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Swiss National Bank dilemma – too much of a good thing

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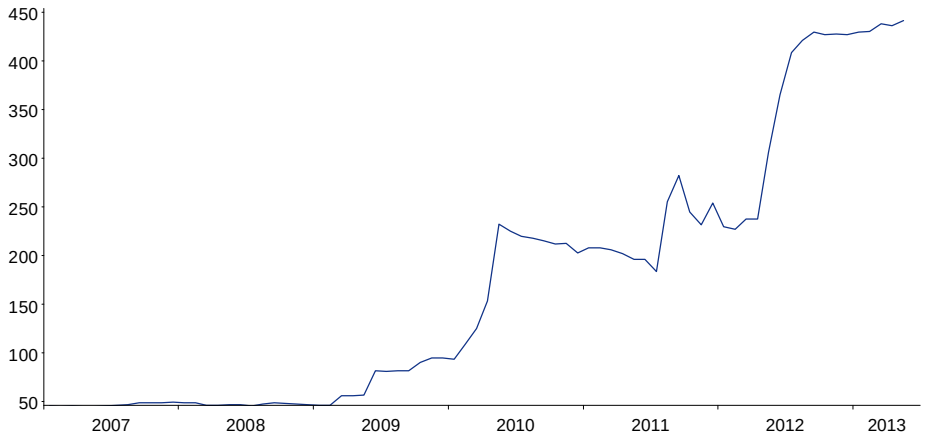
Looking across the financial market landscape, one is struck by the unusual circumstances of a central bank in a country whose currency is indeed robust and whose balance of payments is in order. Disconcertingly though, that same central bank exhibits at the very least a "non-zero" risk of incurring technical insolvency. The name of that somewhat problematic monetary institution is the Swiss National Bank (SNB).

The seeming contradiction has an explanation, which also comes with some reassurances. Economic fundamentals posted by the Swiss Confederation are good, and indeed supportive of Swiss franc (CHF) value. Since the onset of the Global Financial Crisis (GFC), Switzerland and the CHF have enjoyed an elevated "safe haven" status, but not without cost. In 2011, the Swiss monetary authorities introduced an "exchange rate floor" for the Swiss franc in reaction to the surge of capital inflows seeking shelter in the franc's value as a safe haven currency. Thus, the SNB intervened in the foreign exchange markets, massively selling CHF for, namely, EUR to contain the domestic currency's value. The IMF at the time endorsed this exercise in currency manipulation and in a measured way still does.

Swiss National Bank: Foreign Currency Reserves

in CHF bn



Sources: EcoWin, SNB.

As the Fund observes in its May 2013 Article IV report (see *Switzerland 2013 Article IV Consultation* – IMF Country Report No. 13/128, May 2013), the exchange rate floor policy has been successful and appropriate, "given the lack of alternative instruments to prevent further, massive tightening of monetary conditions through a sharp exchange rate appreciation." The Fund continued its comments in a favorable vein, also noting that "…the floor successfully stemmed inflows and reduced uncertainty, helping Switzerland avoid a recession and contain deflation risks."

In its last Monetary Policy Assessment back in March, the SNB highlighted its attachment to the current Swiss franc exchange rate policy floor of CHF1.20 per euro, noting its importance toward indeed preventing an undesirable "monetary tightening". For all capital market participants listening, the Swiss central bank went on to emphasize that it stood ready "... to enforce this minimum rate with the utmost determination and, if necessary, is prepared to buy foreign currency in unlimited quantities for this purpose." The Swiss monetary authorities see the CHF still to be sharply overvalued. They again receive some third-party endorsement on this count, with investment bank UniCredit citing the IMF's External Balance Assessment methodology for the franc, which indicates some overvaluation and estimates a "fair value" level of CHF1.30 per euro. SNB president Thomas Jordan declared in March that the SNB was "still far away from an exit from the minimum rate policy", and UniCredit, for one, expects no deviation from the set course following the SNB's scheduled June 20th Monetary Policy Meeting.

What becomes interesting, however, is the onset of possibly "too much of a good thing", so to speak. As the euro crisis weathered another fraught period during 2012, the SNB continued to follow closely its exchange rate floor policy, and again substantially intervened. The cumulative effects from SNB policy thereby grew from impressive to astounding. During the extensive exchange rate intervention period from May through August 2012, Swiss foreign exchange reserves increased to approximately 65% of GDP; the SNB balance sheet grew to correspond to 85% of country GDP. The foreign exchange matters have since stabilized, permitting the SNB the chance to pause and refresh, but the sheer size of the country's international reserves holdings and the central bank balance sheet both leave Switzerland a bit top-heavy, and maybe a little prone to some dislocation. The IMF and Swiss authorities themselves still see merit in maintaining the exchange rate floor policy for the time being. The SNB's mammoth balance sheet size nevertheless still begs the question of when and how the process of unwinding the foreign exchange interventions in some measured way will unfold. And this will have to be done deftly, unwinding some of those positions while managing the extent of any mark-to-market losses in an appreciating CHF environment. As the IMF also underscores in its twin publication *Switzerland: Selected Issues* (IMF Country Report No. 13/129, May 2013), the SNB equity buffer is thin and the risk is tangible: "At end-2013, (SNB) equity and provisions stood at 11.6 percent of total assets, close to historical minima. If the SNB were to exit the exchange rate floor while it is still binding, the exchange rate would appreciate, mark-to-market losses could be very sizable, and, in some scenarios, these losses could even exhaust the SNB's capital. While central banks can operate with negative equity and use seignorage and other revenues to rebuild capital over time, there is a risk that this may cause political pressures and undermine independence..."

We noted "some reassurances" earlier and there are indeed some that come to mind. The SNB can continue to enhance its capital base through much larger profits retention, and a smaller distribution to the Confederation and cantons; it can use mark-to-market accounting to establish revaluation reserves; it can also consider historical cost accounting as a means of reducing balance sheet and financial income volatility. It can even consider the adoption of a negative interest rates policy say on bank reserves, or on reserves above a minimum requirement (something even receiving a nod from the IMF) as an alternative means toward discouraging capital inflows. However, the potentially "mixed blessing" from negative interest rates may deter the SNB from using such a policy tool. In the meanwhile, the euro area crisis gives some evidence of easing, but remains in a steady-state condition. And, the SNB must still contend with it.

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