The W&P-Perspective

Wanted: A long-term strategy for the Swiss franc

About twenty years ago, the Swiss National Bank introduced a new monetary policy framework. With its comparatively flexible inflation target, the SNB played a pioneering role. However, the bank cannot be happy with the fruits of its strategy in general. On the one hand, its decisions and communications are based on an indicator that has proven to be unreliable, namely the conditional inflation forecast. And on the other hand, the bank has effectively been improvising for over ten years now, since the exchange rate itself played only a minor role in its monetary policy framework. We feel the SNB can no longer avoid defining a long-term strategy on how to deal with the appreciating franc. // Adriel Jost & Klaus W. Wellershoff

The US Federal Reserve and the European Central Bank are currently rethinking their mandates. Among other topics, they are focussing on the inflation target, which should become more flexible. Thus, they would appear to be adopting the example of the Swiss National Bank, which demonstrated admirable foresight when it introduced its new monetary policy concept, in December 1999. It deliberately avoided setting an overly precise inflation target, instead merely describing its goal as "an annual increase [...] in consumer prices of less than 2%". The SNB considered it unreasonable to pursue a tightly defined target. For one thing, it cited measurement errors as an inherent weakness when using a narrowly defined target. For another, it justified its approach by noting that some fluctuation around the inflation trend is not unusual, especially in small, open economies, and require no response from monetary authorities.

The SNB›s inflation forecasts turned out to be unreliable

Over the past twenty years, inflation has remained within the range kept deliberately vague by the SNB. Nevertheless, the verdict on the SNB's monetary policy framework after twenty years is not a positive one. The main problems are with its monetary policy implementation and communications. First, the past twenty years have shown that the most important element for the SNB – namely, the conditional inflation forecast – is of little use when it comes to steering monetary policy. The SNB's forecasts over a three-year horizon are simply not credible (see Fig. 1). Unforeseen economic shocks are the main cause of these faulty forecasts. Such shocks, it turns out, appear with such a regularity that any alignment with conditional inflation forecasts are almost purely coincidental.

The forecasting errors are not due to the fact that the inflation forecasts are conditional. With the exception of the introduction of negative interest rates, money market rates have remained stable over the past ten years. As Table 1 shows, the divergence between the forecast and actual inflation rates was often so large that completely different conclusions would have been drawn if the actual course of future inflation had been known. It would have been better simply to use the average inflation of the past four quarters as a forecasting basis. For the period between one-and-a-half and three years, which is particularly relevant for the impact of monetary policy, this forecasting metric would have proven more accurate. In view of the inaccuracies of its forecasts, the SNB must seriously ask itself whether it is prudent to continue making far-reaching decisions on such an unreliable basis.

The SNB relies on a tool hardly mentioned in its policy framework

Second, with hindsight, it is clear that the SNB did not use the main tool of central banks for implementing monetary policy, that is, interest rates, in more than half of the twenty years of its current policy regime. Instead, for over ten years it has been relying on FX interventions, for which no role was defined in the bank's original monetary policy framework. Ironically, the Swiss franc money supply has regained importance lately, even though the bank's monetary policy framework put it in the second tier at the beginning of the millennium.

Of course, the SNB must react to changes in the exchange rate. A sharp surge of appreciation has a big impact on Switzerland's economy and, given the importance of imports, also on domestic price levels and, thus, inflation.

However, since the SNB advised that foreign exchange interventions were only to be undertaken in reaction to an "exceptional situation," the bank's practices over the past decade seem a bit strange. Nor does it seem likely that this prolonged "exceptional situation" will end anytime soon. For years, Switzerland has consistently had a high current account surplus, as its exports of goods and services have routinely exceeded imports. In order to keep the exchange rate constant despite this surplus, the surplus would have to be offset by investments abroad in the same amount. However, investors, particularly Switzerland's domestic investors, have become increasingly reluctant to invest in foreign currencies (Fig. 2). We think it is unlikely that investors will lose soon their preference for Switzerland. Given the current global economic and political situation, it seems unlikely that investors will lose their reluctance to make additional foreign investments anytime soon.

