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2012 – Swiss monetary policy in uncertain times

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Introduction

Since last summer, Switzerland has been suffering the effects of the negative developments in the global economy, and particularly the escalating debt crisis in the euro area. The uncertainty over the debt crisis led to a massive appreciation of the Swiss franc during the summer months. In their search for safe financial assets, investors drove the Swiss franc to an all-time high against the euro in early August, which posed an acute threat to the Swiss economy and carried the risk of deflationary developments. In response, the Swiss National Bank (SNB) set a minimum exchange rate of CHF 1.20 per euro in early September of last year, which corrected the overvaluation of the Swiss franc to some extent. Thanks to this decision, investment planning for export-oriented companies has been facilitated, and the risk of both deflation and severe structural damage to the Swiss economy has been reduced. Without this policy measure, the extreme overvaluation of the Swiss franc and its volatility would probably have persisted.

However, the situation remains challenging for large sections of the economy – even at the current exchange rate, the Swiss franc is still very strong. We expect it to weaken over time, and fall back to a level more in line with its economic fundamentals. As the data show, economic activity in Switzerland slowed significantly in Q3 2011. Exports, in particular, fell noticeably. In addition to the strong Swiss franc, the general global economic outlook has deteriorated and downside risks prevail. Given this difficult environment, we remain firmly committed to defending the minimum exchange rate of CHF 1.20 per euro. This commitment applies at any time, from the moment the market opens in Sydney on Monday to when it closes in New York on Friday. We will not tolerate any trading below the minimum rate in the relevant interbank market. To enforce this policy, we are prepared to buy foreign currency in unlimited quantities if necessary. Moreover, we stand ready to take further measures if the economic outlook and the risk of deflation so require.

To explain the rationale behind the SNB’s current monetary policy in more detail, let me briefly outline our assessment of the global economic situation, as well as the risks for the Swiss economy.

Subdued global economic outlook and substantial downside risks

In our global baseline scenario, the outlook remains – overall – subdued. Economic growth will continue to be driven by emerging markets. However, we expect growth rates in China and India – the most important countries in emerging Asia in economic terms – to remain below potential in the near term, due to prior monetary policy tightening, high inflation, and sluggish external demand. Looking at the US, recent data suggest that the situation has improved slightly. However, this should not hide the fact that economic growth in the US is likely to remain sluggish. As you may know, unemployment is still high and the fiscal environment remains contractionary. For the euro area – Switzerland's most important trading partner by far – the economic outlook has deteriorated since last autumn. Uncertainty about an escalation of the sovereign debt crisis is undiminished. As a result, the euro area is likely to face a mild recession in early 2012.

This short overview shows quite plainly: We still live in a world with substantial downside risks. Thus, the global economic situation might turn out to be worse than described above. One possible risk is a more pronounced slowdown in emerging market growth. This would reinforce the downturn in European countries. Another risk is that fiscal consolidation in the US may exert a greater drag on growth than projected today. But the main risk is – without doubt – a further escalation of the European debt crisis. Were such a risk to materialize, the consequences for the international financial and banking system – and in turn for global activity – would be severe.

Swiss economic outlook

What does the economic outlook for Switzerland look like, given a baseline scenario with a world economy on a weak growth path as described above?

After two years of fairly robust recovery, we expect the Swiss economy to slow considerably in 2012. The situation remains very challenging for Switzerland. On the one hand, the still very strong Swiss franc is weighing on export performance. Firms are suffering from compressed margins. If the difficult exchange rate situation persists, companies may consider relocating production capacity to other regions. On the other hand, the slowdown in external demand, as expected in our global baseline scenario, will likely weigh on investment spending and labor demand in the quarters to come. Although some recently released indicators point to a slight stabilization, we project the Swiss economy to grow only weakly over the next few quarters.

Moreover, as mentioned before, there is a very high degree of uncertainty regarding the global outlook. This is also true for the Swiss economy, which depends particularly on economic conditions in the euro area. If the risk scenario of a further escalation of the debt crisis were to materialize, economic activity in Switzerland would suffer a much more pronounced slowdown than just described. Such a development would lead to a severe risk of deflation.

Current Swiss monetary policy

Given this highly uncertain outlook, the SNB is – more than ever – committed to enforcing the minimum exchange rate with the utmost determination at any time. We cannot allow the Swiss franc to appreciate further. Hence, we must continue with our current policy, in particular as interest rates are already around zero. To enforce this policy, we are prepared to buy foreign currency in unlimited quantities, if necessary. Moreover, we stand ready to take further measures if the economic outlook and the risk of deflation so require. By setting a minimum exchange rate, we have opted for a simple and clear policy, to which we are fully committed. For precisely these reasons, this policy has been absolutely credible to the markets.

Before concluding, let me elaborate on two potential side effects which are often discussed in the context of our current monetary policy.

On the one hand, it is argued that the significant increase in liquidity since August 2011 may trigger inflation risks in the longer term. Given the current economic situation, however, expanding the supply of liquidity was a necessary monetary policy response. There is currently absolutely no risk of inflation in Switzerland. First, headline inflation turned negative in October 2011 and continued to decline through the end of the year. It is assumed to fall even further in early 2012. Second, neither our inflation forecasts nor the medium-term inflation expectations from our surveys of households and companies show any signs of inflation risks. Consequently, there is no necessity whatsoever for the SNB to reduce the level of liquidity for the time being.

On the other hand, a long period of very low interest rates may lead to imbalances in the domestic credit and real estate markets, which may pose serious risks for financial stability. We are well aware of these risks and are analyzing them very carefully. However, due to the exceptional monetary policy situation, interest rates cannot readily be increased to address such threats. In other words, at the current juncture, monetary policy cannot react to these imbalances with conventional monetary policy instruments. Therefore, the Swiss Government is due to decide soon upon the introduction of so-called macroprudential instruments that can be used – if necessary – to mitigate potential credit and housing market distortions.

Conclusion

The outlook for the global economy remains subdued. This, together with the persistently strong Swiss franc, is weighing on economic activity in Switzerland. Although some indicators have pointed to a slight stabilization recently, we project that the Swiss economy will grow only weakly over the next few quarters. The degree of uncertainty regarding the growth outlook remains unusually high, also by historical standards. Downside risks – in particular stemming from a further escalation of the European debt crisis – are substantial. If these were to materialize, economic activity in Switzerland would suffer a much more pronounced slowdown than just described.

Despite this rather gloomy overall picture, we should not overlook the potential for a more optimistic development. For instance, if the European authorities were to credibly commit to a sustainable solution soon, existing uncertainties would be reduced substantially. In such a scenario, demand for perceived safe financial assets would fall in general, and for the Swiss franc in particular.

However, as downside risks are currently far more likely to materialize, the SNB will enforce the minimum exchange rate with the utmost determination. Under these exceptional circumstances, it is a necessary measure to fulfill our mandate.