The SNB Observatory

# The SNB is not a currency manipulator

Stefan Gerlach, Yvan Lengwiler and Charles Wyplosz

Date December 17, 2020 Report 2020-1

**Our Purpose**

Monetary policy is important. It has broad effects across the economy, affecting young and old, poor and rich, savers, home buyers, firms and workers, profits and wages, the business cycle, and the long-term prosperity of the country.

Public debate about monetary policy is vital not only for basic democratic reasons, but also for the SNB to explain its views, and to listen to the views of the public it serves. The SNB Observatory aims to promote such a constructive debate based on facts and economic science.

The SNB Observatory is currently run by Stefan Gerlach, Yvan Lengwiler, and Charles Wyplosz.

For all our contributions, browse to www.snb-observatory.ch
For inquiries, please email to contact@snb-observatory.ch

**EXECUTIVE SUMMARY**

Over several years, Switzerland has been included in the watch list of the US Treasury as it surveys countries that could be trying to achieve unfair competitive advantage through currency interventions. The Treasury has developed three criteria to pass judgement. We find that all three criteria are misleading, based on flawed principles.

Its first principle is based on the bilateral trade surplus with the US. Yet, this merely reflects the respective position of Switzerland with the US. Switzerland has a trade surplus vis-à-vis the US, but a trade deficit with respect to the United Arab Emirates.

The second principle uses the current account surplus. But this is influenced by demographics, retirement systems, and investment opportunities. Switzerland is a country that saves more than what can be invested here. As a result, these investments are made abroad, which creates the current account surplus. This is no evidence for an undervalued currency or unfair competitive policies.

The third principle uses the fact that the SNB performs significant foreign exchange interventions. Such interventions can, however, be purely defensive if they are designed to prevent merely prevent and undue appreciation.

In fact, the Swiss franc has appreciated continuously; it is a safe haven currency, and is always on the verge of overvaluation. The International Monetary Fund has reached the same conclusion. The SNB would help to strengthen this reading of the facts, however, by providing more systematic and real-time information on its foreign exchange interventions and the motivations that guide them.

This report, the first of our publication series, is based on the situation up to December 15, 2020. On December 16, 2020, the US Treasury has declared that Switzerland is manipulating its currency based on the basis that it has met in 2020 all three criteria above.

Yet it also notes that "Switzerland experienced intensified pressure from safe haven inflows in the first half of 2020 as a result of the COVID-19 crisis. The SNB responded by stepping up its foreign exchange purchases significantly to stem franc appreciation", precisely what we characterize as defensive foreign exchange market interventions.

Our report is, in this sense, outdated. We have decided to publish it immediately because our main point, that the US Treasury's approach is deeply flawed, remains valid.

In January, we will release an updated version of the present report which will offer a detailed analysis of the US Treasury Report.

## 1. Currency manipulation

The US Treasury is mandated by law to determine whether a trading partner manipulates its currency to achieve an unfair competitive advantage. If a country is found to be a currency manipulator, the US Treasury must engage in discussions with that country under the threat of possible sanctions. The monitoring is continuous and the Treasury reports its findings to Congress twice a year. The last report currently available is from January 2020. Switzerland has been on the Treasury's watchlist since 2016, and periodically before, but has never been declared a manipulator.

The International Monetary Fund monitors currency manipulation as part of its systematic review of member countries. None of the IMF's annual Article IV reports on Switzerland since 2015 suggests that its exchange rate is manipulated. In fact, each of them concludes that the Swiss franc is overvalued.

The US Treasury defines currency manipulation when the three following conditions are met in a given year:

- The trade surplus with the United States exceeds $20 billion.
- The current account in a surplus that exceeds 2 percent of GDP.
- The central bank's foreign exchange market interventions exceed 2 percent of GDP, with purchases of foreign currencies in at least six of the last twelve months.

Table 1 shows the US Treasury findings for Switzerland as presented in January 2020 report. Switzerland meets two of the three criteria, while concluding that the amount of the currency interventions falling short of the Treasury's limit on the third criterion. As a result, Switzerland is on the watch list but is not actually declared as a manipulator. In previous years, Switzerland met two criteria: a large current surplus and large, sustained foreign exchange market interventions.

**Table 1. How Switzerland looks on the US criteria**

| Trade balance with the USA | Current account | Foreign Exchange Market Interventions | |
|---|---|---|---|
| | | Amount | At least |
| US$ billion | % of GDP | % of GDP | 6 months |
| 22 | 10.7 | 0.5 | Yes |

Anyhow, these criteria are meaningless.

