Andréa M Maechler: Monetary policy in 2015 – a first assessment

Speech by Ms Andréa M Maechler, Member of the Governing Board of the Swiss National Bank, at the Money Market Event, Geneva, 19 November 2015.

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Accompanying slides can be found at the end of the speech and on the Swiss National Bank's website.

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Ladies and gentlemen

It is my great pleasure to welcome you tonight to our traditional Money Market Event. I feel very honoured to be here in Geneva, the city of my birth, giving my first public speech for the Swiss National Bank (SNB), having joined the Governing Board in July this year.

It has been a very eventful year for monetary policy in Switzerland. In January, the SNB took two momentous decisions: It discontinued the minimum exchange rate against the euro, and lowered the interest rate on sight deposits further into negative territory. Thus, the SNB's monetary policy has changed significantly. Tonight, I shall provide a first assessment of this new monetary policy environment.

My speech is divided into three parts. First, I shall discuss the SNB's monetary policy since the discontinuation of the minimum exchange rate, and the impact on the Swiss franc exchange rate. Second, I will assess how the negative interest rate as a policy instrument has been transmitted to different segments of the financial markets. Finally, I shall discuss the outlook for economic growth and inflation in Switzerland.

Following my speech, my colleague Dewet Moser will take a closer look at the many operational aspects involved in the implementation of our monetary policy.

Monetary policy environment: breaking new ground

On 15 January, the SNB discontinued its minimum exchange rate of CHF 1.20 to the euro, and announced a further cut in the interest rate on sight deposits to –0.75%. These decisions were the response to international developments. Over the course of 2014, market participants began to expect that the US central bank, the Federal Reserve would start increasing its policy rates. Meanwhile, the ECB indicated that additional monetary stimulus would be required in the euro area. As a result, the euro weakened substantially against the US dollar.

The euro/Swiss franc minimum exchange rate came under intense pressure, and by mid-January 2015, it had become clear that it was no longer sustainable. Had the SNB not acted as it did in discontinuing the minimum exchange rate against the euro, it would have been forced to buy enormous amounts of foreign currency. The SNB's balance sheet would have expanded rapidly, potentially to a size that would have severely impaired our ability to fulfil our constitutional mandate in the long term.

Since the discontinuation of the minimum exchange rate, the SNB's monetary policy has been based on two pillars, which are designed to mitigate upward pressure on the Swiss franc and to ensure price stability over the medium term. 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. These two pillars are complementary and mutually reinforcing policy instruments.

The negative interest rate

The negative interest rate applies to sight deposits above a certain threshold, held by banks and other financial market participants at the SNB. This threshold was introduced to limit the financial burden on banks. It was set at 20 times the minimum reserve requirements. By linking the threshold to the statutory minimum reserve requirement, the SNB adopted a measure that is both firmly anchored in law and for which clear rules exist. For depositors that are not subject to minimum reserve requirements, a fixed exemption threshold of at least CHF 10 million has been set.

The thresholds imply that banks which hold large sight deposits relative to their minimum reserve requirements are affected most by the negative interest rate. Thus, like any other monetary policy measure, the negative interest rate affects different market participants differently. However, in the interests of the Swiss economy as a whole, it is important that the negative interest rate be allowed to function as effectively as possible, by applying it broadly and keeping exceptions to a minimum.

The aim of the negative interest rate is to reduce the relative attractiveness of Swiss franc investments, and to counter upward pressure on the exchange rate. Hence, it is primarily directed at the external contributions to monetary conditions in Switzerland. As such, the negative interest rate is not an ordinary policy instrument. It is a consequence of the fragile international environment and its exceptionally low interest rates. Historically, Swiss interest rates have been lower than those of our main trading partners. This interest rate differential is a reflection of our country's long-standing strengths, including political stability, sound institutions, a resilient economy, and a first-class financial sector.

