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Thinking ahead for Europe

The end of an overlooked European currency war

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In September 2011, close to the peak of the euro crisis, the Swiss National Bank (SNB) announced that it would do 'whatever it takes' to ensure that the Swiss franc/euro exchange rate would not fall below 1.2 Swiss francs per euro. The justification was that speculative capital flows induced by the euro crisis were driving the Swiss francs above its equilibrium value. During the preceding years, there had indeed been large capital inflows with a strong impact on the exchange rate, which the Swiss National Bank had in vain tried to counter with massive foreign-exchange interventions. The Swiss franc had appreciated by over 25% in any event. The hope then was that if this commitment to a floor was credible, there would no longer be any need for further foreign-exchange interventions to keep the Swiss franc stable. This aim was indeed achieved temporarily when the SNB showed that it meant business. However, even as the euro crisis abated during 2012 the capital inflows resumed, and the SNB had to intervene again heavily, with reserves reaching the unprecedented level of over 80% of Swiss GDP by the end of 2014.

On January 15th the SNB threw in the towel. When it stopped its interventions, the Swiss franc appreciated immediately by almost 20% (after a temporary overshot of an even larger amount).

The Swiss case contains some important general lessons; and the move by the SNB to stop intervening will have an important impact on the euro-area economy.

Switzerland counts

The total reserves of the SNB of €400 billion are significant at the scale of Europe given that the largest share is in euro. The share of the euro has fallen from 70% at one point, but during the major periods of reserve accumulation it was always around one-half. A good guess is that about one-half of accumulation of €400 billion of reserves by the SNB would translate into roughly €200 billion of purchases of euros.

If the ECB had wanted to neutralise the impact on the euro's exchange rate, it should have bought an equivalent amount of a foreign currency, say US dollars (this is what the Japanese did when the Chinese announced their intention to diversify their reserves into yen). It is clear that if the ECB had bought the equivalent of €200 billion in dollars, the euro would presumably have been much weaker much earlier, and would be even weaker against the dollar today. This is of course only a thought experiment since any 'counter-intervention' by the ECB of this

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scale would surely have been qualified as a real 'currency war' and would have led to significant conflicts between the major monetary powers. By contrast, the Swiss intervention caused barely a ripple.

The Swiss franc/euro exchange is important by itself, given that exports of the euro-area countries to Switzerland are only somewhat lower than exports to China (both around €90-100 billion). Moreover, the Swiss current-account surplus is relevant at the scale of the euro area, being equivalent to close to 0.7% of the euro area's GDP. Switzerland's peg to the euro had thus made the intra-euro area adjustment (elimination of current-account deficit in the South combined with lower surpluses in the North) significantly more difficult.

The end of the silent currency war in Europe

A current-account surplus is the mirror image of a capital export. A country that is running persistent current-account surpluses is thus persistently exporting capital. An important question to consider is which sector is investing abroad: the private or the public sector? If it is the public sector, and particularly if it is done by the central bank via the accumulation of foreign-exchange reserves, this is often called 'currency manipulation'.[1]

In a VoxEU column of 2012, Gros (2012) showed that under most commonly used indicators, Switzerland had done more to 'manipulate' its currency than China. This is still the case if one considers the situation as of the end of 2014, when the value of Swiss foreign-exchange reserves (largely held in euro) amounted to close to 100% of GDP – more than twice as much as the roughly 40% of GDP for China.

The official justification for interventions and the peg of 2011 was simple: during the previous decade, the country had run large and actually rising current-account surpluses while the exchange rate had remained stable against the euro without the need for any intervention, proving that these surpluses constituted market equilibrium. However, with the outbreak of the financial crisis, 'speculators' started to consider the Swiss franc as a safe haven, driving the currency to a level at which the Swiss export sector could no longer compete. From this perspective, the Swiss National Bank was entirely justified in, first, intervening heavily and then fixing the exchange rate against the euro.

This view does not take into account, however, the fact that the stability without intervention until 2008 was underpinned by a combination of factors that was not sustainable: Austrian local governments and households all over the new Eastern European member countries of the EU were willing to indebt themselves in Swiss francs because of its lower interest rates. Moreover, the global credit boom had made investment outside Switzerland appear to Swiss savers as safe as a domestic investment. These illusions were shattered with the outbreak of the great financial crisis. The business with Swiss franc-based mortgages in Eastern Europe dried up and Swiss private investors have continued to offload their exchange-rate risk on the Swiss National Bank. The result is that today the foreign-exchange reserves of the SNB are roughly equal to one half of the sum of the current-account surpluses the country has accumulated over the last 20 years. This implies that the Swiss public sector has taken over one-half of all of the (net) foreign-exchange risk that comes with current-account surpluses.