Start with **bilateral trade balances** and consider the following example (Table 2). As Switzerland has no oil and gas resources of its own, the country runs large current account deficits with oil exporters such as the United Arab Emirates. On the other hand, Switzerland exports machinery, watches and more to China with which it runs a large current account surplus. These bilateral imbalances have no implication for the issue of currency manipulation.

**Table 2. Switzerland's bilateral trade with the United Arab Emirates and China in 2018**

(US$ billions)

| | Exports | Imports | Balance |
|---|---|---|---|
| United Arab Emirates | 4.9 | 10.2 | -5.3 |
| China | 20.4 | 14.7 | 5.7 |

Source: Direction of Trade, World Bank.

**The current account** includes the trade balance as well as trade in services and various payments like income from investment abroad or royalties. The US Treasury does not focus on bilateral current accounts but on the total, which tells us whether a country spends more or less abroad than it receives as payments from the rest of the world. Switzerland's large surplus means that it is saving more than it invests in the home country. This has nothing to do with currency manipulation.

**Foreign exchange market interventions** get us closer to currency manipulation. When the SNB buys foreign currency against francs, more francs are dumped on the market and it tends to reduce their value. This makes Swiss goods cheaper abroad and foreign goods more expensive in Switzerland. So, yes, this directly affects competitiveness. However, intentions matter. Is the SNB trying to boost Switzerland's competitiveness or is it trying to prevent an appreciation of the franc to prevent a deterioration in competitiveness? Simply looking at interventions, as the US Treasury does, does not say anything about the SNB's intentions.

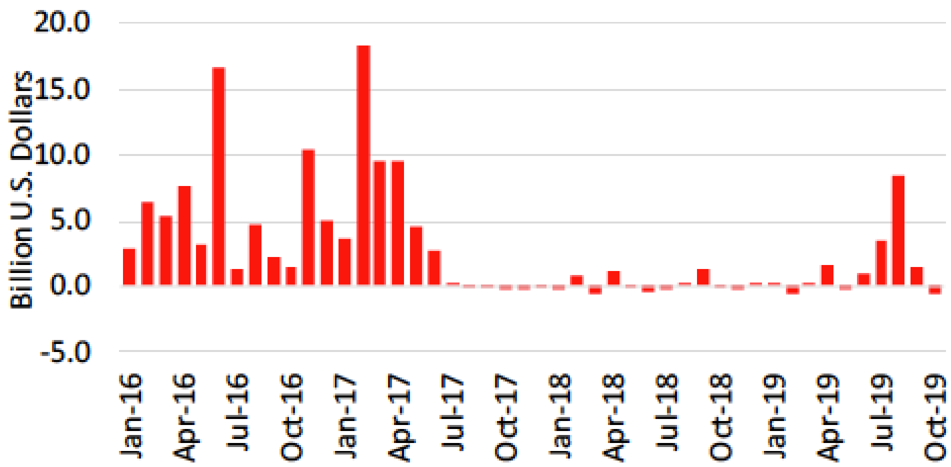
## 2. An uphill battle

Figure 1 depicts the US Treasury's estimates of SNB foreign exchange market interventions over the period 2016-2019. Clearly, the SNB intervenes often and with large amounts, and almost always to weaken the franc. If it were merely smoothing fluctuations, it would intervene both ways. Why such an asymmetry?

The SNB's answer is that the pressure on the franc is asymmetric. Because the franc is a safe haven currency, Switzerland periodically faces large capital inflows, which strengthens the exchange rate. One way of discouraging capital inflows is to lower the interest rate. But, with the interest rate negative since 2015, there is little room for lowering it further. To prevent an overvaluation, the only solution is to intervene on the foreign exchange market. This strategy has been clearly stated by Thomas Jordan, the Chairman of the SNB's Governing Board:

"Our experience shows that foreign exchange market interventions and the negative interest rate are essential for a small open economy with a safe-haven currency in a global low interest rate environment." (Swissinfo, July 14, 2020).

