INFOCUS

MARKET SNAPSHOT

JULY 2020

A century of Swiss franc trends and cycles

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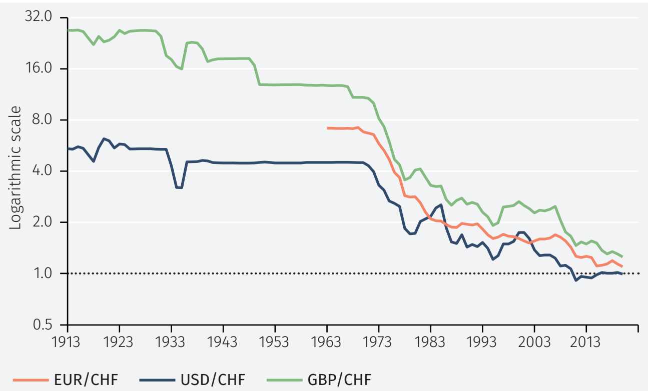
The Swiss National Bank is intervening massively in currency markets to stem the franc's strength. Trading close to historical highs against most currencies, it is not surprising that the SNB thinks the franc is "highly valued". In this edition of Infocus, GianLuigi Mandruzzato looks at the behaviour of the nominal and real exchange rates of the Swiss franc over the last century.

Covid-19 and the long-term impact on public debt
On 18 June, the Swiss National Bank (SNB) confirmed its policy of negative interest rates and interventions in the currency markets as the Swiss franc remains "*highly valued*". The latter conclusion seems indisputable: the Swiss franc is close to historical highs against all major currencies. Hence, continuation of the SNB's interventions, which have already resulted in the accumulation of reserves worth 120% of Swiss GDP, seems warranted.

The Swiss franc nominal trend
The strength of the Swiss franc is not new, having appreciated against the major currencies over the past century. Figure 1 shows, using a logarithmic scale, the annual average exchange rates of the franc against the euro since 1963 and against the US dollar and UK pound sterling since 1913.[1]

1. The Swiss franc since 1913



Source: www.hsso.ch, Bundesbank, Refinitiv and EFGAM calculations. Data as at 23 June 2020.

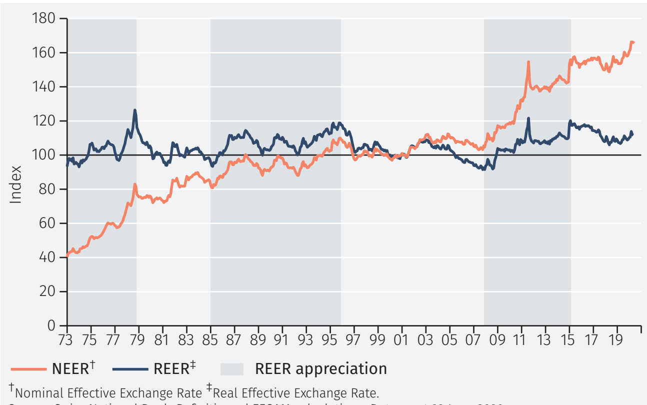
After a period of relative stability between 1913 and the late 1920s, the crisis of 1929 and the subsequent Great Depression triggered the first wave of Swiss franc appreciation. In 1931 the United Kingdom abandoned the gold standard and devalued the pound to contain the crisis in that country. The US devalued the dollar in 1933, accentuating upward pressure on the franc. After the devaluation of the Swiss franc in 1936, the USD/CHF exchange rate was virtually unchanged until 1971. This also followed from Switzerland's de facto adherence to the rules of the Bretton Woods system, which in 1944 established a fixed exchange rates regime linked to the convertibility of the US dollar into gold.

During the 1960s, rising public deficits and inflation in the US led to pressure for a devaluation of the US dollar, undermining the sustainability of the fixed exchange rates' regime. In August 1971, after Germany and Switzerland had already abandoned the Bretton Woods system, the US announced the suspension of gold convertibility of the dollar, marking the beginning of the floating exchange rate regime that is still in place. Since then, the trend rise of the Swiss franc has intensified.

