The SNB Observatory

The SNB is not a currency manipulator: an update

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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 snb-observatory.ch
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ZUSAMMENFASSUNG

Das US-Schatzamt beobachtet die Schweiz seit mehreren Jahren im Hinblick auf mögliche Währungsmanipulation, um unfaire Wettbewerbsvorteile zu erzielen. Im Dezember 2021 hat es nun die Schweiz formell als Währungsmanipulator identifiziert.

Das Schatzamt verwendet drei Kriterien, die jedoch willkürlich und volkswirtschaftlich keine Berechtigung haben. Die SNB hat rein aus defensiven Gründen am Devisenmarkt interveniert, um starke und spekulative Aufwertungen zu bekämpfen, die durch Kapitalflucht in die Schweiz verursacht werden. Es war nie die Absicht, einen unfairen Wettbewerbsvorteil für Schweizer Exporteure zu schaffen, und tatsächlich hat sich die Schweizer Währung trotz der Interventionen stetig aufgewertet.

Die SNB sollte Ihre Interventionen allerdings weit besser erklären. In der aktuellen Situation sind die Interventionen notwendig, aber wie die Entscheidung des Schatzamtes zeigt, sind sie nicht ohne Risiko für die Schweizer Wirtschaft. Die SNB sollte in regelmässigen Abständen ihre Gründe für die Interventionen detailliert erläutern, um Missverständnissen präventiv entgegenzuwirken.

RÉSUMÉ

Depuis plusieurs années, la Suisse figure sur la liste de surveillance du Trésor américain des pays qui pourraient tenter d'obtenir un avantage concurrentiel déloyal par le biais d'interventions monétaires. En décembre 2021, il a officiellement identifié la Suisse comme un manipulateur de devises.

Le Trésor américain utilise trois critères, mais ces critères sont arbitraires et ne sont pas judicieux. La BNS est intervenue sur le marché des changes uniquement pour des raisons défensives, afin de lutter contre les fortes appréciations spéculatives provoquées par la fuite des capitaux vers la Suisse. L'intention n'a jamais été de créer un avantage concurrentiel déloyal pour les exportateurs suisses et, en fait, la monnaie suisse n'a cessé de s'apprécier malgré les interventions.

La BNS peut cependant faire mieux. Compte tenu de la situation actuelle, les interventions sont nécessaires, mais comme le montre la décision du Trésor, elles ne sont pas sans risque pour l'économie suisse. La BNS devrait périodiquement expliquer son raisonnement pour les interventions de manière assez détaillée et afin de prévenir d'éventuels malentendus.

ABSTRACT

Over several years, Switzerland has been included in the US Treasury’s watch list of countries that could be trying to achieve unfair competitive advantage through currency interventions. In December 2021, it has formally identified Switzerland as a currency manipulator.

The Treasury uses three criteria, but these criteria are arbitrary and are not sensible. The SNB has intervened in the foreign exchange market purely for defensive reasons, to combat sharp and speculative appreciations that are caused by capital flight into Switzerland. The intention was never to create an unfair competitive advantage for Swiss exporters, and in fact, the Swiss currency has been steadily appreciating despite the interventions.

The SNB can do better, though. Given the current situation, the interventions are necessary, but as the Treasury's decision demonstrate, they are not without risk for the Swiss economy. The SNB should periodically explain its reasoning for interventions in some detail in order to preemptively counteract possible misunderstandings.

EXECUTIVE SUMMARY

Over several years, Switzerland has been included in the US Treasury's watch list of countries that could be trying to achieve unfair competitive advantage through currency interventions. In December 2020, it has formally identified Switzerland as a currency manipulator.

The Treasury has developed three criteria to pass judgement. It notes that Switzerland has met all three criteria in 2020. 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 and is inappropriate to define whether Switzerland manipulates its currency. 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 domestically. As a result, these investments are made abroad, which gives rise to 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. Its interventions are, however, entirely conducted for monetary policy reasons as the SNB's policy rate cannot be lowered further.