My first chart shows the interest rates of German and Swiss ten-year government bonds. The orange area indicates the interest rate differential. As central banks around the world fought to mitigate the worst effects of the global financial crisis, short-term interest rates in many advanced economies fell towards zero. Importantly, foreign interest rates, including those in Germany, have fallen more sharply than those in Switzerland. As a result, Switzerland's interest rate differential had practically disappeared, making Swiss franc investments more attractive than comparable investments in other currencies. By lowering the interest rate on sight deposits into negative territory, the SNB restored the traditional interest rate differential to more normal levels, as illustrated by the orange area in the chart.

The SNB's willingness to intervene in foreign exchange markets

A higher interest rate differential reduces the relative attractiveness of the Swiss franc. However, financial markets may be exposed to a sudden increase in volatility, which could lead to a sharp rise in the demand for Swiss francs. This is where our willingness to intervene in the foreign exchange market plays a crucial role in stabilising the markets. For example, this summer, when the Greek government announced a referendum on the international bailout programme, we intervened in the forex market at a time of great market volatility and global uncertainty. This willingness to intervene in the forex market as required is a key pillar of our monetary policy.

The size of the SNB's balance sheet reflects our monetary policy measures. One consequence of a larger balance sheet is larger fluctuations in the financial results. In the first three quarters of this year, the SNB incurred a provisional loss of CHF 34 billion, predominantly reflecting valuation effects following the discontinuation of the minimum exchange rate. This is shown in chart 2. It is still too early to draw conclusions for the 2015 year-end result, particularly in the current volatile international environment.

Let me be clear, however: It is not the purpose of the SNB to generate and distribute profits. Instead, the SNB's main concern is to conduct a monetary policy that serves the interests of the country as a whole. Our monetary policy operations have a direct impact on the SNB's balance sheet, meaning that substantial losses may occur in individual years. Significantly, however, in the long term, our financial results should be positive, thanks to our monopoly on creating banknotes and sight deposits, which ensures low funding costs.

The Swiss franc since the discontinuation of the minimum exchange rate

Our two-pronged monetary policy is proving effective in reducing the relative attractiveness of the Swiss franc. After the sharp appreciation immediately following the discontinuation of the minimum exchange rate, the franc has weakened steadily against the euro, despite intermittent bouts of heightened financial market volatility during the summer. However, the Swiss franc remains significantly overvalued. For example, the real effective exchange rate – the Swiss franc's exchange rate against a basket of currencies of our main trading partners – is still around 15% above its long-term average, compared to less than 10% at the end of 2014.

The situation on the foreign exchange market has not yet normalised. Chart 3 shows that private capital outflows, which have traditionally balanced Switzerland's structural current account surpluses, have turned into net inflows since the global financial crisis. Changing investor preferences are behind this reversal of capital flows. While global economic conditions have improved, substantial uncertainty remains, causing some investors to seek the relative safety of the Swiss franc. This also applies to domestic investors, including large institutional investors, which have partly repatriated their assets and investment returns. Until investor preferences normalise, the franc is likely to remain under pressure. The second quarter of 2015 suggests a return to net capital outflows – a development undoubtedly supported by the negative interest rate. However, it is too early to say whether this is the beginning of a new trend.

Transmission of the negative interest rate to financial markets

This brings me to the question of how the negative interest rate has been transmitted to the different segments of the Swiss financial market.

With regard to money and capital markets, our experience so far shows that the negative interest rate has worked remarkably well. The entire term structure of interest rates has shifted downwards without generating market disruptions. This is illustrated in chart 4. After an initial undershooting, the Swiss franc three-month Libor levelled off in the middle of the SNB's target range of –1.25% to –0.25%. Other money market rates followed suit, leaving spreads between the different money market rates more or less unchanged.

From the money market, the negative interest rate worked its way to the capital markets. Government bond yields fell across the entire yield curve, with short-term yields dropping more than yields of longer maturities. Yields on Swiss government bonds are currently negative up to a maturity of 13 years. In the market for private sector bonds, interest rates fell as well, but not by as much as government bond yields, reflecting the greater substitution opportunities for corporate bond investors.