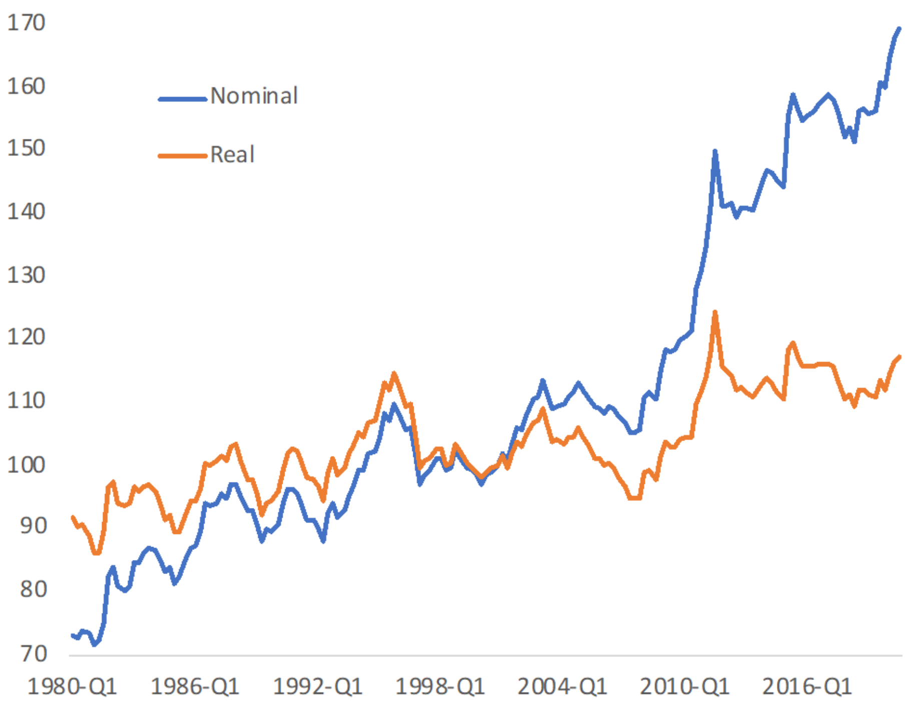
**Figure 1. Foreign Exchange Market Interventions by the SNB**




Source: "Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States – Report to Congress", US Treasury, January 2020.

But how do we know that the interventions do not encourage depreciations? If that was indeed the SNB's intentions, then it is failing in a grand way, as the value of the franc has more than doubled over the last 40 years. The blue line in Figure 2 shows the average (called effective) value of the franc vis-à-vis 43 currencies of countries that trade with Switzerland. (Like the trade balance, bilateral exchange rates vis-à-vis one country is uninformative because we cannot tell whether it is our exchange rate that rises or the other country's currency that declines.) The SNB has plainly not prevented this appreciation.

**Figure 2. The franc.**
(*Nominal and real effective exchange rates; Index: 2000Q4 = 100*)




Source: SNB

Currency manipulation seeks to achieve a competitive advantage. But domestic and foreign good prices also matter for competitiveness. A standard measure of price competitiveness compares domestic and foreign goods, expressed in the same currency through the exchange rate. This measure is called the real exchange rate. Similarly, to the effective nominal rate, the effective real exchange rate involves an average of prices abroad. The Swiss effective real exchange rate is represented by the orange curve in Figure 2. Three observations can be made:

- The real exchange rate has been trending upward since 1980. This continuing real appreciation means that Switzerland's price competitiveness has been eroded.
- Why, then, has the current account surplus remained large as domestic good prices have become relatively more expensive? Largely because many Swiss exports are sophisticated products that are not very price sensitive.

- The real exchange rate has risen by much less than the nominal exchange rate. This means that inflation has been lower than abroad.

Whether it tried or not, the SNB's interventions have not systematically pushed the franc down but merely slowed its rise. In its latest review of Switzerland, the International Monetary Fund reaches a similar conclusion:

> "Despite at times very large FX [foreign exchange market] purchases, several episodes of extreme safe-haven pressure resulted in sharp real appreciations."

Switzerland, Staff Report for the 2019 Article IV Consultation", IMF, May 20, 2019, page 8.

## 3. The other side of monetary policy

Why, then, has the SNB purchased foreign currencies for up to 100% of GDP over the years? In the above statement, President Jordan correctly points out that these interventions are a byproduct of monetary policy. Like many central banks, the SNB's main instrument is the interest rate. Raising the interest rate attracts capital flows from abroad, which lead to an exchange rate appreciation. Given the international integration of the Swiss financial market, the capital flows are large, which means a strong appreciation that has negative effects on production and employment. Two examples explain the implications.

First, if the economy slows, the SNB may want to support it by lowering interest rates, which should lead to nominal and real depreciations. However, economic slowdowns in Switzerland are usually synchronized with difficult times abroad. In such circumstances, foreign investors often look to Switzerland as a safe haven. As capital flows in, the franc appreciates, instead of depreciating, which undermines the SNB's efforts at rekindling economic activity. Preventing an ill-timed appreciation is, again, crucial and requires the SNB to intervene to prevent the franc from strengthening too much.

