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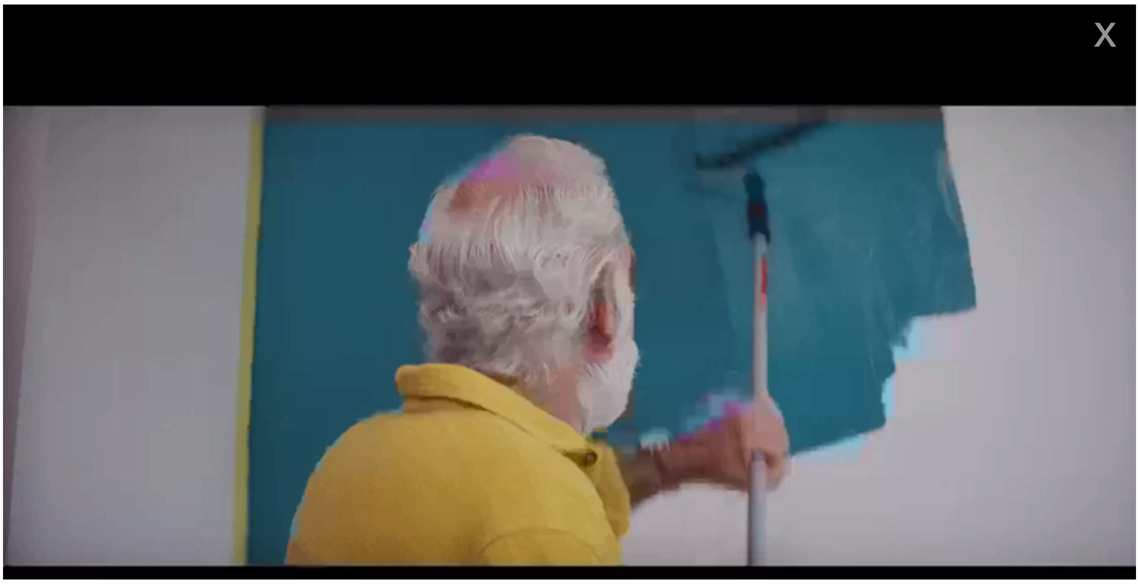
The SNB needs a strategy review

We do not know what its strategy is, not even whether it has formulated one internally. This makes a strong case for the SNB to undertake a review. A column by Charles Wyplosz.

CHARLES WYPLOSZ

«Wherever we look, we find that the exchange rate plays a paramount role.»

The Federal Reserve recently completed one, the ECB and the Bank of England are currently conducting one, the Bank of Canada does one every five years. The last time the Swiss National Bank reviewed its strategy was in 2000. Is it not time to do it again some time soon?



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The strategy as set out in 2000 was in line with then-current best practice: it aimed at price stability and it used the interest rate as its instrument. A key aspect of the strategy, back then, was that the franc was allowed to float freely. Even though the SNB retained the right to intervene on the foreign exchange market, it did not until 2009 when, following the global financial crisis, the franc's safe haven status resulted in large capital inflows. Since the inflows threatened to provoke a sharp appreciation of the franc, the SNB started to intervene on the foreign exchange market. Since then the franc is no longer freely floating. In September 2011, the SNB formally set a limit on how much the franc would be allowed to appreciate vis a vis the euro (the famous 1.20 floor). Occasional interventions became increasingly frequent with the crisis in the Euro Area. Facing ever stronger pressure, the 1.20 floor was abandoned in January 2015. This did not bring a lasting respite, though. Foreign exchange market interventions only grew in size and frequency. Right now, the situation has calmed down, and the franc has recently depreciated a little vis a vis the euro.