While the introduction of the negative interest rate caused interest rates on the money and capital markets to decline, mortgage rates did not decrease to the same extent. Indeed, for long-term mortgages, interest rates are slightly higher than they were at the beginning of the year. This is because banks' refinancing costs have not fallen to the same extent as money market interest rates. As a result, banks' interest margins have come under pressure.[1] To partially offset this effect, banks have raised their mortgage interest rates. As yet, therefore, fears that the negative interest rate might contribute to stronger growth in mortgage lending have proved unfounded.

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[1] This affects the banks' "liability margin", which is the difference between the interest on maturity-matched alternative funding sources and the interest on deposits.

The Swiss economy in a difficult environment

So far, I have spoken mainly about exchange rates and interest rates – that is, monetary conditions in the Swiss economy. I would now like to turn to the real economy. Switzerland is a relatively small open economy.[2] In general, this means that international developments matter a lot to Switzerland. However, during the global recession of 2009 and the sluggish recovery that followed, the Swiss economy proved to be surprisingly resilient. The reasons for this relatively strong performance are manifold: To start with, Switzerland did not suffer from a housing market correction or over-indebtedness of the private sector. Moreover, favourable labour market conditions and migration have remained a constant support to private consumption.

Chart 5 shows the level of GDP for different countries, indexed to 100 at the respective pre-crisis peak. Swiss GDP is now nearly 8% above its pre-crisis peak. As can be seen in the chart, among large advanced economies this performance is matched only by the US. Economic growth held up relatively well even in years when the economy faced a strong and abrupt exchange rate appreciation. A major factor here is monetary policy: With its monetary policy measures, the SNB was able to absorb some of the risks affecting the economy during the various episodes of the financial crisis.

Another factor is the Swiss economy's high degree of competiveness. Chart 6 shows that Switzerland topped the global competitiveness ranking once again in the World Economic Forum's report for 2015–2016. Swiss companies' technological readiness, business sophistication and flexibility are among the factors that make Switzerland one of the most competitive countries in the world.

This is not to say that adjustment is painless. Far from it: Organisational changes are never easy and cost-cutting is often painful – especially for employees. Moreover, the relative resilience of real GDP growth is to some extent due to companies' willingness to accept lower profit margins. Chart 7 shows real, i.e. inflation-adjusted, export volumes and nominal export turnover. While nominal export turnover fell sharply, real export volumes held up much better. Hence, when the strong appreciation of the Swiss franc raised prices for foreign buyers of Swiss products, Swiss companies responded by cutting export prices, thereby preventing a sharp fall in real export volumes. Further evidence for this 'margin compression' comes from our own surveys, which SNB delegates for regional economic relations conduct regularly among Swiss companies.

Global demand conditions have deteriorated somewhat in recent months. Emerging market economies in particular – but also some commodity-producing countries – have seen economic momentum fade. By contrast, major advanced economies continue to recover, albeit at a modest pace. On balance, we expect the global economy to grow moderately in the coming years. This should help to partially offset the drag from the overvalued Swiss franc. Thus, following a contraction in the first quarter of 2015, economic activity in Switzerland expanded again in the second quarter. In our estimation, GDP is likely to grow by close to 1% this year.

Price stability is not in doubt

In the last part of my speech, I would like to present our inflation outlook. Last year, the inflation rate – as measured by the consumer price index – averaged around zero. This year, inflation has fallen well into negative territory. Two factors are behind this development: the sharp appreciation of the Swiss franc following the discontinuation of the minimum exchange

[2] According to World Bank data, the Swiss economy ranked 20th out of 194 countries in 2014. Switzerland's export intensity is significantly above the OECD average.

rate and the pronounced fall in oil prices last year. These factors are transitory, and as such do not pose a threat to price stability over time in Switzerland.