However, a rising exchange rate is not necessarily a cause for economic concern if the domestic inflation rate is lower than that of a country's trading partners. An appreciation of the currency consistent with the inflation differential will not jeopardise its competitiveness. Such a situation would be reflected in a rising nominal exchange rate but a stable real, inflation adjusted, exchange rate.

The Swiss economy and the franc fit this template. Figure 2 shows the indices of the trade-weighted nominal effective exchange rate (NEER) and real, producer prices adjusted

2. Swiss franc trade-weighted indices



†Nominal Effective Exchange Rate ‡Real Effective Exchange Rate.
Source: Swiss National Bank, Refinitiv and EFGAM calculations. Data as at 23 June 2020.

[1] www.hsso.ch provides a database with Swiss macroeconomic and financial data up to the 18th century developed under the supervision of the Swiss Society for Economic and Social History in collaboration with the Universities of Zurich, Geneva and the Federal Institute of Technology Lausanne. The EUR/CHF exchange rate for the period before 1999 was reconstructed based on the exchange rates of the German mark against the euro and the Swiss franc published by the Bundesbank.

effective exchange rate (REER) of the franc since 1973.[2] The nominal exchange rate index has risen by more than 300% over the last five decades, equivalent to an average annual trend of 6.9%. During the same period, the real exchange rate index has remained within a relatively narrow range.[3]

This reflects lower tradeable goods price inflation in Switzerland relative to its main trading partners. Since January 1964, average annual producer price inflation was 1.16% in Switzerland, 3.34% in the US and 4.96% in the UK; since January 1982, average annual producer price inflation was 0.37% in Switzerland and 1.88% in the euro area.[4] According to Purchasing Power Parity theory, these inflation differentials would justify an appreciation of the Swiss franc of around 230% against the US dollar, 690% against the British pound and 75% against the euro over the periods considered.

The Swiss franc real cycles

A closer look at the Swiss franc REER reveals two interesting features. The first is a moderate upward trend of about 0.4% per year over the sample period.[5] The literature links the appreciation of the Swiss franc's real exchange rate to the high productivity of its export sector and the advancement of its technological content witnessed, for example, in the large number of patents submitted by the firms based in the Confederation.[6]

However, the starting point of the sample matters when assessing the steepness of the underlying trend. At the beginning of 1973, based on Purchasing Power Parity, the Swiss franc was about 15% undervalued against both the US dollar and the German mark (see Appendix). Interestingly, in the following two years, the Swiss franc REER rose by about 14%, suggesting it was moving towards underlying fundamentals. Since December 1974, the Swiss franc REER has risen by only 5%, equivalent to an annual trend appreciation of just 0.1%.

The second feature that stands out is the way in which the real effective exchange rate shifts between episodes of appreciation – shown by the shaded areas in Figure 2 – and episodes of depreciation.[7] The size of these swings was typically around 30%. These cycles were strongly influenced by monetary policy shifts in Switzerland and abroad.

The 1973-78 rise of the franc reflected comparatively tight Swiss monetary policy geared to price stability. As the franc strengthened, the SNB imposed penalties on foreign deposits, cut interest rates to zero, and eventually intervened in open markets to keep a lid on the exchange rate against the German mark.

The currency depreciation that followed and the more accommodative SNB monetary policy stoked Swiss inflation and triggered the 1979-85 Swiss franc REER fall which ended after the Plaza Accord of September 1985.

The 1985-95 upswing of the franc was first driven by rising Swiss interest rates as the SNB tried to quell a housing boom. In the early 1990s, the crisis in the European Exchange Rate Mechanism of 1992 and the recession in the US fostered demand for the Swiss franc.

The subsequent fall of the Swiss franc REER between 1995 and 2008 was triggered by tighter US monetary policy at a time when the SNB was still dealing with the correction of the 1980s housing market excesses. In the 2000s, the increased globalisation of financial markets often saw the Swiss franc being used as a funding currency for leveraged trades, putting downward pressure on the exchange rate.

Flight-to-safety flows sparked by the collapse of Lehman Brothers and the euro area debt crisis were behind the last upcycle of the Swiss franc REER. Despite large interventions in the foreign exchange market, the SNB was forced to introduce a floor on the EUR/CHF exchange rate in September 2011 to prevent the franc from appreciating. Upward pressures on the franc temporarily returned in the aftermath of the discontinuation of the EUR/CHF exchange rate floor in January 2015.

