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Swiss National Bank: It's the real exchange rate that matters, not the nominal

The SNB has not changed monetary policy nor its exchange rate assessment, despite the current high level of the Swiss franc against the euro. It tried to justify this by emphasising the inflation differential

Despite an encouraging decline, the SNB continues to see inflation as a persistent problem

How to describe the value of the swiss franc?

As expected, the SNB did not change its monetary policy, keeping the key rate at -0.75% and remaining ready to intervene in the foreign exchange markets if necessary. The SNB still believes that the franc is highly valued. It may seem surprising that the central bank has not changed its description of the franc's valuation. Against the euro, the franc is at its highest level since 2015 when the SNB decided to discontinue the unofficial minimum exchange rate of CHF 1.20 per euro. Some expected the SNB to describe the franc as significantly overvalued. Chairman Thomas Jordan therefore spent time at the press conference explaining the SNB's view of the exchange rate, distinguishing between nominal and real developments. It is true that the franc has appreciated by 6% since the beginning of the pandemic and by 3% since September in nominal terms. However, the current inflation differential between Switzerland and other countries must be taken into account. In November, inflation in Switzerland stood at 1.5%, its highest level since

2008. However, it remains well below the inflation observed elsewhere: 4.9% in the eurozone and 6.7% in the US. As a result, the inflation differential has widened significantly. Therefore, if we look at the real effective exchange rate, the value of the franc has not changed a lot since the beginning of the pandemic, explaining why the franc is still described as “highly valued”.

It seems therefore that, with these explanations, the SNB is trying to justify letting the value of the franc rise to current levels against the euro and to reinforce its credibility that it will continue to act if necessary. Nevertheless, by insisting on measuring the trade-weighted real exchange rate, the SNB becomes more difficult to read, as this is an indicator that is not easy for observers to follow on a day-to-day basis, nor to predict. The risk is therefore that the message will be blurred.

The exchange rate as a tool to fight inflation

For Jordan, allowing the franc to appreciate in nominal terms is in fact a tool to fight inflation because it reduces the value of imports. Once again, we have the illustration that the SNB's monetary policy does not resemble the monetary policies of other developed economies. For the SNB, there is no need to raise interest rates, letting the franc strengthen is enough to avoid any risk of too high inflation.

Nevertheless, the risk of deflation is never far away in Switzerland. Jordan pointed out that the current health situation is synonymous with uncertainty, which could further strengthen the franc and thus push inflation too far down or even into negative territory. This justifies the SNB's continued readiness to act in the foreign exchange markets, even if a slightly stronger franc in nominal terms is acceptable given the inflation differential.

Looking ahead, eyeballing the SNB's inflation forecasts tells us that we should not expect any rate hikes in Switzerland. Even though it has revised its forecast for 2021 slightly upwards (from 0.5% to 0.6) and for 2022 (from 0.7% to 1%), the SNB's forecast for 2023 is still 0.6%. In this context, there is little reason to consider a rate increase. One can imagine that when other central banks start to raise rates, the pressure on the Swiss franc will ease a bit, which could push inflation up slightly. But we think that's a story for 2023 at the earliest. So rates will probably stay at their current level until 2024 when the SNB could start to raise rates, almost a year after the European Central Bank, according to our current forecast.

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