Exchange rate appreciation and the energy price decline are the results of international spillovers that affect consumer prices primarily by lowering import price inflation.[3] Chart 8 shows that most of the downward pressure on Swiss inflation is attributable to these international spillovers. However, as can be seen in the chart, domestic price components have shifted down as well. This harks back to the flexibility of Swiss companies, which I referred to earlier. In particular, those Swiss companies that compete in markets for imported goods have lowered their prices in order to maintain competitiveness in the wake of the exchange rate appreciation. Such price cuts play an important role in restoring the Swiss economy's price competitiveness over the medium term. They are thus part of the adjustment process in response to the sudden exchange rate appreciation. That such a process can be painful for some of the companies directly involved goes without saying.

For this year, we expect consumer price inflation to average about –1.2%. We think that the inflation rate will reach its trough this quarter. For 2016, we expect average inflation of −0.5%. As you can see from the chart, inflation will move back into positive territory in early 2017. These forecasts assume that the three-month Libor remains at –0.75% over the entire forecast horizon, that the Brent crude oil price remains at USD 50 per barrel and that the Swiss franc weakens.

Again, our forecasts show that the current period of negative inflation is temporary. Nevertheless, even temporarily negative inflation rates are undesirable. Yet they cannot always be avoided – especially during phases of strong exchange rate appreciation. What matters is that inflation expectations remain firmly anchored and that monetary policy is able to ensure medium-term price stability. Medium and long-term inflation expectations are still positive. This can be seen in various surveys of inflation expectations, and is confirmed by discussions between the SNB's delegates for regional economic relations and company representatives from different sectors of the economy. Thus, we do not expect sustained negative inflation, let alone a deflationary spiral.

Concluding remarks

This brings me to the end of my speech. Earlier this year, the SNB took some far-reaching decisions: It discontinued the minimum exchange rate against the euro, and lowered the negative interest rate on sight deposits significantly into negative territory. These measures were necessary to promote adequate monetary conditions for the Swiss economy, and to ensure the SNB's ability to provide medium-term price stability in the future.

Since mid-January this year, the SNB's monetary policy has been based on two complementary pillars: The negative interest rate and our willingness to intervene on the foreign exchange market as required. These instruments are proving effective at countering excessive pressure on the exchange rate, thereby ensuring price stability in the medium term. However, I would like to stress that, at current levels, the Swiss franc remains significantly overvalued.

With an interest rate of –0.75% on sight deposits, we have gone far compared to most other countries. We have observed that money and capital markets are functioning smoothly under the negative interest rate. However, mortgage rates have not fallen to the same extent as interest rates on money and capital markets. Hence, fears that the negative interest rate