Second, capital inflows motivated by safe-haven considerations are often driven by events unrelated to Switzerland such as a sudden increase of global political uncertainty or tension in the euro area. In this case, the real appreciation is a nuisance and the SNB is justified to intervene.

The SNB makes available information regarding its foreign exchange interventions in senior management interviews and speeches, and in its publications, but does not publish intervention amounts. That may be because doing so would attract undesired attention, or because the data on "Average of sight deposits in Swiss francs at the SNB" published in the weekly press release on "Important monetary policy data" are just as informative. However, given the importance the SNB attaches to these latter data, it is surprising that they are not available in weekly form in the SNB's data base. This is an unfortunate shortcoming that should be corrected. It is interesting, for instance, that the US Treasury had to create an *estimate* of SNB interventions. What is gained by being secretive about it?

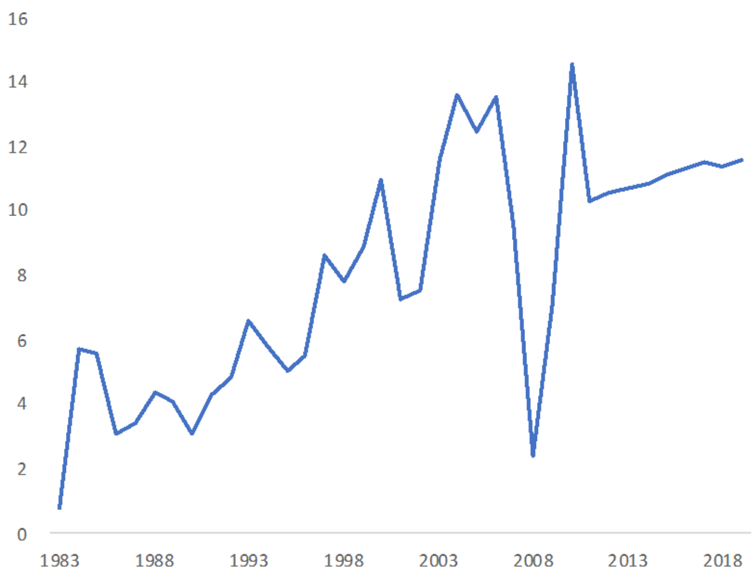
Even more importantly, the SNB should explain after each intervention the reasoning of the governing council for doing so. By being transparent about the motivation, the suspicion of trying to achieve an unfair competitive advantage can be addressed head on.

**Recommendation.** *The SNB should publish in regular intervals (e.g. quarterly in the Bulletin) a detailed report about the interventions. This report should not only state the amount of the interventions, but also the concrete arguments that lead to the decision to intervene.*

## 4. The current account surplus

In the end, the case against Switzerland being a currency manipulator is unconvincing. The almost perpetual current account surpluses year after year for decades may be puzzling, though (see Figure 3).

