THE SNB AND ITS WATCHERS

Introduction to Policy Panels on Exchange Rate Policy and Central Bank Balance Sheets

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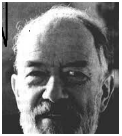

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Some important questions

Exchange Rate Policy

- Did the SNB exchange rate interventions contribute to better price stability/ macroeconomic performance than what would have occurred otherwise?
- Did they play a stabilizing or destabilizing role?
- Are there any long-term benefits/costs from those interventions?

SNB Balance Sheet

- Is the size of the SNB balance sheet socially optimal?
- Does its large size create trade-offs in the conduct of monetary policy that might undermine the SNB's pursuit of price stability?
- Does the SNB need to keep a large balance sheet to achieve price stability?
- Should fiscal policy (public debt issuance/retirement) play a more active role in the management of the CHF exchange rate?
- Should the "wealth fund" be managed by the SNB or the Treasury?

I will suggest a novel framework for thinking about these issues that is based on the specialness of the Swiss currency.

- Switzerland has long been a major financial center. As a result, the Swiss franc has enjoyed the status of an international reserve currency.
- This property gives rise to a "privilege": the expected rate of return on safe assets denominated in CHF (*net of exchange rate movements*) is lower than that on similarly safe assets denominated in other (non-reserve) currencies.
- This implies a systematic violation of Uncovered Interest Rate Parity (UIRP) and makes the issuance of liabilities in CHF "cheap."

- Investors have been exploiting this privilege by engaging in *carry trade*: borrowing in CHF-investing the proceeds in foreign currency safe assets.
- Because UIRP is violated in favor of the vehicle currency, this strategy is on average profitable; but it can lead to losses when the vehicle currency appreciates significantly.
- If the CHF carry trade is profitable for private investors, shouldn't the main issuer of CHF liabilities (the Swiss government and/or the SNB) try to profit from it too in order to raise fiscal revenue?
- This would relax the government budget and allow for lower tax rates and/or higher spending.
- Note that the profit from the carry trade is distinct from the profit from investing in *risky foreign currency assets*! The former comes from the privilege the latter from risk taking.

- Unlike private investors, the Swiss govt/SNB is well placed to withstand occasional capital losses because of its deep pockets, unfettered ability to borrow to smooth out the impact of losses on the budget, and also because it can limit the size of losses through exchange rate policy.
- Economic theory (Angeletos-Dellas, Dellas, forthcoming) suggests that this risk is worth taking as carry trade extracts a "fee" from foreigners (the excess return on the carry trade) for acquiring CHFs. It improves public finances and welfare.
- This strategy was not pursued in the past by the public sector in Switzerland (but has been used by Swiss banks and pension funds).

- Only recently and inadvertently –through the large foreign exchange market interventions– has the Swiss public sector engaged systematically in carry trade.
- The built up of large foreign currency holdings, though, has been purely accidental. It arose from the SNB's pursuit of price stability rather than any profit-seeking motives.
- An accidental but nonetheless fortuitous development from the point of view of Swiss fiscal revenue and welfare!

Four important questions

If one accepts the premise that carry trade by the public sector is valuable because it lowers the tax burden / allows for more public spending, then

- Q1: What is the optimal size (and composition) of public *gross* liabilities?
- A1: Under investigation (Angeletos-Dellas, Dellas)
- Q2: How should they be invested? Is it a good idea to go beyond the carry trade and try to profit from investing in *risky* foreign assets?
- A2: The SNB and many central banks do it nowadays. I am skeptical.

SNB ”ownership” of the wealth fund

- Q3: Is it essential for the pursuit of price stability?
- A3: No, foreign reserves are not essential. CHF depreciation can be prevented (when desired) by raising the policy rate, R; appreciation by lowering the rate (or, by *selling* CHFs).
  But some use of foreign reserves in the management of the CHF –instead of R only– may be beneficial.
- Q4: Does it interfere with its pursuit of price stability?
- A4: A trade-off between price stability and fiscal profit objectives when the inflation rate exceeded its target. A CHF appreciation helps suppress inflation but dents SNB profits.

- But this trade-off need not be consequential: The SNB can resist political pressure to target profits.
- Its job could be made easier if the distributions from the profits were decoupled from short-medium term capital gains and losses (which are predominately related to exchange rate movements).
- The SNB could hand out an appropriate fraction of the annuity value of the *expected long term gains from the carry trade*.
- This is not unlike what pension funds do, pooling cross-sectionally while the SNB would be pooling over time.
- The gross asset position is large enough to support such a scheme (if necessary, debt could also be issued temporarily to smooth out things).

A summary

- The acquisition of foreign currency assets through issuance of CHF liabilities by the Swiss govt/SNB allows the country to raise "tax" revenue from the international users of its currency.
- A more efficient/politically palatable tax than other taxes in CH.
- The SNB could provide this benefit to the Swiss society without sacrificing its mandate.
- But it ought to be protected with the right social/political contract. A distribution policy that resembles an annuity (that pays a fraction of the *long term expected profits from the carry trade*) could be part of the protection scheme.

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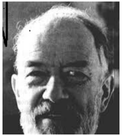

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