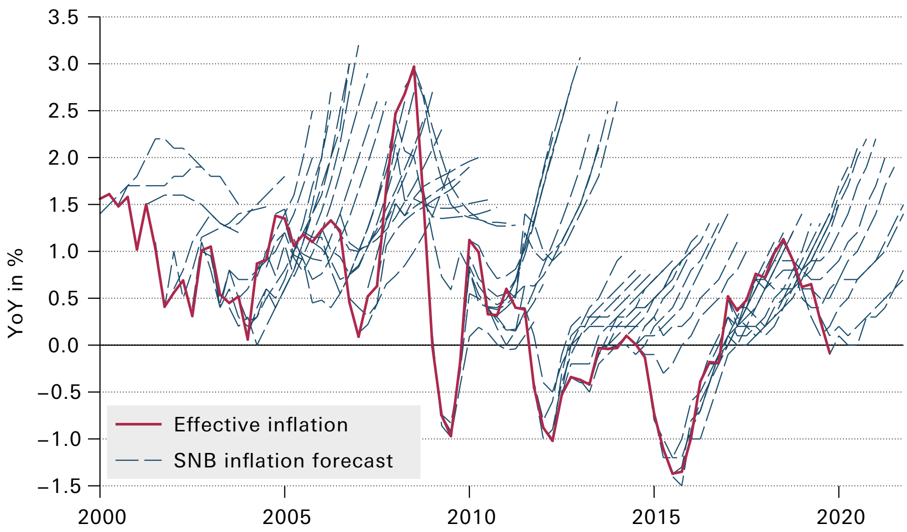
We think this leaves only two options for Switzerland: more "muddling through", as it has over the past ten years, or a discussion about a long-term strategy on how to deal with the persistently appreciating franc.

SNB credibility demands a long-term strategy

From the SNB's perspective, "muddling through" is hardly preferable. It was the SNB itself that emphasized the importance of clear communication when introducing the current monetary policy framework:

> The new strategy should continue to guarantee **a transparent monetary policy based on clear rules**, so that the public would be able to predict correctly how the

Fig. 1: SNB inflation forecasts since 2000



For twenty years, the SNB has based its decisions and communications on conditional inflation forecasts. In retrospect, however, it's evident that these forecasts differ significantly from the actual inflation rates. This is due to economic shocks that are unpredictable. It turns out that the SNB's decisions have often been based on flawed assumptions.

Source: SNB, Wellershoff & Partners

> SNB would act and therefore form expectations for long-term inflation that were compatible with the National Bank's intended policy. At the same time, however, it should allow for a pragmatic monetary policy and provide the Governing Board with sufficient leeway to respond flexibly to shocks.[1] (Emphasis ours)

The hoped-for balance between clear, transparent rules and room for flexible action has vanished in the past five years, after the euro-peg was lifted. The SNB's actions were "pragmatic" in the sense that they gave the bank's Executive Board adequate room to manoeuvre but they hardly gave the public any confidence in policy processes "based on clear rules and transparency".

Monetary policy must be comprehensible to economic actors so that they can adapt their actions accordingly and allow their measures to unfold. In addition, clear justifications are vital if the SNB is to remain a credible institution. With the introduction of the negative interest rate and the very substantial expansion of its balance sheet, which is already much larger than the country's total economic output, the SNB embarked on an extreme path. The risks to price stability are enormous, as are the financial risks. The costs of the negative interest rate are also visible. No wonder that the public demands clear reasons as to why these measures were, and continue to be, necessary.

We expect public pressure will continue to increase. Without articulating a long-term strategy, justifying these measures is hardly possible. There is no escaping it, in our view: The SNB therefore needs a long-term strategy for its monetary policy that also explicitly takes into account the development of the franc's external value.

1 Thomas J. Jordan & Michel Peytrignet (2007). Der Weg zur Zinssteuerung und zur Inflationsprognose. In: Die Schweizerische Nationalbank 1907-2007, NZZ Libro.

