THE SNB AND ITS FIGHT AGAINST THE WINDMILLS

Reflection by Albin Kistler AG

October 2019

The Swiss National Bank (SNB) has been battling against the appreciation of the Swiss franc for ten years. Looking at global events and the fundamental data for the Swiss franc, it could be said its recurring interventions are reminiscent of Don Quixote's fight against the windmills: do not count on either an imminent weakening of the Swiss franc or a reduction of the SNB's balance sheet positions.

The SNB and its fight against the windmills

October 2019, Benjamin Schoch

In brief

- The strength of the Swiss franc is not a temporary phenomenon
- Developments speak against a weakening of the Swiss franc
- The SNB's balance sheet will expand further

Summary

The comparison of the interventions of the Swiss National Bank with Cervantes' Don Quixote is of course unfair as the former has a legislative mandate to fulfil and the latter was a fictional character. However, this comparison allows for the SNB's interventions to date to be placed in the context of the relevant fundamental data and global developments since the financial crisis. This reflection provides both the opportunity to better understand why it will be almost impossible for the Swiss franc to weaken in the near future and why the SNB balance sheet is set to expand (yet) further.

A look back at past events

Let's go back to August 2011: the financial markets had recovered somewhat from the worst effects of the financial crisis but were looking anxiously towards the eurozone where the next crisis was looming: due to capital inflows from (neighbouring) foreign countries as well as the repatriation of significant assets by Swiss investors and companies from abroad back to Switzerland, the Swiss franc appreciated by 20% against the major currencies during the first eight months of the year.

The price movements gave rise to palpable unrest in the Swiss export industry and politicians from all parties called on the SNB to take greater measures to tackle the strength of the Swiss franc. The response of the SNB followed on 6 September in the form of an unequivocal press release: "(…) With immediate effect, it will no longer tolerate a EUR/CHF exchange rate below the minimum rate of CHF 1.20. The SNB will enforce this minimum rate with the utmost determination and is prepared to buy foreign currency in unlimited quantities."[1] In the almost four years prior to the abandoning of the exchange-rate floor, the balance sheet of the SNB grew by 50% from around CHF 365 billion to CHF 561 billion in the wake of numerous interventions.

The abandoning of the exchange-rate floor on 15 January 2015 and the stepping up of negative interest rates for high Swiss-franc-denominated liquidity holdings once again gave rise to fluctuations in the value of the Swiss franc and the equity prices of Swiss export firms. While the global economy recovered in the years that followed, the Swiss franc remained strong. If you take account of the fact, in particular, that the SNB balance sheet again expanded in the four years up to 2019 by 50% from CHF 561 billion to CHF 841 billion, questions about the long-term effectiveness of the SNB's interventions come to the fore.

Is the strong Swiss franc really a temporary (crisis) phenomenon or is this instead a structural fact that even massive interventions on the part of the SNB can do very little to rectify? Is the SNB also planning a balance sheet expansion of 50% over the coming four years in keeping with the motto "whatever it takes" even though its balance sheet size has already exceeded the Swiss gross domestic product (GDP) of CHF 689 billion? Can the SNB at least be given credit for diversifying the currency mix in its balance sheet more in favour of additional currencies since the EUR/CHF exchange-rate floor interventions?

A look at the research

A great deal of research work and numerous commentaries, such as the recently published G30 report of Mark Carney[2], expressly make reference to the fact that in today's closely networked world there is almost no country that can escape international developments. If we apply these thoughts to Switzerland, the following conclusion can be reached:

[1] SNB press release, 6 September 2011: https://www.snb.ch/en/mmr/reference/pre_20110906/source/pre_20110906.de.pdf

[2] Group of Thirty, Washington D.C., Occasional Paper 96, Mark Carney: "Pull, Push, Pipes – Sustainable Capital Flows for a New World Order."

