Can the Swiss National Bank tame the Strong Swiss Franc? If so, is it worth it?

Simon J. Evenett

Last week the Swiss National Bank (SNB) announced--much to the surprise of financial markets--that it would take all necessary measures to ensure that the Swiss Franc traded at no less than 1.2 to the Euro. Previously the Swiss Franc had approached parity with the Euro, leading to a wave of complaints from Swiss exporters and the tourist sector. Swiss importers and holidaymakers, on the other hand, were quietly enjoying the best summer in recent decades.

The move by the SNB raises plenty of questions: Can it deliver? If it does deliver, at what cost to the Swiss economy? The purpose of this short note is to answer each question in turn.

Can the SNB deliver?

Almost certainly. Fixing the price of a currency isn't quite like trying to fix the price of a commodity, like an apple. This is because one party--the central bank--can generate an infinite quantity of a currency, whereas infinite demand or supply by apple farmers isn't physically possible. What this means is that--for a currency where purchases far exceed sales and the currency is appreciating--is that a central bank can step in and sell as much domestic currency as it likes. The potentially unlimited nature of such interventions makes it unwise to bet against the SNB. (When a central bank tries to stop a currency from depreciating, however, the story is completely different because the central bank only has a finite amount of foreign currency to sell as investors flee the domestic currency. Once those foreign currency reserves are gone, then the only available tool is ever higher interest rates, which sends the economy into a sharp recession. In short, intervening to stop a currency from appreciating isn't constrained in the same way as intervening to limit depreciations.)

While some commentators have argued that the SNB's actions will provide an artificial target for hedge funds to speculate against, an important countervailing force has been overlooked. If the Swiss Franc is not expected to fall below 1.2 to the Euro, then so long as Swiss interest rates remain much below those in world markets, then the Swiss Franc will become the perfect vehicle for the carry trade. Investors (in particular those wishing to buy Eurozone assets) will be all the more keen to borrow in Swiss Francs precisely because they believe this currency will not appreciate further against the Euro. Indeed, any future depreciation of the Swiss Franc would make repaying Swiss Franc borrowings less expensive in euro terms. One of the key risks associated with the carry trade would be taken off the table by the SNB, encouraging large scale borrowing from Swiss-based banks (including foreign banks) and sales of the Swiss Franc, which is exactly what the SNB wants to engineer. As a result the SNB may not have to intervene that often, so long as international interest rate differences remain as they are. Yet another reason not to bet against the SNB.

At what cost?

Before the SNB made its dramatic announcement much of the media commentary focused on the harm done by the rising Swiss Franc to selected Swiss commercial interests. Little attention was given to the beneficiaries of the high Swiss Franc. The one-sided nature of the discussion overlooked the redistributional nature of exchange rate policies. As will be argued below, any illusion that setting a certain exchange rate is going to make some better off without making others worse off should be dispelled. As well as having potentially important macroeconomic consequences, the SNB's actions effectively raid Peter's pocket to pay Paul.

One point a lot are making is that future inflows of funds into Switzerland will lead to a surge in property prices and stock market valuations. The "hot money," we are told, must go somewhere. Compared to what? is surely the right question to ask. Before the SNB acted one of the reasons for hot money inflows into Switzerland was the safe haven effect, which may remain. Another was the expectation that the Swiss Franc will continue to appreciate. If the SNB's action reduces the number of investors who continue to believe that the Swiss Franc strengthen over the short to medium term, then presumably one of the rationales for investing in Swiss Francs no longer applies. Unless, that is, market investors believe that rates of returns on Swiss assets are going to rise to offset the loss in exchange rate appreciation. Expectations of stock market and property price gains fit precisely here, which is why I suspect many make the point. But so do rises in interest rates on Swiss government bonds which, if any, will act as a drag on both property prices and the stock market. It is not so obvious that asset bubbles must follow the SNB's defence of the Swiss Franc.

Rising Swiss interest rates would have other consequences, some of which are adverse to the Swiss economy. Many rental contracts in Switzerland essentially link monthly payments to interest rates, implying the rises in the latter will reduce money left over to spend on other goods. Aggregate consumption will fall, as well as the traditional depressing effect of higher interest rates on fixed capital formation by firms. This highlights the "robbing Peter to pay Paul" nature of the SNB's actions: in order to spare exporters and those firms that earn most profits abroad from further pain the SNB has taken steps that essentially harm Swiss renters, consumers, and investing firms. The redistributive measure has received far less attention that it deserves.

Worse, should the SNB prints create huge amounts of new Swiss Francs in response to inflows of financial capital and not sterilise these inflows (a technical manoeuvre that would further raise Swiss interest rates), then some fear that over the medium term inflation will rise in the Switzerland. Were this to be the case then it would truly expose the short term nature of the SNB's actions. After all, those exporters and Swiss-based firms--like banks--who make most of the money abroad, that are supposed to be the beneficiary of the SNB's recent steps, would find themselves facing higher domestic costs and, therefore, lower international competitiveness over the medium term.

The last paragraph highlights the appalling dilemma faced by the SNB. If it did nothing, then essentially it condemns one group of Swiss firms in the short term and possibly medium term to significant pain (the length of time depending on how long you think the Swiss Franc would remain popular in these troubled times.) If it acts to stem the rise of the Swiss Franc, then medium to longer term pain is inflicted on those very same firms--meanwhile in the short term those firms obtain relief while many other Swiss residents and firms are hurt. However, as the pain is "democratised" and spreads throughout the Swiss population there is no guarantee that public opinion will not shift

again, this time in favour of their own interests and away from exporters and the like. Once short term thinking sets in, every month and quarter can see shifts in policy. Suddenly Swiss macroeconomic policymaking is looking very European after all.