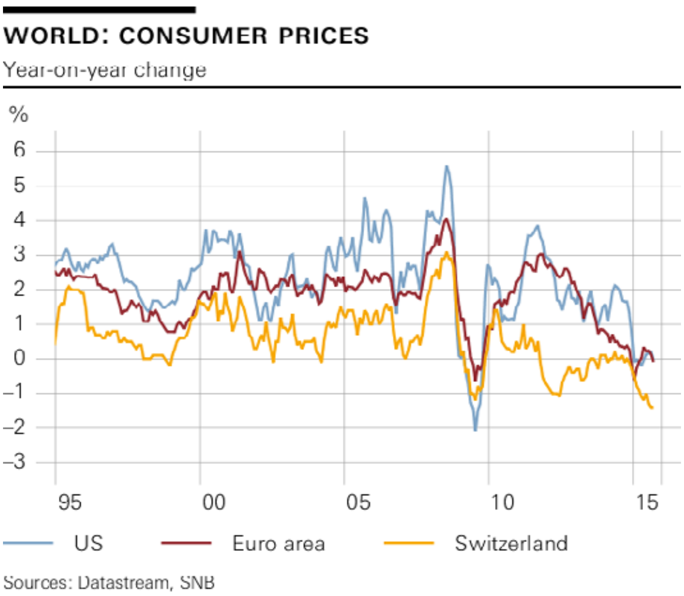


Chart 3

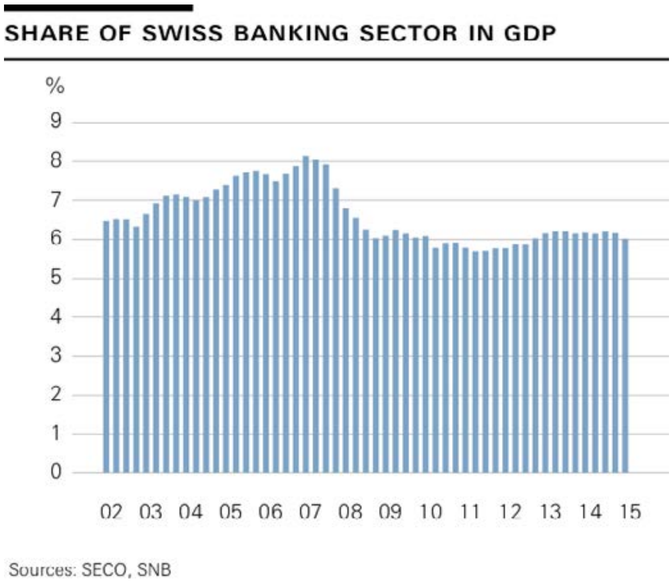


Chart 4

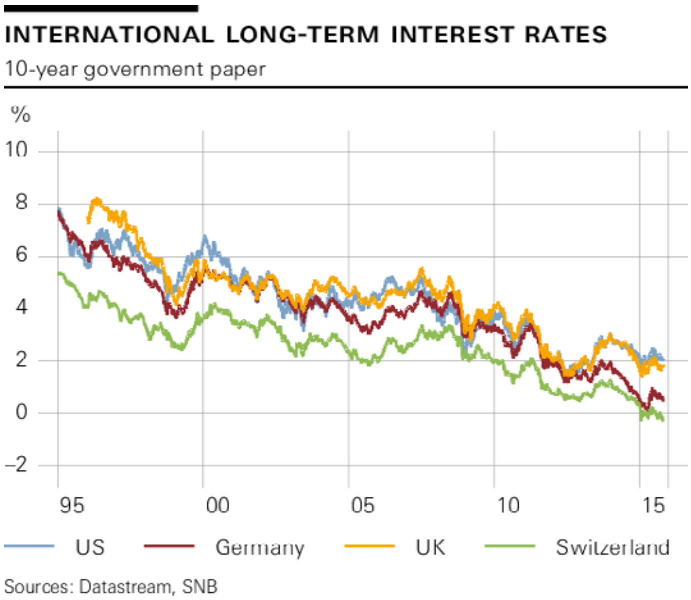
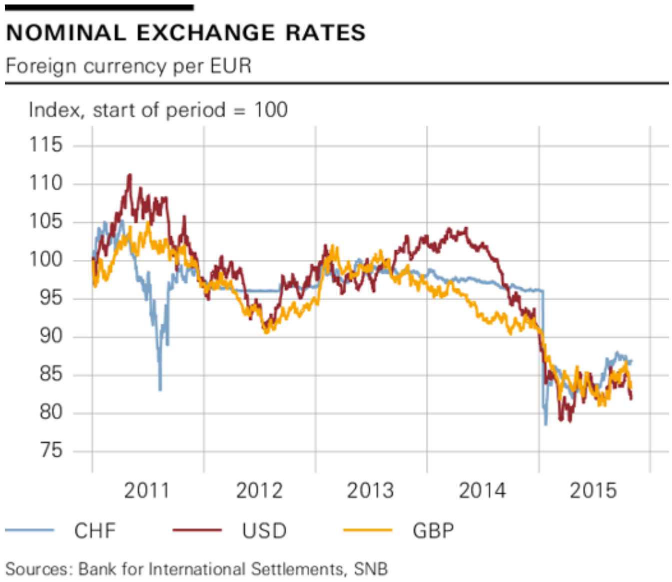


Chart 5


NOMINAL EXCHANGE RATES
Foreign currency per EUR
Index, start of period = 100
115
110
105
100
95
90
85
80
75
2011
2012
2013
2014
2015
CHF
USD
GBP
Sources: Bank for International Settlements, SNB