Thomas Jordan: Comments on Swiss monetary policy

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the 108th Ordinary General Meeting of Shareholders of the Swiss National Bank, Berne, 29 April 2016.

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Mr President of the Bank Council

Dear Shareholders

Dear Guests

Our last ordinary general meeting was dominated by the discontinuation of the minimum exchange rate. The past year has been a difficult one, with the Swiss economy once again demonstrating great flexibility and adaptability. It was also a year during which there has been broad discussion in the public arena of the monetary policy of the Swiss National Bank. It is essential that the judgements we make and the measures we take are fully understood, if our monetary policy is to be effective and trust is to be maintained in the SNB. In my comments today I would therefore like to outline once again our current monetary policy and our views on key issues.

I shall divide my speech into two parts. First, I will talk about economic developments and briefly recap our reasons for discontinuing the minimum exchange rate. Then I will take a look at the current economic situation. In this context, I will discuss our mandate of ensuring price stability. I will conclude this part by looking ahead to the challenges that face us in the future.

In the second half of my speech, I will address two ideas, which are the subject of current public debate and which would have a direct impact on the SNB were they to become reality: namely the creation of a sovereign wealth fund using the SNB's foreign exchange reserves, and the sovereign money initiative.

Economic developments

Discontinuation of minimum exchange rate

Let's start then by casting our minds back to last year. On 15 January 2015, the SNB discontinued the minimum exchange rate of CHF 1.20 per euro. This had been introduced as a temporary measure in September 2011 in exceptional circumstances. The Swiss franc's safe-haven status had caused it to appreciate rapidly and sharply against virtually all currencies. The consequent massive overvaluation of the Swiss franc had posed a threat to the Swiss economy and carried the risk of deflation. The minimum exchange rate put a stop to these developments.

In the subsequent almost three and a half years until January 2015, the situation changed fundamentally. Global uncertainty eased and the Swiss economy gained ground once again. By contrast, recovery in the euro area continued to be sluggish. The euro had already steadily weakened against major currencies in the second half of 2014. Furthermore, at the start of 2015, there were signs of further easing of monetary policy in the euro area. Against this backdrop, the euro was expected to weaken further. In contrast to 2011, the environment at the beginning of 2015 was no longer characterised by Swiss franc strength, but by broad-based euro weakness.

In these circumstances, the minimum exchange rate was no longer sustainable. The SNB could only have enforced it through ongoing foreign currency purchases of rapidly increasing magnitude. However, there would still have been no prospect of a long-term stabilisation of the situation. An uncontrolled expansion of the balance sheet would have compromised the SNB's ability to conduct monetary policy in the long term. Continuing to uphold the minimum exchange rate was therefore no longer justifiable.

Delaying any decision to discontinue would also not have helped the situation. On the contrary, if we had not faced facts and had delayed abandoning the minimum rate, the turbulence on the foreign exchange markets would have been no less severe. The impact on the economy would have been just as great, while the losses on the foreign exchange reserves would have been considerably heavier.

The Swiss franc initially appreciated sharply on 15 January 2015. In the meantime, it has broadly declined, although it is still considerably stronger against the euro than before discontinuation. This is attributable to the persistent weakness of the euro. Developments since January 2015 have confirmed that our assessment at the time was correct.

Current situation

The discontinuation of the minimum exchange rate marked a shift in our monetary policy focus. It is now based on two key elements. The first is the negative interest rate, which is currently –0.75%. This is charged on sight deposits held at the SNB by banks and other financial market participants. The second is our willingness to intervene in the foreign exchange market as necessary, while taking the overall currency situation into consideration. Our monetary policy is thus expansionary and aimed at easing pressure on the Swiss franc, thereby ensuring price stability in the medium term.

Many feared a recession on the back of the discontinuation of the minimum exchange rate and the rapid appreciation of the Swiss franc. Yet our economy grew by 0.9% last year. This may not be a strong growth rate, but it is still a good sign. On the one hand, it reflects the flexibility and adaptability of Swiss companies and employees. On the other, the economy was also supported by our expansionary monetary policy. This contributed to the weakening of the Swiss franc over the course of the past year. It remains significantly overvalued, however.

The slight increase in economic output in Switzerland is a positive development, particularly in view of the continued tentative recovery of the global economy. This hesitant recovery was accompanied by a collapse in commodity prices in 2015, in which both weak demand and increased oil production played a role.

The drop in oil prices and the appreciation of the franc following the discontinuation of the minimum exchange rate pushed inflation in Switzerland into negative territory. Both factors produce a one-off downward adjustment in prices. The resulting effect on inflation is thus only temporary. Over recent months, inflation has been observed to be edging back up towards the zero mark.