In fact, the Swiss franc has appreciated continuously; it is a safe haven currency, and is frequently 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.

The US Treasury recognizes 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.

The US Treasury further expands its analysis to include the joint impact of Swiss fiscal and monetary policies on the exchange rate. We welcome this bigger picture and agree that the policy mix between fiscal and monetary policies is imbalanced.

A first version of this report was issued on December 16, 2020, the same day as the US Treasury declared Switzerland a currency manipulator. That version reflected the situation up to December 15, 2020. The present update further examines the new US Treasury arguments.

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 following three conditions must be met in a given year for the US Treasury to name a country a currency manipulator:

- The trade surplus with the United States exceeds $20 billion.
- The current account surplus 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 its December 2020 report. Switzerland meets all three criteria. 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 (2019Q3-2020Q2)

Trade balance with the USA	Current account	Foreign Exchange Market Interventions	
		Amount	At least
US$ billion	% of GDP	% of GDP	6 months
49	8.8	14	Yes

Our view is that the two first criteria cannot be used to determine currency manipulation and that the third cannot fault Switzerland.

2. Bilateral trade balances

Bilateral trade balances are meaningless. 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 signs of 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.

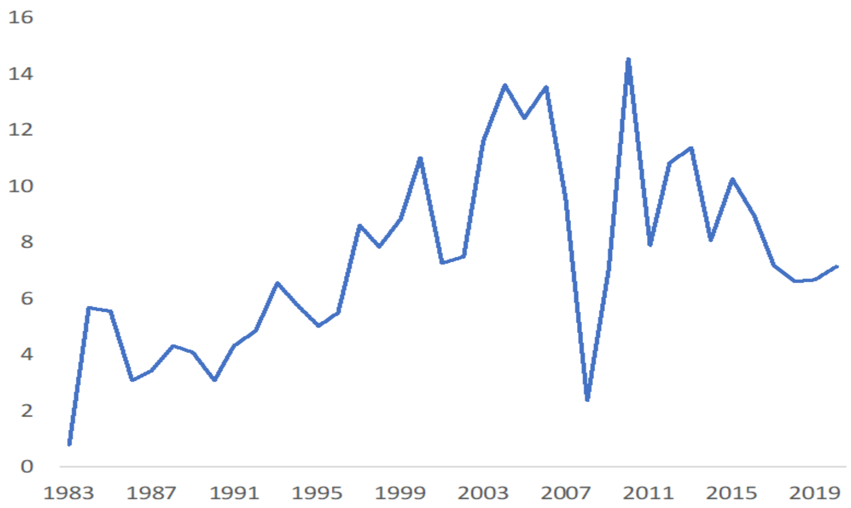
In addition, a large part of Swiss exports consists of "niche" or sophisticated products such as watches or pharmaceuticals. Demand for such products are not really sensitive to their prices so that the effects of exchange rate changes on the trade balance are limited.

3. The current account surplus

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 at home. This has nothing to do with currency manipulation.

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 1, which displays the current account since 1983 simply says that, collectively, Swiss households, firms and the federal and cantonal governments have been saving, and increasingly so, over decades. Why?

Figure 1. Current account (% of GDP)



Source: SNB

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). Their decisions to do so are obviously unrelated to the exchange rate.