Is the recent depreciation of the Swiss franc surprising?

Since January 2015, the SNB has stepped up its currency interventions. This has contributed to the 8% depreciation of the Swiss franc REER from its last peak. The lower REER also reflected an increase in investor risk appetite. However, the past behaviour of the Swiss franc REER shows that normally once a peak has passed there follows a prolonged downswing.

[2] The SNB publishes a range of real exchange rate measures based on consumer prices (CPI), unit labour costs (ULC), and producer prices (PPI). The analysis considers the PPI-adjusted REER as it better reflects the relative development of tradeable goods prices.
[3] The SNB series of the overall, PPI-adjusted REER index starts in January 1984. The index was reconstructed backwards to January 1973 based on the bilateral PPI-adjusted REER indices against the German mark, the French franc, the Spanish peseta, the Dutch guilder, the US dollar, and the British pound.
[4] The time series of euro area PPI is available since 1981 from Eurostat.
[5] The hypothesis of stationarity of the REER on sample January 1973-May 2020 is rejected with high probability by statistical tests.
[6] See Baltensperger and Kugler, "*The historical origins of the safe haven status of the Swiss franc*", University of San Gallen Aussenwirtschaft 67.2, 2016, and Reynard, "*What drives the Swiss franc?*", SNB Working Paper 14, 2008.
[7] An episode of appreciation goes from a major trough to a major peak. A major trough is identified when it is lower than the previous and successive minor lows and it is at least two standard deviations below trend. Accordingly, a major peak is identified when it higher than the previous and successive minor peaks and it is at least two standard deviations above trend. The exception is the 2008-2015 period where the peak after the discontinuation of the exchange rate floor is considered as the end of the Swiss franc appreciation episode.

This raises the question if the recent fall could have been anticipated and, hence, be interpreted as a continuation of the cycles of the last 50 years.

To answer this question, a simple econometric model of the Swiss franc REER is estimated over the January 1973-December 2015 sample period.[8] A dynamic forecast of the REER over the January 2016 - June 2020 period is then computed. If it predicts a fall of the REER, it would suggest the current downswing is the continuation of the past REER cycles.

3. The Swiss franc REER and model forecast

†Real Effective Exchange Rate.
Source: Swiss National Bank, Refinitiv and EFGAM calculations. Data as at 23 June 2020.

Figure 3 above shows the model forecast and the two-standard errors confidence band around it. The model correctly predicts the REER fall since early 2015. The rise of the franc between mid-2019 and March 2020 is probably due to the increased demand for safe assets amid trade tensions between the US and China and the Covid-19 pandemic. However, even at its March 2020 peak, the REER value fell within the forecast range. Finally, the model forecast of the June 2020 Swiss franc REER is about 108, less than 3.5% below the last index published by the SNB for May, suggesting it is only moderately overvalued. These observations give credit to the SNB's activism for preventing extreme developments on the exchange rate despite very adverse market conditions.