Mandate

The SNB's statutory mandate is to ensure price stability while taking due account of economic developments. We equate price stability with a situation in which the inflation rate is below 2%, but still positive. Unlike other central banks, we do not have a percentage inflation target.

There are good reasons for this. A small open economy like Switzerland is continuously exposed to powerful outside influences. Monetary policy cannot always entirely offset these influences. It therefore makes sense for us to stabilise inflation within a range over the medium term. In the case of very large or recurrent unfavourable influences from abroad, inflation may temporarily turn negative. Often, this is also part of the process of real economic adjustment.

The global economy has been exposed to a series of powerful shocks over the past ten years or so. Central banks worldwide have reacted with interest rate reductions and unconventional measures. We too have resorted to unconventional methods and, as in the past, we will not shy away from using these methods if it is in the interests of the country as a whole. However, any action we take will always be based on careful consideration of the costs and benefits in the short and long term.

Outlook

Let me conclude the first part of my speech with a brief look into the future. The world economy is recovering at a slower pace than anticipated at the end of 2015, but the global outlook remains positive. We are expecting moderate economic growth in Switzerland for this year of 1–1.5%. Inflation will rise slightly, although the annual average will remain negative at an expected rate of –0.8%. The inflation rate should re-enter positive territory in 2017.

As in past years, the economic outlook is fraught with a number of different risks. This applies to the euro area, to the US and to emerging economies. The international financial markets are characterised by uncertainty, which in turn can have adverse effects on the global economy. And last but not least, there are considerable political risks in Europe and beyond.

In this difficult environment, we will continue to deploy the instruments available to us to ensure price stability in Switzerland in the medium term. Even though we have already gone a long way with negative interest and our willingness to intervene in the markets, there is still room for manoeuvre in our monetary policy.

Ideas for Switzerland: sovereign wealth fund and sovereign money initiatives

I would now like to turn in the second part of my speech to the sovereign wealth fund and sovereign money initiatives. The events of recent years have given cause for reflection on the financial system and the role of central banks. As the President of the Bank Council has already described, we welcome such discussions. They enhance the public's understanding of what central banks do and why they do it.

Sovereign wealth fund

The SNB's balance sheet has expanded sharply since 2008. It is this growth that inspired the idea to set up a sovereign wealth fund to manage the SNB's foreign exchange reserves. A number of different options are being proposed for the structure of the sovereign wealth fund. Although proponents' goals differ quite considerably, they all draw parallels with the sovereign wealth funds of countries such as Norway.

However, comparisons with Norway are misleading, since this country supplies its sovereign wealth fund with tax revenues, licence fees and dividends from the oil sector. When companies in a country discover new natural resources, the country becomes richer as a result of the revenue generated and its wealth increases. By contrast, the exceptional growth in the SNB's balance sheet since 2008 is primarily attributable to foreign currency purchases based on monetary policy considerations. We bought foreign currency in order to limit the appreciation of our own currency, thereby putting more Swiss francs into circulation. Such an expansion of the money supply, however, does not create any real value.

This difference between oil revenues and foreign exchange reserves is important when contemplating setting up a sovereign wealth fund. Norway is able to transfer oil-sector tax revenue and other receipts into its sovereign wealth fund, because they constitute profit for the country as a whole. The SNB's foreign exchange reserves, however, do not represent profit. They are an asset item on our balance sheet and are offset by the increased money supply as a liability item. If we were to make an unrequited transfer of our foreign currency to a sovereign wealth fund, our equity would reduce or even become negative.

The sovereign wealth fund or the Confederation would therefore have to buy the foreign currency from us. But where the money would come from for this is not clear. In principle, the Confederation could borrow from the capital markets, though this is unlikely to be feasible due to the debt brake. Or, we could grant the Confederation a loan, but this would be equivalent to state financing via the central bank's printing press, which is prohibited under the National Bank Act.

A further problem would arise if, in the future, a reduction in the money supply were to become necessary for monetary policy reasons. The money supply was originally expanded to satisfy the increased demand for francs. However, it is possible that demand may also fall again. If there were to be a sharp decline in demand, the SNB would have to reduce the money supply again in order to keep monetary policy conditions stable. The simplest way would be to buy back Swiss francs, namely by selling foreign exchange reserves. But if the foreign exchange had already been transferred to a sovereign wealth fund, this would no longer be possible.

