Central Bank Balance Sheets: The SNB

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How did CB balance sheet expansion come about?

- In aftermath of the financial crisis, CBs aggressively lowered interest rates.
- ZLB led to use of other, nonconventional instruments, in particular huge programs of QE.
- Ironic that those who have argued strongly in past that monetary aggregates are irrelevant for monetary policy have come to rely strongly on programs of quantitative monetary expansion.
- My view: this policy was fully justified during actual crisis, but maintained far too long afterwards, strong imbalance between benefits and risks.
- US FED initiator, ECB (and others) imitators, SNB practically forced to react to this change in global environment with its FX purchase policy.
- Otherwise, SNB very likely would have created deflationary pressure for Switzerland.

Risks of big CB balance sheets?

- Risks to monetary stability: difficult to withdraw or immobilize the liquidity created in the course of balance sheet expansion once this becomes necessary. This is a political-economic risk: The huge public and private debt encouraged by this policy does make it *politically* very hard to raise interest rates adquately.
- Fiscal phantasies: Politicians see assets the central bank „does not really need“, big pot of „free money“, to be spent outside normal budgetary processes and constraints. Including the idea that central banks could simply cancel the government debt held in their books.
- Governance issues: Influence of CBs on capital markets and credit allocation today far greater than it should be. Concentration of financial and political power.
- If large public sector FX position is desirable for fiscal reasons (Dellas), government should be responsible party, not CB. (But I remain skeptical.)

Rescaling CB balance sheets desirable, but unlikely

- Balance sheet reduction, like balance sheet expansion, must be seen in an international context.
- Crucial what FED, and especially ECB, do with their balance sheets. In a global environment which remains swamped with liquidity, very difficult for SNB to systematically rescale its balance sheet.
- Opportunity for SNB FX asset sales best in a phase of CHF weakness, especially relative to Euro. May happen on occasion, but not as a rule, as long as Euro inflation high.
- FED and ECB systematically reducing their balance sheets would create environment allowing SNB to do the same.
- But will they?

Fiscal – central bank interactions

- SNB balance sheet likely to remain large for foreseeable future
- Large CB revenues, large revenue fluctuations, large profit/loss potential
- Fiscal –central bank interactions are impossible to fully avoid, as CBs influence macroeconomic conditons and CB profit is part of public revenue.
- Widespread agreement that CB profit must be residual, not determined by fiscal motivations. Danger of fiscal domination of CB always present, nevertheless.
- With large SNB balanc sheet, political dispute about profit distribution and control/management of its FX assets will remain intense.

Profit distribution

Core question: what is SNB‘s long-run (average) profit and distribution potential. Not easy to determine. I prefer erring on conservative side.

A few (not very controversial) principles:

- SNB should distribute what it does not need as own capital buffer.
- Smoothing is desirable: separate disbursments from short-run profit fluctuations.
- Disbursements should not be linked to specific expenditure programs.
- Capital buffer should be related to size and nature of SNB assets.
- Careful and transparent discussion of these issues is important.

SNB-OBS addresses both the *size* of distributions and the *concept* of distribution determination.

Two concepts of distribution reserve

- Current SNB mechanism is debatable, of course. But SNB-OBS interprets it unfairly.
- Main critique: losses always assigned by SNB to distribution reserve (which can become negative), should be borne by „provisions“ instead.
- SNB concept: *distribution reserve* as funds *provisionally* set aside for distribution, but *conditional* on further developments. Reflects kind of a learning mechanism, in view of uncertainty about long-term profit potential.
- Total equity capital, representing SNB‘s loss absorption capacity, equals sum of distribution reserve + provisions. The role of „provisions“ is that of a guideline showing where SNB thinks total equity should be. Actual equity can exceed or fall short of it (depending on whether distribution reserve is positive or negative).
- SNB-OBS envisages a *distribution reserve* representing funds *definitively* set aside for distribution, just not paid out yet. *Fiduciary holding* on behalf of government, economically not part of SNB balance sheet anymore.

Comparison

- SNB-OBS concept is worthy of discussion, of course. But would it be better?
- In my view underestimates risks of extraordinary losses and need for adequate capital buffer.
- Would have implied *additional* distributions of about 90 billion CHF from 2007 to 2020 (their calculation) and left SNB with equity (provisions + distribution reserve) of about 110 billion CHF by end 2021.
- Declares a distribution reserve varying around zero and provisions of about 10% of SNB FX assets as ideal.
- Note that 2022 under SNB concept will bring us fairly close to such a state: mid-year distribution reserve just slightly positive, provisions about 10 % of FX assets.
- Had SNB-OBS concept been in place since 2008, distribution reserve would have been run to zero over last decade, provisions by mid-2022 would have been close to zero (wiped out by first half-year loss). Currently, provisions would be – 40 billion, about 140 billion below target.
- It could take many years without distributions to make up for this. Would have implied a very uneven pattern of distributions.

Transfer of FX assets to Sovereign Wealth Fund (SWF)?