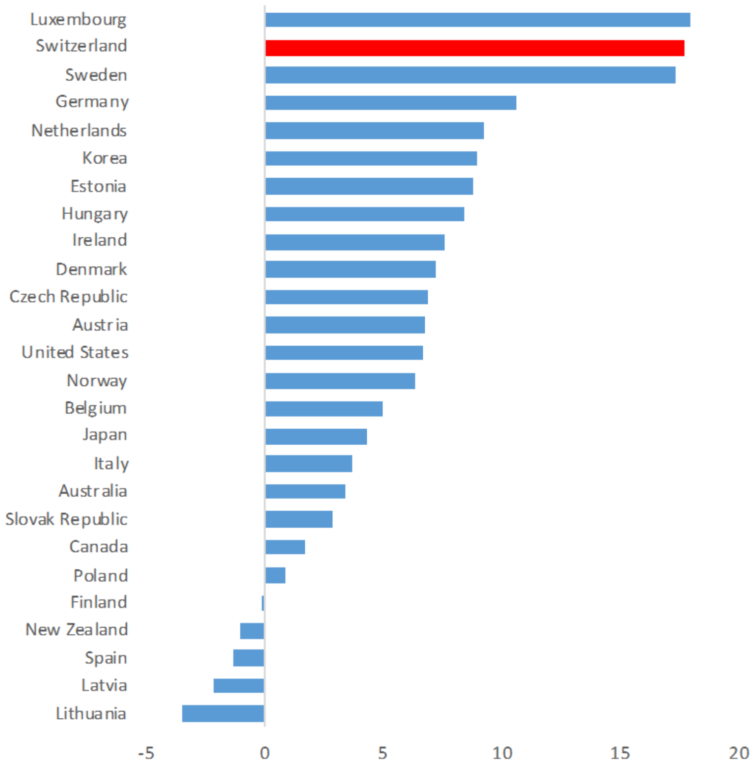
Swiss **households** save, a lot, as is seen from the comparison of OECD countries displayed in Figure 2. This is a consequence of the quasi-unique Swiss retirement system: under Pillars 2 and 3, people save a large part of their income for retirement. As the country is aging, these savings have increased 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. Figure 2 shows that this is also the case in Luxembourg.

In the end, the current account is largely unrelated to the exchange rate. The fact that it has long been in surplus is well explained by the saving patterns of the public and private sectors.

Figure 2. Household saving (% of GDP, 2019)



Source: OECD

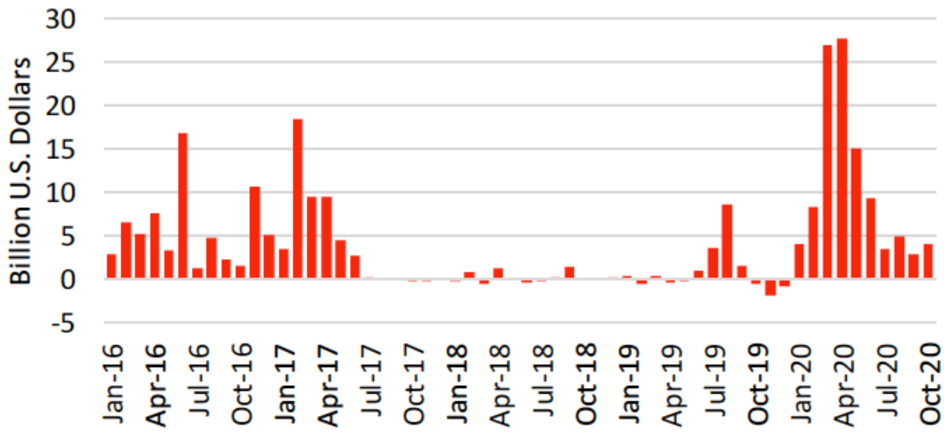
4. Foreign exchange market interventions: An uphill battle

Foreign exchange market interventions get us closer to the allegation of currency manipulation. When the SNB buys foreign currency against francs, more francs are put onto the market and it tends to reduce their value. The question is what are the SNB's intentions: boost Switzerland's competitiveness, smooth exchange rate fluctuations, or prevent an appreciation of the franc to prevent a deterioration in competitiveness? Simply looking at interventions, as the US Treasury does, cannot reveal the SNB's intentions.