With its dogged fiscal policy (debt brake!) and its credible monetary policy, Switzerland emerges as a paragon of virtue in the European debt landscape. The monetary policy of numerous significantly larger currency zones remains expansive or is becoming even more expansive. The structures of the global financial system are also shifting from a financing environment that is greatly driven by banks and supranational organisations to a more pro-cyclical environment shaped by investment products (of sovereign wealth funds and central banks). Before we analyse these three factors for Switzerland, we will hypothesise that it is almost impossible for the Swiss franc to be weakened on a long-term basis and that it will appreciate markedly once more at the latest upon the next European or global crisis.

The pull factors

The most important pull factors of a currency zone are its fiscal and monetary policy, the economic framework conditions, including legal certainty, and political stability. Switzerland's fiscal policy can be summarised as follows: since the "debt brake" was applied in 2001, government debt has halved to around 28% of Switzerland's gross domestic product and since the same time the country has predominantly reported budget and trade surpluses. Outside Switzerland, more difficult conditions can be observed: government debt that has grown to well over 60% of economic output (GDP), budget deficits of at least 2% and persistently recurring trade deficits.

Purchasing power in Switzerland is also very stable: together with Japan, Switzerland regularly reports the lowest core inflation rates in the world. On the one hand, this fact can be attributed to the country's very predictable monetary policy. On the other, however, it is also greatly influenced by Switzerland's stable economic and legal framework conditions. It is therefore hardly surprising that Switzerland's interest rates are at absolute rock bottom by global standards. A look to the past also shows that significant inflation differences between two countries with flexible exchange rates are also reflected to a corresponding extent in the relevant currency translation rate.[3] It therefore needs no sorcery to assume that due to the persistently higher rates of inflation in neighbouring countries the Swiss franc will appreciate further against these currencies over the long term.

The push factors

Push factors refer to those global influencing factors that determine risk appetite and thus also worldwide capital flows. Looking again at the Swiss franc, these factors especially include the global interest rate situation, the stability and creditability of foreign banking systems as well as the attractiveness of global investment opportunities. The past shows that a deterioration of these push factors has in each case led to capital flight to safe haven currencies such as the Swiss franc and the Japanese yen. In particular, during the emerging market crises of the 1990s, the bursting of the Internet bubble between 2001 and 2003, the financial crisis of 2007 to 2009 and the subsequent euro crisis of 2011 to 2013, the Swiss franc appreciated markedly in each case.

This capital flight not only involves the temporary search for safe havens by foreign investors, but also the large-scale repatriation of foreign assets by Swiss companies, pension funds and private individuals. During the euro crisis of 2011 to 2013 alone, there were capital outpourings from abroad into Swiss francs with an equivalent value of CHF 174 billion.[4] This inflow and the above-mentioned repatriation of funds is largely responsible for the increase in the SNB balance sheet. It is therefore perfectly logical to assume that if the push factors worsen once more the upward pressure on the Swiss franc will increase again.

[3] Example: US vs. Switzerland from 31 July 1999 to 31 July 2019: cumulative inflation difference to the disadvantage of the US of around 40% (producer price index, IMF database) or 33% (consumer price index, IMF database). During the same period, the Swiss franc appreciated 28% against the US dollar.

[4] See R. Auer, SNB Quarterly Bulletin 02/2015: "A safe haven: international demand for Swiss francs during the euro area debt crisis".

The structures of the financial system (pipes)

The structures of the global financial system have also changed noticeably during the past decade. Since the financial crisis, equity requirements for banks have increased from around 8% (Basel I) to up to 13% (Basel III). The banks' trading books have simultaneously shrunk by half, while interbank liquidity has fallen by more than 30% since the period prior to the financial crisis (2007). The influence of global development banks (International Monetary Fund, World Bank) has also declined in favour of new regional development banks (AIIB, NDB). Last but not least, the numerous globally active sovereign wealth funds and asset managers have had a significant impact on the structures: the combined assets of the world's 15 biggest sovereign wealth funds now exceed the sum of the balance sheets of the US Federal Reserve and the European Central Bank.[5]

The financial system and thus also the ownership structures on the global bond and equity market have changed from a system that was previously dominated by the banks to an environment that is determined by central banks, asset managers and sovereign wealth funds. An end to this trend is not to be expected. On the basis of further capital gains for these stakeholders, we therefore anticipate a continual increase in the concentration of ownership for equities and bonds as well as the constant influencing of smaller currency zones by these trends.