The argument

- SNB balance sheet has become fiscally relevant
- SNB profit and asset allocation have become political issues, distract from monetary policy.
- Fear of big losses could constrain monetary policy, e.g. exchange rate policy.
- Large concentration of power in one institution

SWF would

- Allow more freedom in portfolio choice
- Generate higher average return (and risk): fiscal benefit
- Would (largely) transfer exchange rate and market valuation risk to government.
- Would free SNB from fiscal considerations and shield SNB from political pressure.

Funding through issue of government debt?

- Exchange of FX assets for (interest-bearing and tradable) government debt. SNB balance sheet size unchanged, but asset composition, return/risk potential changed. Would leave a large part of government debt with SNB. Desirable?
- Note: such a fund could have been created by government at any time, without recourse to SNB, if it is really deemed to be so profitable. Would have lessened need for SNB to intervene in FX market.
- Would politicians be much interested in such a model? Hardly. Would impair ability to issue future debt. Politicans want to money from SNB, not inject capital into SNB or fund.

The SNB Observatory‘s proposal

- Exchange of SNB FX assets against special, nontradable debt issued by SWF itself.
- Current SNB income stream is transferred to SWF, in exchange for a (smaller) income stream paid by SWF to SNB, technically in form of interest on SWF debt, providing the SNB with (just) enough income to allow it to pursue its monetary policy mandate.
- Note that with interest rates positive again, SNB must pay interest on its outstanding monetary liabilities (bank reserves, SNB bills).
- Proposed asset exchange is presented by SNB-OBS as 1: 1 exchange of SNB assets for SWF debt, leaving SNB balance sheet unchanged otherwise.
- But economic value of SNB‘s new income stream is considerably lower than value of current SNB FX assets.
- An economically meaningful interpretation reveals this as transfer of SNB capital and of financial power from SNB to fiscal authority.

What does the transfer really mean?

- Economically, this is a transfer of SNB capital to the SWF/government in the amount of the difference between the value of the FX assets transferred and the claim the SNB receives in exchange.
- Example: assume income stream paid to SNB by SWF is determined such that SNB can just pay interest on bank reserves at its policy rate (for simplicity disregard other SNB cost items). Then the economic value of this income stream (discounted at the SNB policy rate) equals the SNB‘s outstanding monetary liablities.
- This claim against the SWF is SNB‘s main asset, bank reserves (monetary liabilities) its liability.
- SWF balance sheet: has the FX assets transferred to it on the asset side. On the liability side obligation to the SNB (equal to the SNB‘s monetary liabilities) plus the transferred capital.
- It can be argued that from a consolidated point of view all this does not matter, as both SWF and SNB are parts of public sector. But then we abandon notion of SNB as an independent financial institution within the public sector.

Shift in balance of political and financial power

- The SNB currently enjoys a status of (relatively) strong independence from politics and interest groups. This has served the country well.
- Proposal would turn SNB from *originator* of a transfer into simple *recipient* of a transfer from a politically controlled agency of the fiscal authority, the SWF.
- This amounts to a shift in balance of political and financial power. It would leave the SNB as a financially dependent agency of government.
- It is naive to believe that a SWF could be invested with the same legal or even constitutional independence from politics which the SNB has now. It being a fiscal institution, politics would insist and find ways to maintain control of it.

Conflicts of interest

- When interest rates rise, the SWF‘s payment to the SNB must increase (to finance increased interest payments on bank reserves). SWF debt not fixed interest debt. At the same time, SWF assets decline.
- We are talking about potentially very large amounts here. Bank reserves end 2021: 650 billion CHF.
- Creates interdependence and conflict of interest between the SWF and the SNB‘s monetary policy. Strong incentive for political influence on SNB‘s MP.
- Imagine SWF experiences a 10 or 15 % loss on its assets (as it would now). At same time, inflation requires SNB to raise interest rates and to pay interest on bank reserves accordingly. To banks!
- Alternatively declare bulk of bank reserves as required reserves? Would be huge tax on banks and their deposit business. Introduce Vollgeld (100% reserves) after all? Sight deposits end 2022: 628 billion CHF. Savings deposits: 325 billion CHF.
- Hard to see how proposed arrangment would shield SNB from political and interest group pressure.

Why the Swiss case is different from Norway / Singapur

Are SNB FX assets wealth (like assets of Norway / Singapur funds)?

- Of course, they are. Real question is: are the monetary liabilities created when SNB buys FX assets really a debt?
- Since SNB (like any modern CB) is not legally required to buy back its own currency, a case can be made that economically they are not (an old question discussed since 1950s).
- But then: with interest paid on bank reserves they are a real liability, no doubt.

In any case, the central difference between Norway and an SNB-financed fund is this:

- There are no limits to the assets the SNB can acquire and the amount of francs it can create, while there is a clear limit to the volume of oil Norway can extract.
- Past monetary policy has made possible creation of proposed SWF. What would prevent politicians to ask for a repeat: continue FX purchases for fiscal motives? Why not let the money machine run a bit more? *Politcal* temptation huge.

Concluding

- It is true that SNB will face these challenges anyway.
- Therefore, we need to maintain and strenghten its financial and political independence.
- SNB-OBS proposal would achieve the opposite.