Figure 3 depicts the US Treasury's estimates of SNB foreign exchange market interventions over the period 2016-2020. Clearly, the SNB intervenes often and with large amounts, and almost always to weaken the franc. If it intervened with the objective of smoothing fluctuations, it would intervene both ways. Why such an asymmetry?

The US Treasury notes that the interventions are mostly one-sided, meaning that they strongly seek to prevent appreciation when capital flows in but not depreciation when capital flows out. The US Treasury fully recognizes the safe haven status of the franc and that capital inflows always reflect financial fears that arise outside Switzerland. When these fears ease, capital flows out, but more slowly than on the way in. By not

Figure 3. 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, December 2020.

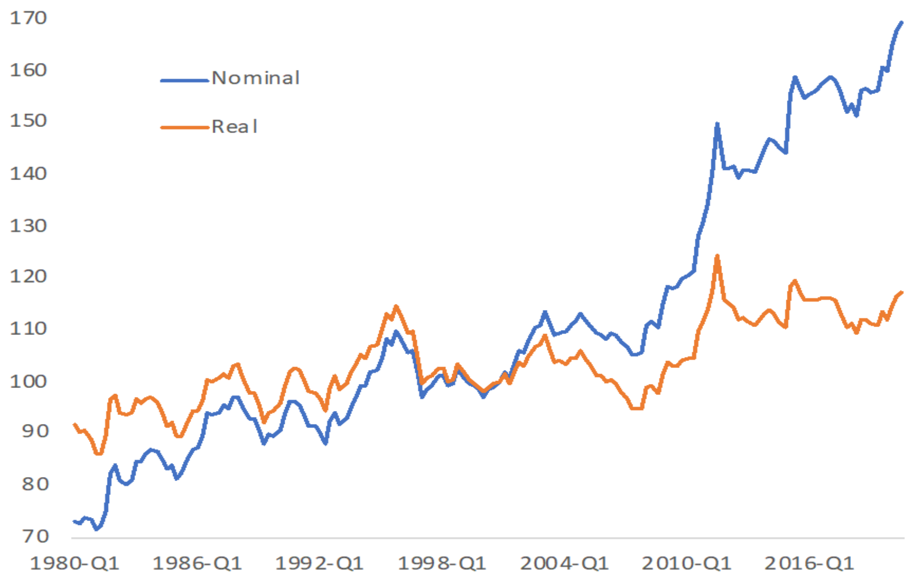
intervening, or by intervening very moderately, the SNB allows the exchange rate to occasionally depreciate. Yet, as Figure 4 shows, these depreciations are small in comparison with the appreciation spells and, moreover, they are fully reversed soon after they occur. Without the trend appreciation, the SNB might well be willing to tolerate deeper depreciations.

The SNB's answer is that the pressure on the franc is asymmetric precisely because the franc is a safe haven currency. In order to prevent an overvaluation, which would depress inflation, the only solution is to intervene on the foreign exchange market. This debate about intentions is interesting, maybe, but cannot be resolved by mere declarations, so we have to dig deeper.

We observe that, if the SNB intended to keep the franc undervalued, it has failed in a grand way. Indeed, the value of the franc has more than doubled over the last 40 years. The blue line in Figure 4 shows the average (called effective) value of the franc vis-à-vis 43 currencies of countries that trade most with Switzerland. (Like the trade balance, bilateral exchange rates vis-à-vis one country are uninformative because we cannot tell whether it is the home-country exchange rate that rises or the other country's currency that declines.) The SNB has plainly not prevented this appreciation.

In addition, 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

Figure 4. The franc.
(*Nominal and real effective exchange rates; Index: 2000Q4 = 100*)



Source: SNB

represented by the orange curve in Figure 4. Three observations can be made:

- The real exchange rate has been trending upward since 1980. This trend 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.

The conclusion fails to detect any gain in price competitiveness. Once more, if the SNB tries, it failed, and cannot be blamed for it. 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.