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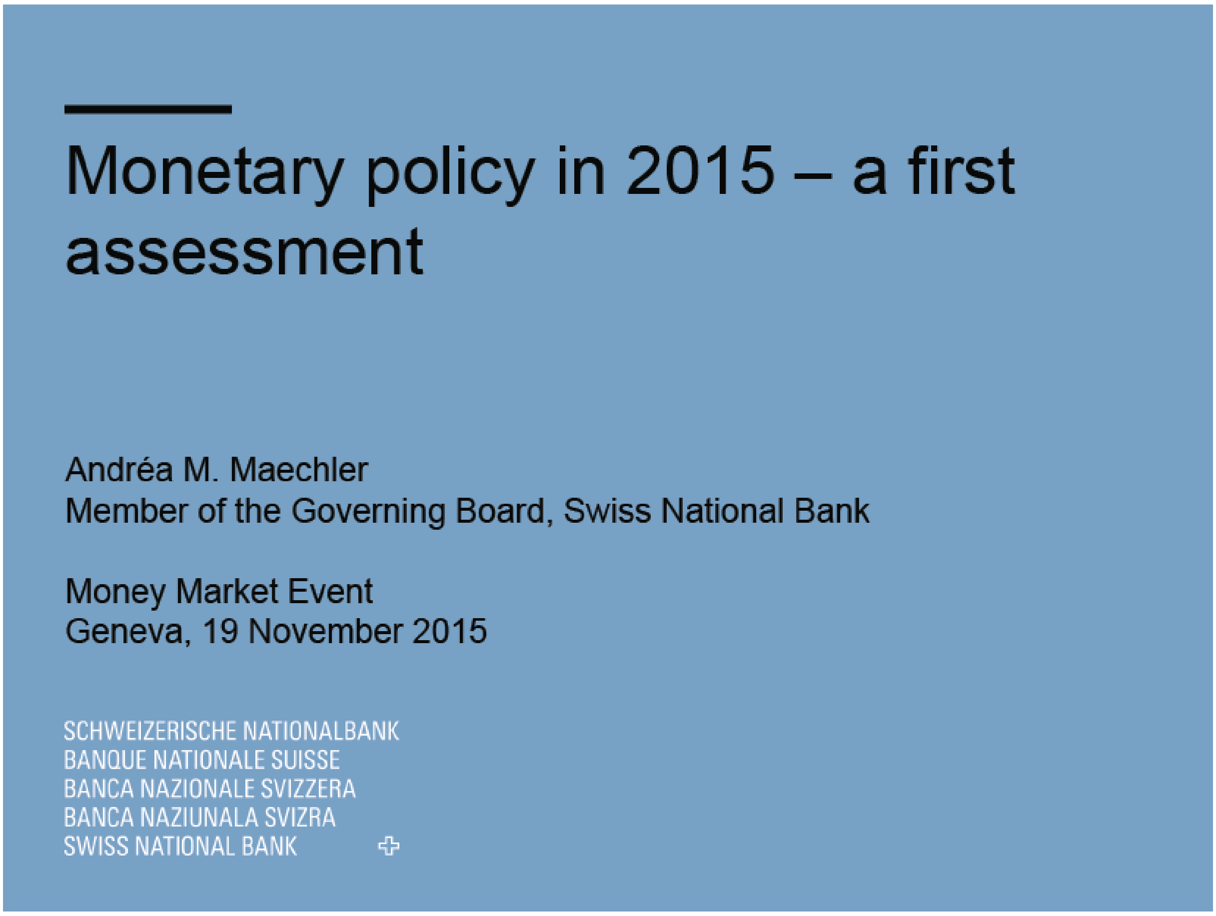
3 Jordan, T. (2015) "The impact of international spillovers on inflation dynamics and independent monetary policy: the Swiss experience", conference paper prepared for the 39th Economic Symposium on 'Inflation Dynamics and Monetary Policy' in Jackson Hole, 28 August 2015.

could contribute to imbalances on the mortgage and real estate markets have so far proved unfounded.

Finally, economic conditions remain challenging in Switzerland. The SNB monitors the situation continuously, and our latest analysis and forecast will be published at the next monetary policy assessment on 10 December. In general, we believe that the economy has returned to a moderate path of recovery, although significant downside risks remain. These originate, in particular, from the fragile international environment and exchange rate developments. Currently, the inflation rate is too low, but the main factors pushing down domestic inflation are of a transitory nature. Medium-term price stability is not in doubt.

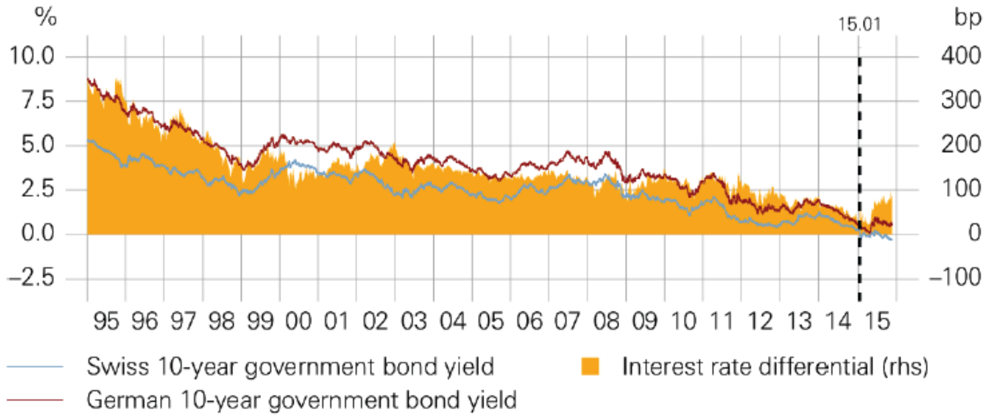
Thank you very much for your attention.



