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Should Central Banks Manage the Exchange Rate?

Should central banks intervene in currency markets? In theory, within a flexible system, central banks should leave the process of determining appropriate exchange rates to the currency markets. In practice, however, central banks have frequently intervened to "manage" the exchange rates according to their goals and priorities. This article discusses whether central banks can effectively intervene in currency markets and describes some lessons other countries could learn from the Swiss experience.

It was a heroic battle that the Swiss National Bank (SNB) fought against the financial markets. It lasted 1227 days. But in the end, in January 2015, an exhausted SNB finally capitulated and gave up its desperate fight for a weaker Swiss franc. The lesson to be learned: do not try to manage currency rates. Central banks – at least those of smaller countries – are not able to overcome the power of the markets.

The SNB's decision to peg the Swiss franc to the euro

The SNB first announced that it would aim for a substantial and sustained weakening of the Swiss franc on 6 September 2011. Targeting an exchange rate no lower than CHF 1.20 to €1, the SNB reasoned that a strong Swiss franc posed a significant threat to the Swiss economy. The extremely high level of uncertainty in global financial markets led to the further risk of an exceptional revaluation of the Swiss franc, causing serious harm to the Swiss economy. Under these circumstances, the SNB proclaimed that it would execute its strategy with the "utmost determination" – meaning that the SNB was prepared to "buy foreign currency in unlimited quantities".[1]

For a while, the SNB's decision to peg the Swiss franc to the euro and to fight against the free floating of flexible exchange rates was remarkably successful (see Figure 1). Within the first day of the SNB announcement, the Swiss franc devaluated by 8.3 per cent. Afterwards, the exchange rate stabilised within a very narrow band of CHF 1.20-1.25 to €1. The tendency for the Swiss franc to continuously appreciate – characteristic of the period from March to August 2011 – was halted.

However, the SNB strategy to maintain a weak Swiss franc turned out to be very costly. Between September 2011 and December 2014, the SNB had to intervene several times in the currency market to purchase US dollars, euros, British pounds and Japanese yen and sell Swiss francs (Figure 2). In the end, these interventions exploded the foreign currency reserves of the SNB from CHF 264 billion in September 2011 to CHF 541 billion in December 2014 (see Figure 3). This corresponds to more than 80 per cent of the 2014 Swiss GDP of about CHF 650 bil-

Figure 1
Swiss franc-euro exchange rates

Source: Deutsche Bundesbank.

1 SNB: Press release, Zurich, 6 September 2011.

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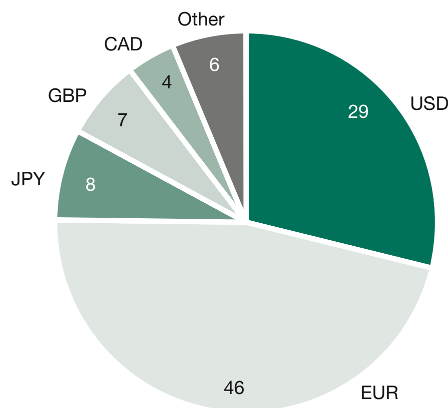
Figure 2

Foreign currency reserves of the SNB, 2014

in %



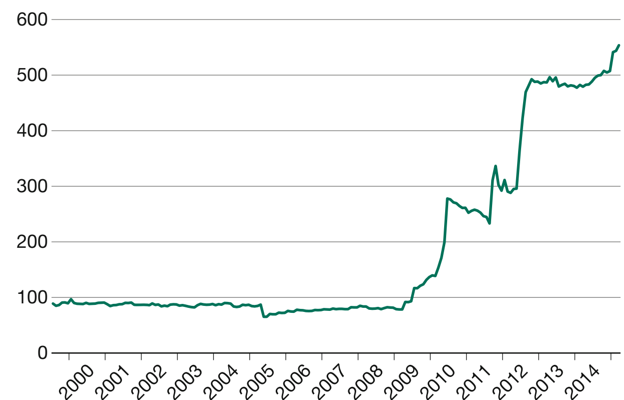
Note: Distribution of most important currencies at the end of 2014. Percentages converted by approximate market values.

Source: Swiss National Bank.

Figure 3

Foreign currency reserves of the SNB

in billion Swiss francs



Note: Monthly values, converted by approximate current market values.

Source: Swiss National Bank.

lion. Comparisons to the United States (where the Federal Reserve's balance sheet reached about 25 per cent of US GDP) or to the eurozone (where the European Central Bank's balance sheet also reached about 25 per cent of eurozone GDP) show that the SNB has taken much higher risks than other central banks and might have become the world's largest currency market speculator.

The European Central Bank's decision to pump an additional €1.14 trillion of quantitative easing (QE) into the monetary system between March 2015 and September 2016 increased the pressure on the SNB. Furthermore, the return of political troubles to the eurozone and fears of a "Grexit" – Greece exiting the eurozone – had led to a stampede into the apparent safe haven of the Swiss franc. Under these new pressures, the SNB could either hold to its minimum rate strategy, which would further increase the risks by imponderable dimensions, or it could capitulate and discontinue the minimum exchange rate policy.