About the author

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Using the interest rate as the policy instrument lies at the heart of the 2000 strategy. Why then has the policy rate remained unchanged at –0.75% since January 2015? One interpretation is that there has been no need to change the policy, but it does not square easily with the repeated undershooting of the inflation rate as defined the SNB. A more convincing interpretation is that, in fact, the SNB is unable either to raise its interest rate, for fear of an exchange appreciation, or to lower it because it believes that it is the effective lower bound. Importantly, the apparent inactivity of the SNB mirrors the ECB's policy of keeping its own interest rate unchanged. This later interpretation suggests that monetary policy in the Euro Area exerts a powerful, possibly dominant influence on Swiss monetary policy. If true, this dominance must be acknowledged in the formulation of the strategy, which is not currently the case.

Side effects of foreign exchange interventions

The SNB is not the only central bank that has set a very low interest rate in the belief that it would not last. As it appeared that very low rates were more than a short-lived phenomenon, like many other central banks, the SNB has expanded its balance sheet several times over. Since 2000, the balance sheet as been multiplied almost 14 times, probably a world record. But, in sharp contrast with other central banks, this increase is almost entirely the side effect of foreign exchange interventions. While other central banks decide on their QE operations, which involve acquiring domestic assets along a planned and pre-announced path, the SNB purchases foreign assets as needed to stabilize the exchange rate. Thus, while balance sheet expansion is considered by other central banks as a new nonstandard policy instrument, in Switzerland it is the unplanned consequence of the SNB's exchange rate policy. Wherever we look, we find that the exchange rate plays a paramount role.

So, what is the exchange rate policy? On page 22 of its latest Annual Accountability Report (2019), the SNB states that «an independent monetary policy that is geared towards the objective of price stability fundamentally requires flexible exchange rates. This does not mean, however, that the SNB disregards exchange rate developments. In a small open economy such as Switzerland's, with a currency seen as a safe haven in times of uncertainty, changes in the exchange rate have a significant impact on inflation and the economy. They thus influence monetary policy decisions.» In clear, there is no exchange rate strategy.

The inescapable conclusion is that the monetary policy strategy announced in 2000 is still officially in place, but it has been quietly abandoned for at least a decade. The SNB may hope that it can be revived, but that depends on conditions over which it has no control, like the international financial and sanitary situations that occasionally make the franc a desirable safe haven. Meanwhile, we do not know what its strategy is, not even whether it has formulated one internally. This makes a strong case for the SNB to join its counterparts and undertake a review, if only to bridge the current situation to when it will be possible to revive the previous one, assuming that it is still desirable.

Caught in a vicious circle

What could such a review say? A key issue is the role of the exchange rate. The decision to let the franc float freely may have made sense twenty years ago, but this question deserves being revisited in view of what has happened since. It can be argued that a small open economy with a large financial sector highly integrated in international markets cannot simply disregard its exchange rate. The opposite view is that the Swiss economy is highly flexible and can absorb significant fluctuations of its currency. We need an evaluation of the past experience, in Switzerland and in other similar countries.

A review might also consider the inflation objective. Officially in charge of price stability, the SNB states that it «equates price stability with a rise in the Swiss consumer price index (CPI) of less than 2% per annum. Deflation, i.e. a sustained decrease in the price level, is also regarded as a breach of the objective of price stability.» Over the 12 years since 2009, inflation has been negative 5 times, so the SNB missed its own definition of price stability almost half of the time. This should not come as a surprise. It is caught in a vicious circle where low inflation means low interest rates and no room for the SNB to further lower them. Again, the SNB is not alone to be in this predicament, which has led other central banks to undertake reviews. There probably is no magical solution but various options deserve serious scrutiny. For instance, some central banks have committed themselves to a point target, usually set at 2%, sometimes higher or adjustable. Following its review, the Federal Reserve now aims to reach its target on average over business cycles, which could become the new standard.

A strategy review does not call for a revolution. It may even conclude not to change anything. It could open up the possibility for the SNB to engage into a discussion with all interested parties on what is the best that can be done under the current circumstances. It is especially helpful when the actual strategy differs from the announced one and when the key objective of price stability, as currently defined, is not achieved about half of the time.