The negative interest rate partly restored the traditional interest rate differential

INTEREST RATE DIFFERENTIAL

Spread between German and Swiss 10-year interest rates



Sources: SNB, Bloomberg

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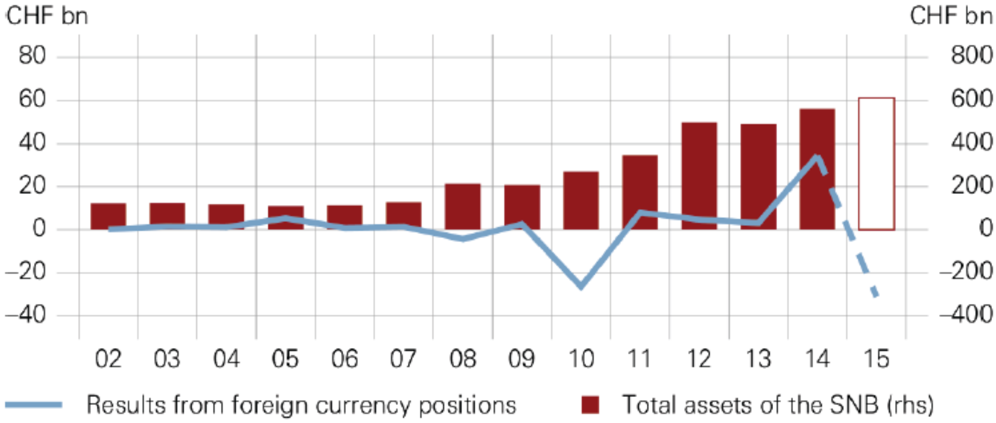
The SNB's financial results have become more volatile

TOTAL ASSETS AND RESULTS OF THE SNB

Values for 2015 are provisional and include only the first three quarters



Source: SNB

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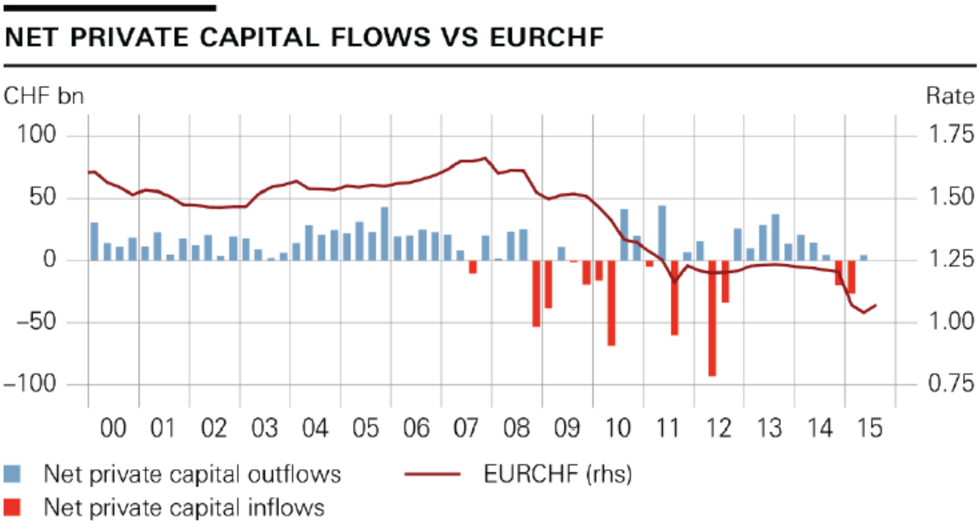
Swiss franc's strength reflects net private capital inflows