The SNB's decision to abandon the peg

On 15 January 2015, the SNB decided to abandon the Swiss franc's peg to the euro.[2] The consequences were dramatic.[3] Within a single day, the price of one euro dropped from CHF 1.201 to 1.028, an appreciation of the Swiss franc against the euro of 14.4 per cent.

After overshooting led to a brief drop below parity for a few days, the exchange rate stabilised at a level of about CHF 1.04-1.05 to €1 in March and then declined slightly to CHF 1.03 to €1 by late April. Seen from a historical perspective, this corresponds to a very strong Swiss franc, raising two key questions: first, whether the SNB should intervene to avoid an overvaluation of the Swiss franc, and second, whether it could even prevent this if it wanted to. In fact, the SNB left open exactly this option by proclaiming that it will

> continue to take account of the exchange rate situation in formulating its monetary policy in the future. If necessary, it will therefore remain active in the foreign exchange market to influence monetary conditions.[4]

Should central banks intervene in currency markets?

In theory, within a flexible system, central banks should leave the process of determining appropriate exchange rates to the currency markets. Supply and demand and the reactions of currency traders to changes in the macroeconomic setting result in the free floating of exchange rates. In practice, however, central banks have frequently intervened to "manage" the exchange rates according to their goals and priorities.

2 For a discussion of the reasons for abandoning the informal peg of the Swiss franc to the euro, see K. Pilbeam: Intervention in the Foreign Exchange Market: Rationale, Effectiveness, Costs and Benefits, in: Intereconomics, Vol. 50, No. 2, pp. 64-70.

3 For a discussion of the short-term consequences of the SNB decision to abandon the informal peg of the Swiss franc to the euro, see A. Bris: A Strong Franc: Is Switzerland the New Japan?, in: Intereconomics, Vol. 50, No. 2, pp. 70-75.

4 Swiss National Bank: Press release, Zurich, 15 January 2015. The initial data for January and February 2015 show increases of the SNB's foreign currency reserves from the CHF 541 billion at the end of 2014 to CHF 544 and CHF 554 billion.

There might be many good reasons to legitimise a managed floating. It could be argued that markets might fail, which could lead to "wrong" exchange rates deviating more or less severely from the "right" ones. Consequently, central banks would have to intervene because a) they might have more and better knowledge than the currency traders about the underlying economic fundamentals and their developments, and b) free market prices could overreact, leading to an overshooting (i.e. a short-term deviation from long-term purchasing power parity equilibria, provoking unnecessary adjustment costs).[5]

Whatever a "wrong" rate of exchange means and however the "right" rate would be defined and measured, and ignoring the questions of why a central bank should have more and better information than market actors and why an intervention would be a better reaction than simply disseminating and sharing all of the relevant available information, it does not change the judgement that in most cases a managed float is nothing more than a cave-in to the lobbying pressure of vested interest groups. The strategy of weakening the national currency is just a policy of protectionism.

The devaluation of a currency is an incredibly potent weapon to protect domestic companies from foreign competitors. It acts as a subsidy for exporters and as a duty for importers. It makes domestically produced products cheaper and products from abroad more expensive. Thus, domestic producers can sell more abroad, and domestic customers will buy fewer imported goods and services.

A devaluation strategy works no differently from any other strategy of protectionism. It prevents an efficient division of labour. Like all other duties, it helps a few but hurts many, namely consumers and savers. It reduces the purchasing power of domestic assets and thus makes everyone poorer.

A devaluation strategy can become particularly expensive if other currencies begin to fight back against their appreciation, which could easily escalate into a full-blown "currency war". If the currency printing presses are let loose everywhere, money will lose its function as a store of value and as a measure of the relative shortage or surplus of goods, labour and capital, and monetary stability will be lost everywhere.

5 For a discussion of the arguments for (some degree of) discretionary interventions in currency markets by central banks, see K. Pilbeam, op. cit.

Can central banks effectively intervene in currency markets? The Swiss example

The question of whether the SNB even could return to a managed float of the Swiss franc concerns the limited options that a relatively small country has available to pursue a devaluation strategy in a globalised world economy.

Firstly, the SNB could return of a strategy of buying euros "without a firm commitment". The difference from the policy of the last three and a half years would be that the SNB would not have to secure a minimum rate of 1.20 Swiss francs per euro. It could more or less "voluntarily" intervene in the currency markets. However, the advantage of a certain degree of freedom of action would be paid for with the loss of predictability of SNB policy. Furthermore, the SNB's foreign reserves would further increase. That would again increase risks and costs, which would provoke speculative attacks testing the will of the SNB to maintain a managed float.

Secondly, the SNB could establish negative interest rates, as it has already been doing since January 2015. In the 1970s, the so-called "punishment tax" on accounts held by foreigners was several times higher than the negative interest rates of today. However, the effect of high negative interest rates could be cancelled out by a change of behaviour: foreigners would no longer hold Swiss francs "electronically" in Swiss bank accounts but as "cash" in Swiss bank vaults.