Conclusions

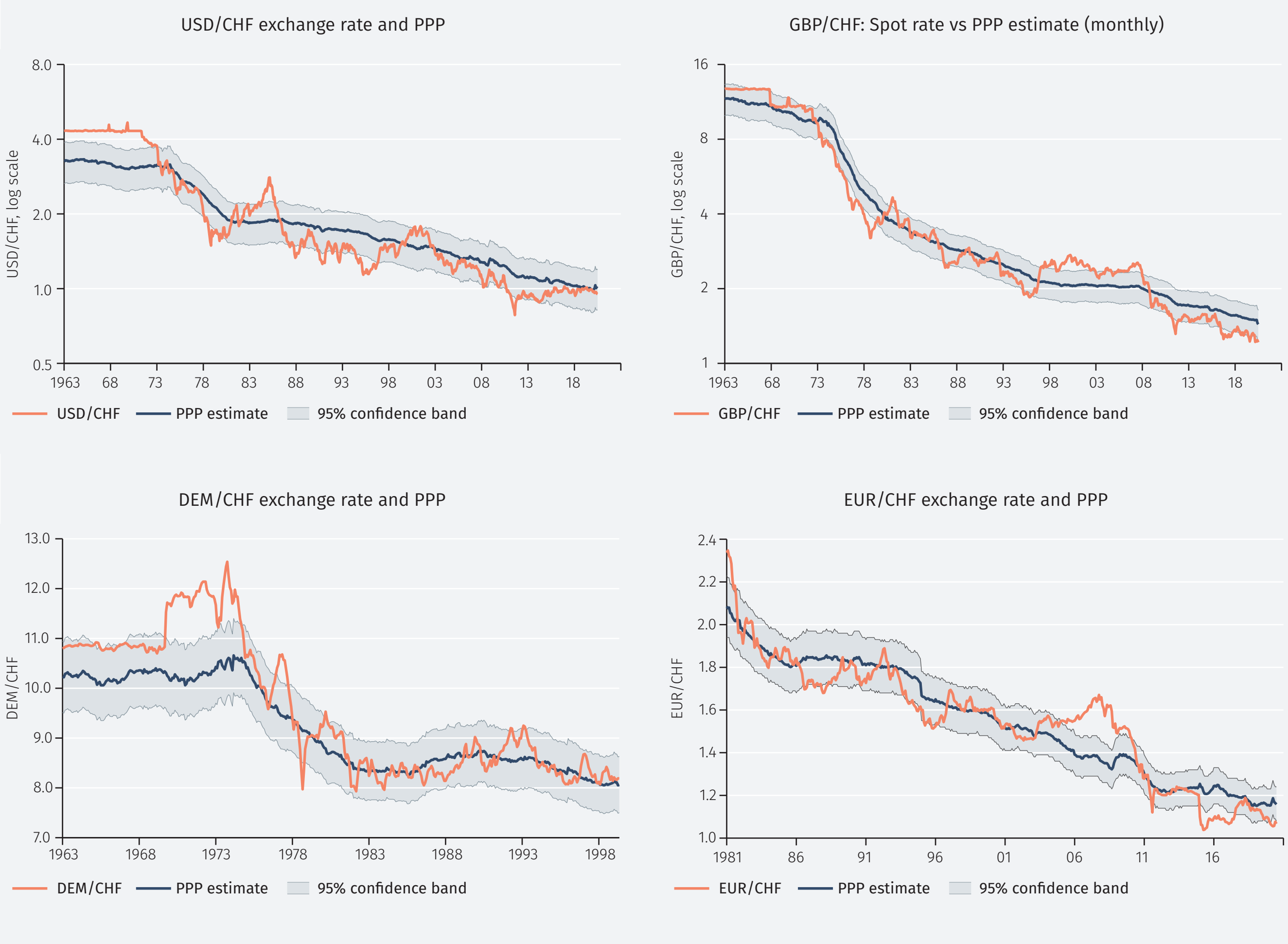
At the last monetary policy meeting on 18 June, the Swiss National Bank noted that the Swiss franc remains "*highly valued*" and it stressed its willingness to intervene "*more strongly*" in currency markets. However, despite nominal Swiss franc exchange rates being close to historical highs, the real exchange rate has risen by much less since the end of the Bretton Woods fixed exchange rate system. This reflects the lower inflation rate in Switzerland compared to its main trading partners and suggests Swiss export competitiveness has not been damaged by the nominal exchange rate rise. In support of this conclusion, the Swiss trade balance recorded a surplus close to CHF 42 billion in the twelve months to May.

It is also interesting that after peaking in February 2015, immediately after the SNB ended the EUR/CHF exchange rate floor, the Swiss franc real trade weighted index has depreciated by about 8%. This fall continues the cycles of appreciation and depreciation that have characterised the behaviour of the Swiss franc over the last 50 years and that were strongly influenced by monetary policy in Switzerland and abroad. Considering the SNB's commitment to market interventions, the gentle downswing of the Swiss franc real exchange rate seems likely to continue.

[8] In the model, the monthly change of the REER is estimated as a function of its past changes and of the gap between its level and the underlying trend.

APPENDIX

Swiss franc exchange rates and bilateral PPP estimates



Source: Swiss National Bank, Bundesbank, Refinitiv and EFGAM calculations. Data as at 23 June 2020.

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