Sources: SNB, Bloomberg

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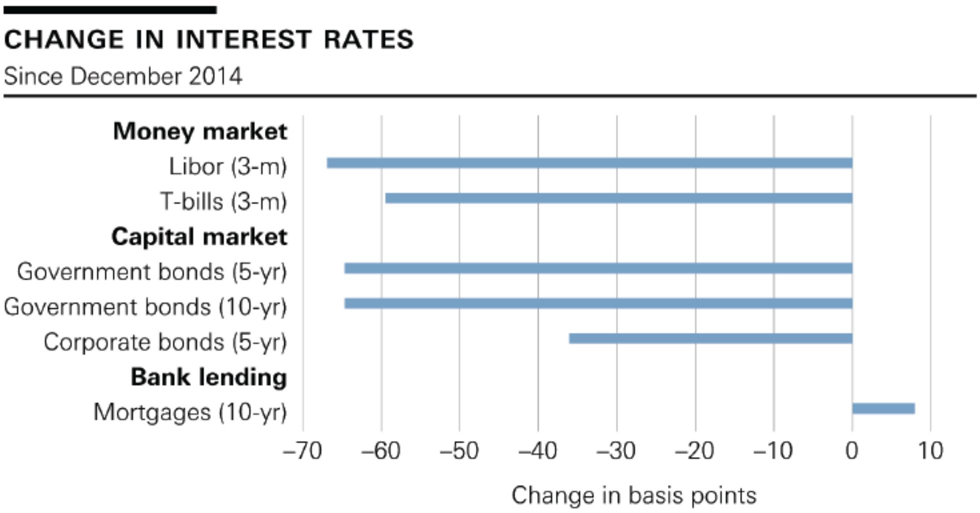
Transmission of the negative interest rate to money and capital markets has worked remarkably well



Sources: SNB, Bloomberg

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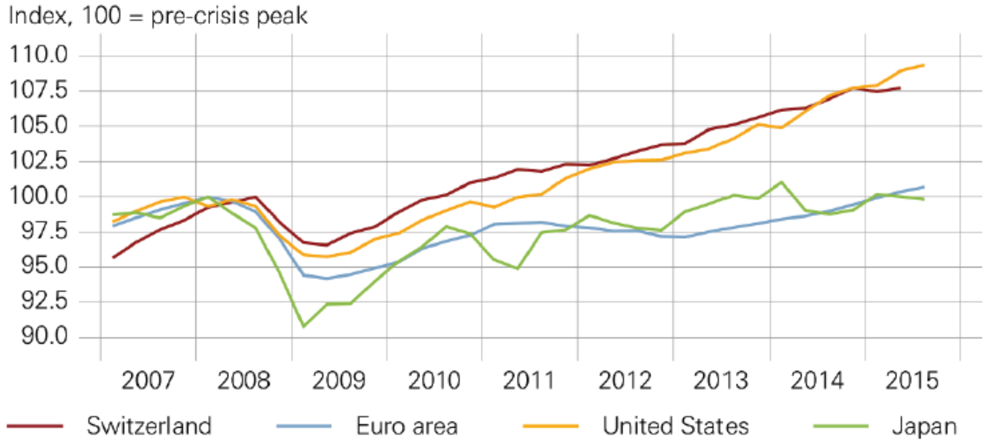
The Swiss economy performed relatively well in a difficult international environment