Thirdly, it is conceivable that Swiss politics could intervene. The government could decree that Swiss banks not be allowed to accept foreign funds in Swiss francs and prohibit foreigners from holding assets in Swiss securities, land and property. Likewise, further rules to ban the holding of cash or liquidity in Swiss francs could be adopted. But all these policy interventions would constitute the end of a capitalist monetary system and the beginning of a nationalisation of the monetary economy.

Taken together, the answer is "no". The SNB should not return to a managed floating of the Swiss franc. The limitations of such a policy and the risks to the SNB are too obvious. Consequently, the Swiss franc will remain strong for a considerable time. As long as the euro area does not return to sustainable stability, increasing growth and declining unemployment, the Swiss franc will be under more or less constant pressure to appreciate.

What could be learned from the Swiss case?

Switzerland's recent experience reveals the consequences – both positive and negative – of a strong currency

for the domestic economy. Even if the impact of changes in exchange rates for a huge country like the United States is less substantial than for a small open economy like Switzerland, there might still be some lessons to be learned from the Swiss case – especially if one concludes that a strong currency is not a problem, even for a small open economy such as Switzerland. Accordingly, it might be even more justified to expect that the strong dollar will not harm the much bigger US economy, which is less open to the world market and more dependent on its internal market.

When the SNB decided to abandon its defence of the minimum exchange rate of CHF 1.20 per euro on 15 January, the resultant appreciation of almost 15 per cent against the euro within a single day was dramatic. However, it was not unique in the history of Swiss monetary politics. The appreciation of the Swiss franc is nothing new. On the contrary, it has been a constant over the last several decades.

In 1971, one US dollar was worth more than four Swiss francs. By 1981, the dollar had devaluated to two Swiss francs, by the turn of the century, to 1.6 Swiss francs, and by April 2015, to less than parity (i.e. CHF 0.98 to $1). The Swiss franc has long been highly attractive, which has driven its price upwards. Stability and prosperity acted like a magnet, attracting assets from around the world to the safe haven of Switzerland.

Over the decades, the Swiss economy has proven that it is able to compensate for the external appreciation of the Swiss franc in the medium and long term through internal (cost) devaluations. The key asset of the Swiss economy is the high flexibility of small and medium-sized businesses and their workforces. They adapt quickly and effectively with a judicious mix of cost savings, productivity improvements and innovations of all kinds to changing macroeconomic conditions. There are several good reasons to expect that these demonstrated abilities will continue to apply in the future.

Firstly, the strong Swiss franc reduces the cost of capital good imports, intermediate consumption, raw materials and energy. Lower costs for imports automatically and immediately reduce the costs of production for goods and services.

Secondly, the strong Swiss franc leads to low interest rates. While some (i.e. savers) suffer, others (i.e. debtors) profit from cheap credit. The low cost of capital for companies allows for more capital-intensive production, which increases labour productivity and international competitiveness.

Thirdly, Swiss employers and employees will continue to carefully consider the extent to which they can jointly reduce costs through mutual concessions, as they have in the past. They will balance job security and wage (or working condition) flexibility. Due to the appreciation of the Swiss franc, prices for imported consumer goods are likely to fall, which strengthens the real purchasing power of wages and increases flexibility for wage adjustments.

Fourthly, labour-intensive activities might be shifted abroad. This would release capacities and provoke incentives for new and higher added-value activities. Quality will replace quantity, and quality products are less price elastic. Foreign customers will continue to place value in the “Made in Switzerland” label, even if Swiss-made products or services are more expensive. This is the case partly because Swiss quality cannot be substituted so easily and partly because Swiss quality might be seen as irreplaceable, especially for luxury goods, precision instruments, high-tech products, optical devices and medications, as well as for financing, insurance and consulting services.

Fifthly, the weak euro improves the international competitiveness of firms from the eurozone, which will increase their sales to global markets. As a consequence, employment and growth in the eurozone will be stimulated. The Swiss economy would benefit enormously from a strong recovery in the eurozone, because almost half of Swiss exports are sold in the eurozone, with Germany alone responsible for a share of almost 20 per cent. Thus, an economic improvement in the eurozone will lead to higher demand for Swiss (investment) products.

Conclusions

The challenges of currency appreciation are part of the Swiss economy’s history of success. These challenges have not weakened but rather strengthened Swiss companies. Therefore, it is realistic and not merely unjustified optimism to expect that the Swiss economy can again cope with a strong Swiss franc. The near future is likely to be difficult, but the long term remains promising. Therefore, the SNB should not return to a managed floating exchange rate for the Swiss franc, but instead keep it flexible.

Thus, the lessons other countries could learn from the Swiss experience are, firstly, that a strong currency can be a stimulus rather than a liability for the economy, and secondly, that central banks might be well advised to abstain from market interventions to weaken the national currency.