«SNB Listens»

As we have outlined here, adjustments to the SNB's monetary policy approach are overdue. In particular, the role the exchange rate should play, regardless of the unreliable inflation forecast, has to be clarified. Weighing the risks associated with FX interventions requires a broad public discussion. Is Swiss society ready to take these risks in order to give the export sector a short-term boost? What role should the SNB play? The US Federal Reserve has held numerous "Fed listens" events in recent months to take the pulse of a wide range of stakeholders and determine where the pressure points are in order to better define their mandate. We think a similar

Table 1: Forecast error in the SNB inflation forecast

Forecast	Average forecast error (in percentage points)		Maximum forecast error (in percentage points)	
	SNB	Unchanged inflation	SNB	Unchanged inflation
In 1 year	0.53	0.83	1.92	1.66
In 2 years	1.00	0.80	3.06	2.19
At the end of the forecasting period	1.48	0.84	3.44	2.88

The table shows the average and the maximum absolute deviation of the SNB's inflation forecasts since 2009 compared to the actual inflation rates. For comparison, the forecast error is noted that would have occurred if the forecast had consisted of the average inflation rate of the previous year.

Source: SNB. Wellershoff & Partners

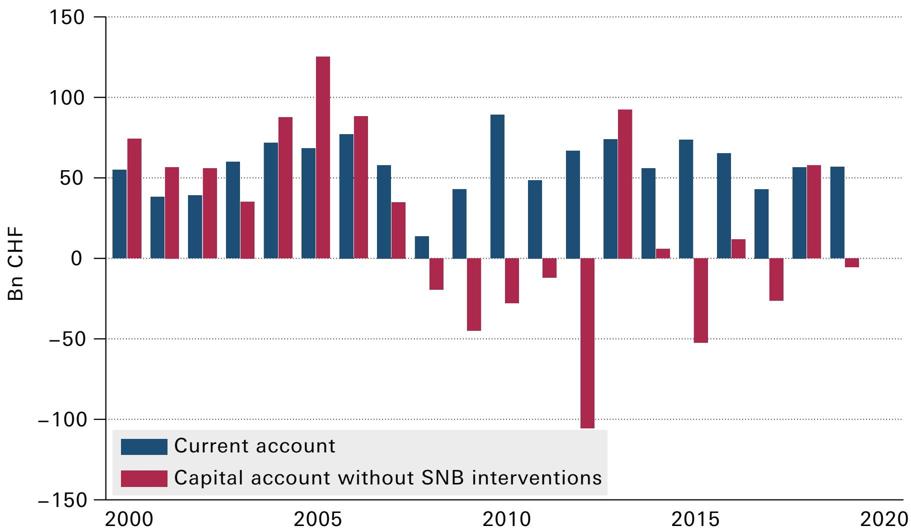
broad-based discussion would also be welcomed in Switzerland. It would help the SNB develop a clear strategy for how to deal with the appreciating franc in the coming years and decades. In particular, the benefits of currency interventions would have to be more clearly defined.

Conclusions

Five years ago, the SNB stopped defending a minimum exchange rate with the EUR and introduced the negative interest rates. Almost ten years ago, it began intervening more on the foreign exchange market. However, our analysis show that another anniversary may be even more important. Twenty years ago, the SNB introduced its new monetary policy approach.

After two decades, we now can see that the SNB's approach has considerable shortcomings. First, the most important basis for the bank's decisions and communications – the conditional inflation forecast – turns out to be extremely unreliable. Second, the SNB has made currency market interventions the new normal, although these interventions played only a minor role in the approach when it was launched, being reserved for "exceptional" situations only. An appreciating franc is not just a fleeting phenomenon. There is a real risk that the SNB's monetary policy will turn into a string of "pragmatic", short-term, situational responses and that the basic strategic orientation necessary for a monetary policy geared to long-term stability will be lost.

Fig. 2: Current account surpluses and private capital flows



The foreign trade data show a break during the depths of the 2008/2009 financial crisis. Previously, Switzerland's current account surpluses were offset by the fact that investors had invested more money abroad, which has not been the case since then. To keep the exchange rate constant, the SNB had to intervene heavily on foreign exchange markets.

Source: SNB, Wellershoff & Partners (through Q3 2019).

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