**Figure 3. Current account (% of GDP)**



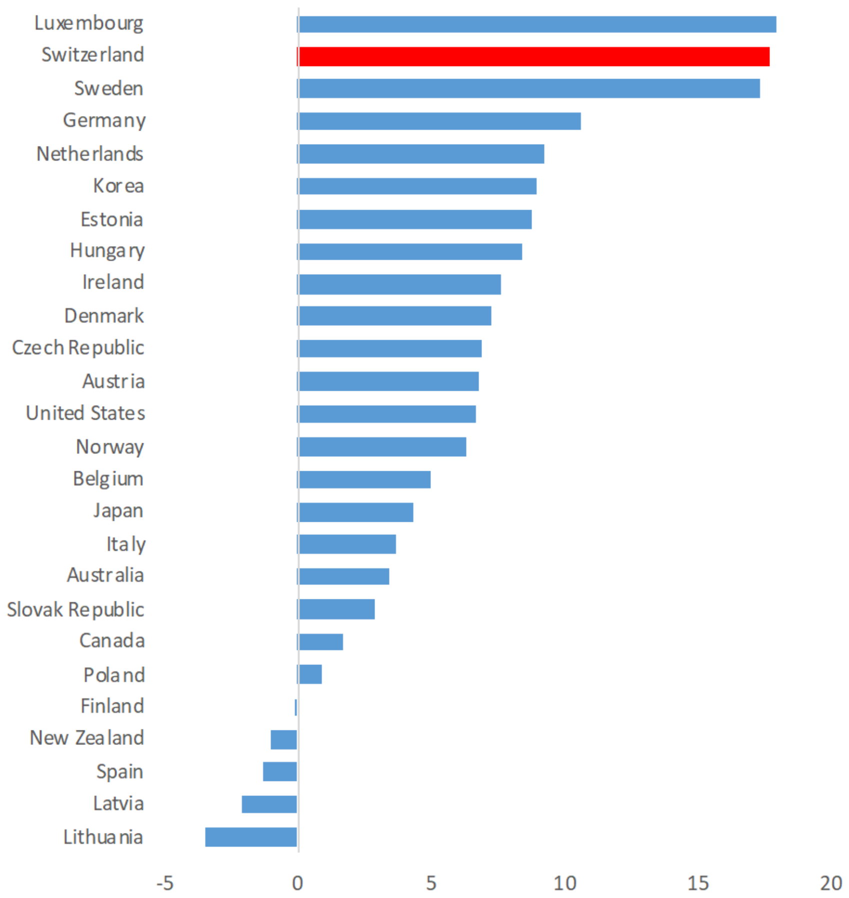

Source: SNB

The current account is the difference between all income received from abroad and all spending abroad. Income less spending is saving. When the current account is positive, the country is saving or, equivalently, lending, to the rest of the world; when it is negative the country is borrowing from the rest of the world.

Figure 3 simply says that, collectively, Swiss households, firms and the federal and cantonal governments have been saving, and increasingly so, over decades. Why?

- The federal and cantonal **governments** do not run sizeable deficits, and have run surpluses in recent years (this is changing in 2020 with the Covid-19 epidemic).
- **Households** save, a lot, as is seen from the comparison of OECD countries displayed in Figure 4 . This is a consequence of the Swiss retirement system: under Pillars 2 and 3, people save a large part of their income for retirement. As the country is aging, these savings have increased over time.
- Switzerland hosts an unusual number of large **corporations**. Given the country's size, they cannot put all of their savings to work internally. Switzerland, it seems, just does not offer sufficient investment opportunities that are as good as the ones available abroad, and is unable to absorb all of its savings.
- The Swiss **financial center** is very large relative to the size of the economy. Its stable legal framework and long-established reputation attract wealthy people, who become residents. In fact, they bring in their incomes but spend little locally. As Figure 4 shows, that is also the case in Luxembourg.

**Figure 4. Household saving (% of GDP)**




Source: OECD

## 5. The bottom line

There is no evidence that the SNB is keeping the exchange rate undervalued. Rather, the SNB is focused on preventing overvaluation. The large and continuing current account surpluses correspond to large domestic savings, not to unfair competition.

Even on the basis of its three misleading criteria, the US Treasury find it difficult to criticize Switzerland, as indicated by its latest report:

> "Over 2019, movements in the Swiss franc largely mirrored changes in risk sentiment. The nominal effective exchange rate (NEER) appreciated slightly over the first 11 months of 2019 period by 1.6 percent, while the real effective exchange rate (REER) depreciated slightly by 0.2 percent. The SNB maintains the assessment that the franc is highly valued."

Its final recommendations, which are reasonable, do not suggest the slightest suspicion of currency manipulation:

> "Treasury urges Switzerland to use its ample fiscal space — with the budget in surplus and public debt around 40 percent of GDP — to cut taxes and pursue structural reforms to spur investment. In particular, Switzerland could increase expenditures to deal with high savings related to population aging as the high level of household savings would seem to point to a need for improved public policies to help with population aging and retirement needs."

("Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States – Report to Congress", US Treasury, January 2020, pages 7-8.)

The IMF has explicitly rejected any suggestion that Switzerland is an exchange rate manipulator:

> "The fiscal position is strong and the external trade surplus remains large and stable despite several episodes of intense appreciation pressure owing to the Swiss franc's reputation as a safe haven."

Switzerland, Staff Report for the 2019 Article IV Consultation, IMF, May 20, 2019, page 1.

> "Reserves are the byproduct of monetary policy operations aimed at avoiding volatility in output and inflation especially when the policy interest rate is close to the effective lower bound."

Switzerland, Staff Report for the 2019 Article IV Consultation, IMF, May 20, 2019, page 9.

We should acknowledge, though, that the US Treasury does monitor all its trading nations with respect to currency manipulation. The criteria they use are unsound, but that does not diminish the potential danger this program poses for Switzerland. We believe that the SNB would do well to provide much more transparency about the motivations for and the size of the interventions.