REAL GDP



Sources: SNB, Datastream

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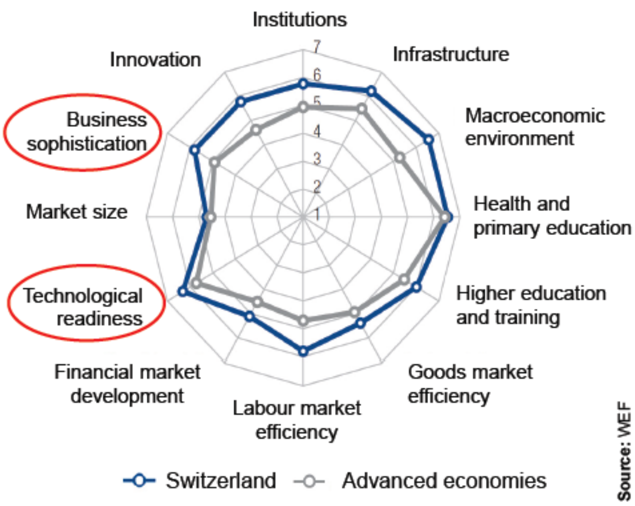
The Swiss economy is highly competitive

WEF GLOBAL COMPETITIVENESS REPORT 2015-16

Rank	Country
1	Switzerland
2	Singapore
3	US
4	Germany
5	Netherlands
6	Japan
7	Hong Kong
8	Finland
9	Sweden
10	UK



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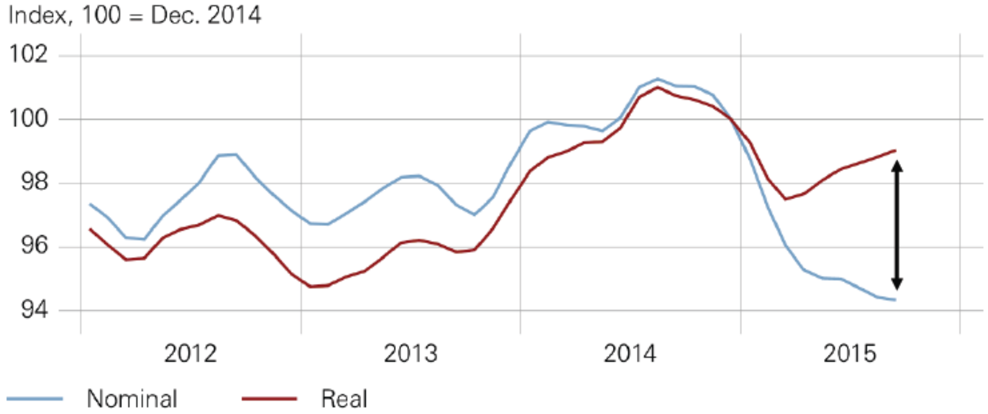
Exporters lowered profit margins to maintain real export volumes

SWISS MERCHANDISE EXPORTS

Trend-cycle components

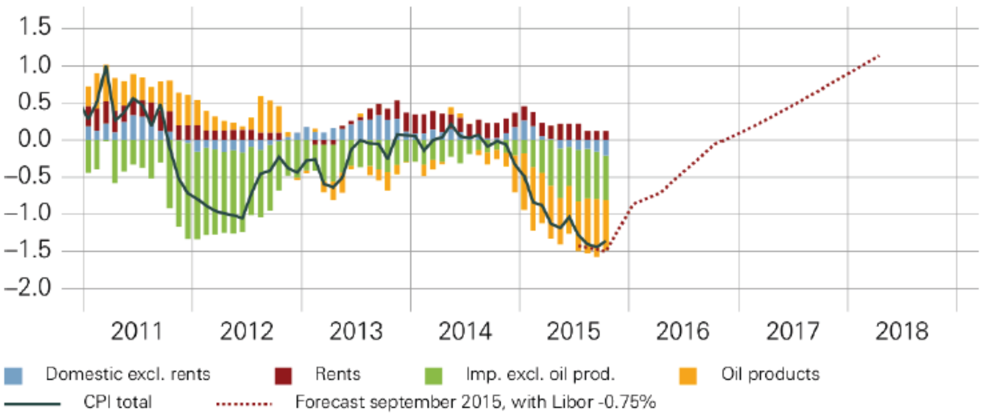


Sources: SNB, SCA

Price stability is ensured over the medium term

CONTRIBUTIONS TO CPI INFLATION AND CONDITIONAL FORECAST

In percentage points, CPI inflation y/y in %



Source: SNB