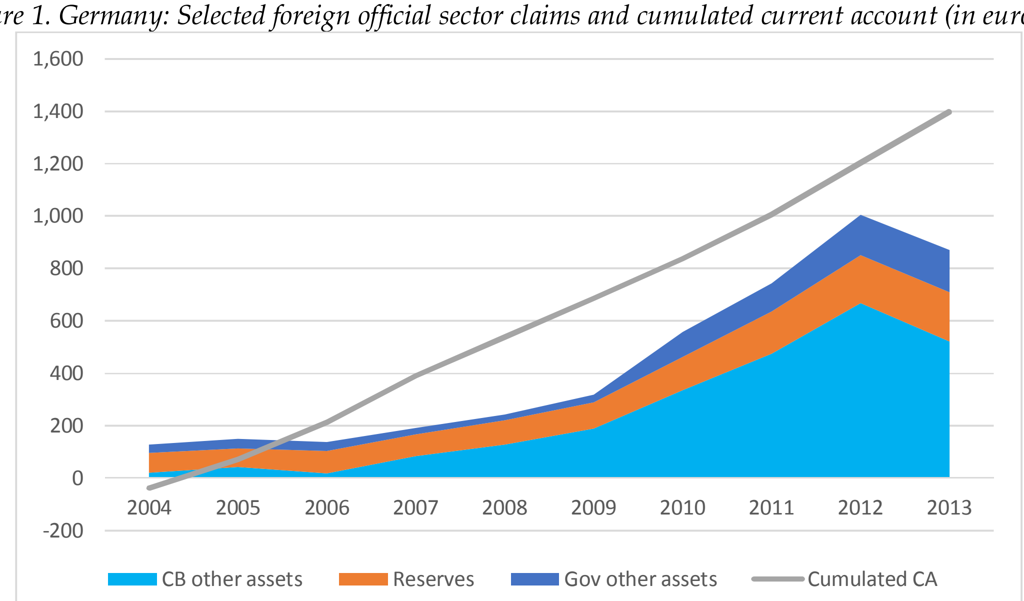
[1] There are of course valuable reasons why countries hold foreign-exchange reserves (insurance against shocks, for example) without the aim of manipulating the exchange rate, but any country that persistently increases its reserves above the level needed to offset short-term shocks is by definition manipulating its currency. See Gagnon (2012).

This risk has now materialised, inflicting extraordinarily large losses on the Swiss National Bank. With foreign-exchange reserves of about one half of GDP, an appreciation of 15% (as has materialised in one day) implies a (accounting) loss of 7-8% of GDP. One lesson from the Swiss case is that the political implications of central-bank losses can be completely different depending on the source of the loss. Fundamentally the foreign-exchange interventions of the SNB are not different from the Target balance of the Bundesbank within the euro-area's payment system or the acquisition of government bonds by the Bundesbank within the forthcoming QE programme of the ECB. Any small loss for the Bundesbank in the context of these operations would create outrage in Germany. But the loss of close to 100 billion Swiss francs (now equal to about €100 billion) by the Swiss National on January 15th caused barely a ripple in Swiss political circles.[2] In terms of German GDP, such a loss would be equivalent to over €500 billion, many times more than any conceivable loss the Bundesbank (and the government) might suffer from a Greek default and exit from the euro area.

The parallels between the German and the Swiss problem of who holds the risk inherent in the accumulation of large claims on foreigners when the domestic savers are extremely risk-averse can be seen by the importance of the foreign-asset position of the official sector. In the case of Switzerland, it is mainly the central bank with its foreign-exchange reserves. In the case of Germany, it is again the central bank which takes a large share of the risk of the capital flows abroad, but with Target balances instead of foreign-exchange reserves. Moreover, there is an important contribution from the government via its share in the European rescue funds.

The figures below show for each country the foreign assets held by the official sector compared to the sum of past current accounts.

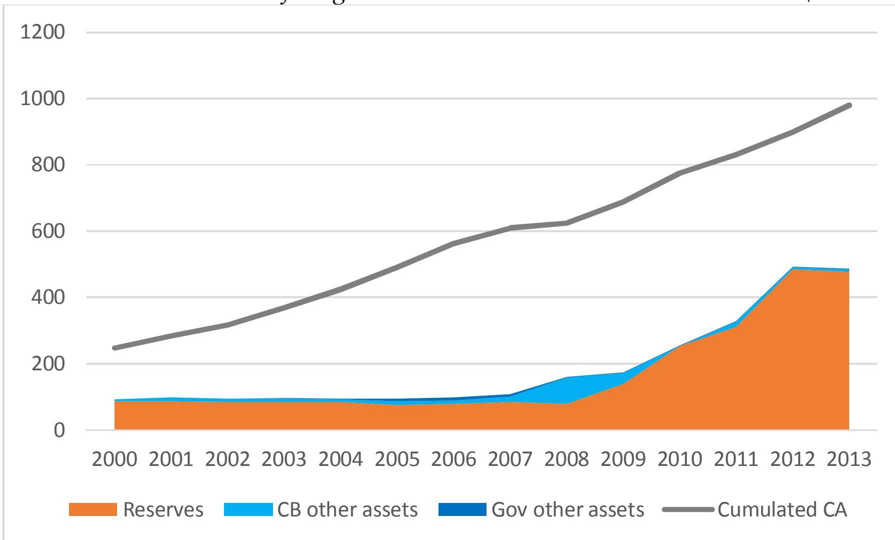
Figure 1. Germany: Selected foreign official sector claims and cumulated current account (in euro)



Data source: Eurostat.

[2] This was the loss on the day the exchange-rate floor vanished. This figure has to be partially offset by the gains the SNB made on its dollar holdings during the preceding year, when the depreciation of the euro against the dollar led to gains of over 30 billion CHF on its large dollar holdings. Nevertheless, the losses on the euro holdings remain.

Figure 2. Switzerland: Selected foreign claims and cumulated current account (in CHF)



Data source: Swiss National Bank.

Another lesson from the Swiss experience is that even large exchange-rate changes offer no guarantee for an adjustment in the current account. The effective exchange rate of the Swiss franc appreciated by about 25% between 2009 and 2012, but the current-account surplus has not fallen.

Moreover, a flexible exchange rate provides no guarantee that the central bank can achieve the holy grail of central banks in today's advanced countries, namely to steer the economy clear of the danger of deflation. The Swiss National Bank has already failed by a larger margin than the ECB, given that Switzerland has already experienced near deflation for the last few years. With the recent massive appreciation of the Swiss franc, outright deflation is now a certainty for the near future.

References

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