Another hope expressed in connection with the creation of a sovereign wealth fund is better management of foreign exchange reserves. However, the SNB already manages its foreign exchange in a professional manner and is considered to be a leading central bank in asset management. We have also invested in a broad range of assets for a number of years now. Our portfolio is diversified over different currencies and asset classes, and we invest heavily in foreign shares and corporate bonds. Equity exposure is 20%, which is high for a central bank.

On a long-term average, higher profits are only possible by taking higher risks. This would also apply to a sovereign wealth fund. However, higher risks also mean that profit fluctuations would be greater than before.

Of course, a sovereign wealth fund could hedge against certain risks. Exchange rate risk represents the biggest risk for foreign currency investments. But it is precisely this risk that a sovereign wealth fund should not be allowed to hedge, as it would conflict with monetary policy. This is because hedging would result in upward pressure on the Swiss franc, which would run counter to our monetary policy. Incidentally, this is also the reason why a sovereign wealth fund should not be permitted to sell foreign currency. To sum up: a sovereign wealth fund would not make monetary policy easier but more difficult.

Sovereign money

The other initiative that I would like to talk about today is the sovereign money initiative submitted some time ago. This has two main elements. The first one relates to household and corporate bank accounts, the second to the mechanism with which new money is put into circulation.

The initiative calls for the creation of payment accounts for households and companies, to be held off-balance sheet by banks, just as securities custody accounts are now. These accounts would be fully covered by SNB money. The idea is that this would prevent bank runs and thereby improve the stability of the banking system. A bank run typically occurs when customers fear that their bank will no longer be able to pay out their deposits. As payment accounts in a sovereign money system would be covered by SNB money, there would be no more reason to doubt the security of these deposits.

Yet, this does not mean that the financial system would become more stable overall. For example, the sovereign money system cannot prevent financial bubbles, as these are based primarily on investor misjudgement. Although the sovereign money initiative would somewhat complicate the financing of such misinvestments, it would not prevent them. Improved bank capitalisation, which is something we have advocated, contributes considerably more to increasing the stability of the financial system than a sovereign money system.

The second element of the sovereign money initiative is the so-called debt-free creation of new central bank money. Money would enter circulation by the SNB gifting it, so to speak, to the Confederation, the cantons or directly to citizens. Such money distribution would fuel the politicisation of monetary policy.

The Federal Council has rejected the initiative without a counterproposal. It maintains that a sovereign money system would be an experiment for which there are no comparable models in other countries, and would carry risks for the Swiss economy. The implementation of the sovereign money idea would entail a complete restructuring of today's monetary system. This would give rise to great uncertainty, could jeopardise the financial centre and thus damage Switzerland as a whole. The Federal Council also fears that the sovereign money system would harm lending and restrict the SNB's ability to conduct monetary policy.

We share the Federal Council's concerns. A feeling of disquiet about the existing financial system is not enough reason for a radical overhaul. It is also difficult to predict what impact such an experiment would have on Switzerland as a business location. Moreover, the SNB's independence would be undermined if we had to distribute new money directly to the state or to private households. The SNB would become a political football and the fulfilment of our mandate would be hampered.

Conclusion

Let me conclude: the discontinuation of the minimum exchange rate did not plunge Switzerland into recession as many had feared. The economy actually grew slightly in 2015, despite appreciation of the Swiss franc and a hesitant recovery in the international economy. The main reason for this growth is that Swiss companies and employees actively exploited optimisation potential and showed great flexibility. The SNB's expansionary monetary policy contributed to the depreciation of the Swiss franc over the course of the year and thus also supported the economy.

Inflation is currently negative, due to the appreciation of the Swiss franc following the discontinuation of the minimum exchange rate and to the reduction in commodity prices. We expect it to return to positive territory in 2017. We will keep our options open should other measures be necessary to fulfil our mandate. But, as always with monetary policy decisions, we need to carefully weigh up the pros and cons to serve the interests of the country as a whole.

In the wake of the financial crisis and the use of unconventional measures, central banks have become the focus of intense public interest. Various reform proposals are being discussed and we welcome these public debates. New ideas need to be seriously considered and evaluated. The intentions behind the sovereign wealth fund and sovereign money projects are commendable. But, on closer examination, the drawbacks outweigh the benefits in both cases.

Finally, on behalf too of my colleagues in the Governing Board, Fritz Zurbrügg and Andréa Maechler, I would like to take this opportunity to thank our employees for their hard work and dedication. We would also like to thank our shareholders for their solidarity with the SNB and for their loyal support. Last but not least, a thank you also to our young guests from the Kantonsschule Olten and the Centro Professionale Commerciale Lugano for showing an interest in monetary policy and the SNB.

Thank you all for your attention.