5. Foreign exchange market interventions are the other side of monetary policy

There is another reason why looking at foreign exchange market interventions solely through the prism of currency manipulation is misleading in the Swiss case. Foreign exchange market interventions are an inherent part of monetary policy, at least in a very open and financially integrated economy such as Switzerland.

As in the case of many other central banks, the SNB's main instrument is the interest rate. 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 crucial and requires the SNB to intervene to prevent the franc from strengthening excessively.

For a long time, the Swiss interest rate has been among the lowest in the world, which has limited the room for lowering it further. Furthermore, since the global financial crisis and now with the pandemic, most central banks have cut interest rates to what they regard as the effective lower bound. The SNB has even pushed its interest rate below zero, deeper than all other central banks. Unable to use their usual instrument, many central banks have adopted quantitative easing (QE) and flood markets with cash. Other central banks do this by purchasing various domestic assets.

The SNB, instead, purchases foreign assets through foreign exchange interventions. The reason is that the stock of public debt, the main asset acquired by central banks, is relatively small in Switzerland, while the flows of capital are comparatively much larger in respect of the size of its economy. The IMF concurs with our view:

"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.

6. Link with fiscal policy

While the US Treasury does not fault the SNB with intentional currency manipulation, it argues that the broader Swiss economic policy strategy indirectly, and possibly unintentionally, weakens the franc and contributes to the current account surplus. This is an argument that cannot be dismissed.

The US Treasury characterizes Swiss fiscal policy as tilted toward budget surpluses as a result of the federal and cantonal debt brakes. This increases national saving and thus contributes to the current account surplus.

The US Treasury further notes that the reluctance to use fiscal policy to reduce economic slowdowns leads the SNB to be more active than otherwise. This combination of tight-fiscal and easy-monetary policies is known to weaken the exchange rate. Hence the US Treasury recommendation:

"We strongly urge Switzerland to use its substantial fiscal space to reduce the economy's reliance on the SNB's policy measures, rebalance its external sector, and boost potential growth. […] We also urge the Swiss authorities to re-examine the debt brake rule to reorient its purpose towards debt stabilization."

> "Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States – Report to Congress", US Treasury, December 2020, page 62.

Whether a country runs current account surpluses or deficits is the result of saving decisions by its residents and of the choice by the central and subcentral governments regarding their budget balances. There is no presumption as to whether a current account should be in surplus and deficit. The US Treasury does not justify its recommendation to cut the surpluses, because it cannot. Still, it is true that the fiscal policy stance often leaves the task of dealing with adverse shocks in the hands of the SNB, in effect encouraging lower interest rates than otherwise. As low interest rates tend to weaken the franc, the US Treasury has a point, but not about interventions.

7. Recommendations

While we reject the US Treasury's position on currency manipulation, we believe that some more thought could be devoted to the SNB's exchange rate policy.

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. This lack of transparency is one reason behind the suspicion of currency manipulation. 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? Instead, the SNB should make intervention data available on a weekly basis in its publicly accessible database.

Interventions belong to the SNB's toolkit. The Swiss franc has never been a freely floating currency. The external value of the currency was always managed, which is what most small open and financially integrated countries also do.

The SNB should explain the strategy that guide their interventions. Such a strategy should explain how it assesses overvaluation, including its procedure to evaluate the equilibrium exchange rate, and how strongly it needs to intervene when it sees it necessary. A major benefit of a fully worked-out and transparently communicated strategy would be to increase the effectiveness of interventions. This might not have mattered when it intervened sporadically but the systematic actions of recent years stand to be enhanced when markets understand clearly the SNB's intentions.

In addition, the SNB should be open about its interventions and explain in some details the deliberations of the governing board 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 formulate and publish the strategy they follow for their exchange rate policy and interventions. This would strengthen their credibility and would make the job easier. In addition, the SNB should provide data on a weekly basis about the interventions, and explain in some detail the deliberations of the governing council about the interventions.*