It therefore also comes as no surprise to us that various organisations, ranging from the G7 and G30 to the central banks and the Bank for International Settlements (BIS), are dealing with the possible effects of this development: in the next crises, what impact will increasingly pro-cyclical asset flows have in an ever-more-pronounced negative interest rate environment without significant new safety nets or the introduction of the required economic reforms? Nobody can provide a definitive answer to this question. It is, however, possible to assess how the Swiss franc will respond to the aforementioned factors.

Back to the Swiss franc

A sustainably weaker Swiss franc would only be conceivable in the following (hypothetical) scenarios: (1) Swiss inflation rates markedly outstrip those seen abroad. The purchasing power of the Swiss population declines and in order to protect their assets they flee to foreign currencies. (2) The global economy grows significantly stronger than the Swiss economy and central banks around the world continuously hike interest rates. (3) The price stability of the Swiss franc is undermined by an overly generous fiscal policy (overindebtedness), a misguided monetary policy (loss of trust) or political arbitrariness and anarchy. Switzerland would lose its status as a safe haven.

The first scenario is almost inconceivable in the context of the historical data. The second scenario would be desirable with a view to sluggish global economic growth. However, the almost complete decoupling of the Swiss (export) economy from global developments is difficult to imagine as many Swiss companies are too flexible and adept at responding to the relevant challenges. The third scenario can also not really be viewed as realistic. There are hardly any convincing arguments for a significant weakening of the Swiss franc.

On the contrary, the above-mentioned pull and push factors as well as the changed structure of the financial system will lead to the next flight of capital and repatriations in the direction of the Swiss franc during crisis periods. The past, current and future SNB interventions may perhaps slightly reduce or delay the appreciation of the Swiss franc, but they will not be able to stop it. Can and will things continue like this indefinitely? Questions are already being raised with respect to the consequences of this further growth in foreign-currency positions. These positions are not only subject to fluctuations in the Swiss franc, but also to volatility on the global equity markets.

---

[5] The assets of the Norwegian sovereign wealth fund alone now total more than USD 1,000 billion and thus more than the balance sheet of the SNB.

How comfortable will the SNB Governing Board, politicians and economic players feel if the SNB's investment losses no longer total "just" CHF 23 billion or CHF 15 billion as was the case in 2015 and 2018, respectively, but rather increase to more than CHF 150 billion? This figure is really not so absurd if one assumes that the balance sheet is set to grow by a further 20% prior to the next major crisis.[6] Greater opposition and warnings from abroad are also conceivable: the US is already designating numerous countries as currency manipulators. The fact is that even the massive foreign-currency interventions of the past ten years have failed in weakening the Swiss franc on a sustainable basis and the SNB cannot continue it purchases for evermore due to the increasing size of its balance sheet. Even Don Quixote had to put an end to his hopeless struggle at some point.

The investor perspective

What does this reflection mean for investors with the Swiss franc as their reference currency? A permanently high foreign-currency exposure or the strategic hedging of foreign-currency risks rarely generates the desired added value. Upon looking closely, it can be seen that strategic foreign-currency hedging, in particular, actually serves to thwart the efforts of the SNB aimed at weakening the Swiss franc. For this reason, the Swiss franc allocation in our client portfolios remains high and we select the best companies according to sector rather than country.

Benjamin Schoch
Head of Asset Management, Currencies/Bonds Analyst

The periodically published studies are available to download in PDF format on the Albin Kistler website: www.albinkistler.ch/studies

[6] An appreciation of the Swiss franc of 10% on CHF 1,000 billion generates a loss of CHF 100 billion. Depending on the crisis, losses of up to 40% on global equity positions are conceivable, which with an equity allocation of 20% equates to additional loss potential of CHF 80 billion. Any losses on the bond portfolio are not included here.