Switzerland Watch

Group Economics
Macro & Financial Markets Research

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Why continue FX interventions?

Georgette Boele
Co-ordinator FX & Precious Metals Strategy
Tel: +31 20 629 7789
georgette.boele@nl.abnamro.com

- **Swiss FX reserves have risen again...**
- **…because of a valuation effect and FX interventions**
- **Meanwhile, the economy has picked up strongly…**
- **…mainly driven by higher exports**
- **There is less need to continue FX interventions…**
- **…but the SNB will likely continue as long as CPI is close to zero**
- **Positive investor sentiment and no step-up of pace of ECB QE…**
- **…will likely result in a slightly weakening of franc**

A rise in FX reserves again…

Yesterday morning the August preliminary Swiss National Bank (SNB) foreign exchange reserves were released. They came in above expectations at CHF 626.62bn, which was a considerable increase from CHF 615.55 bn in July. The increase can be the result of valuation effect and/or the result of the selling of Swiss franc in currency markets. According to our calculations, taking into account the composition of these reserves, more than half of the CHF 11bn increase came from valuation effects. As the euro (41% of the FX reserves), US dollar (34%), sterling (7%), yen (8%) and Canadian dollar (3%) appreciated versus the Swiss franc during August, there was an increase in FX reserves denominated in Swiss franc (accounting for around 60% of the rise). In addition, roughly 40% of the increase in FX reserves appears to be the result of FX intervention.

Reserve composition

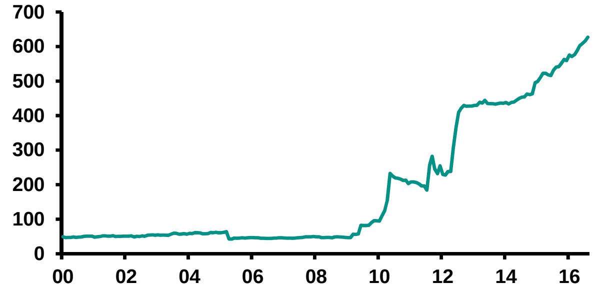
FX composition in %			27-Jul-16	31-Aug-16
USD	34.0	USD/CHF	0.9695	0.9826
EUR	41.0	EUR/CHF	1.0832	1.0963
GBP	7.0	GBP/CHF	1.2823	1.2911
JPY	8.0	JPY/CHF	0.00950	0.00951
CAD	3.0	CAD/CHF	0.7439	0.7486

Source: Bloomberg (FX), Reserve composition SNB Q2 2016

Since 2010, the foreign exchange reserves at the Swiss National Bank have risen substantially to approximately 97% of GDP. Last year, the SNB abandoned the floor in EUR/CHF. One of the reasons was that FX reserves would otherwise rise too sharply and become too large as compared to GDP. However, shortly after abandoning the floor, FX reserves have risen substantially again (see graph below) reflecting intervention in currency markets to dampen the impact of the strong franc on the economy and valuation effects.

Foreign exchange reserves continue to rise

In bn CHF



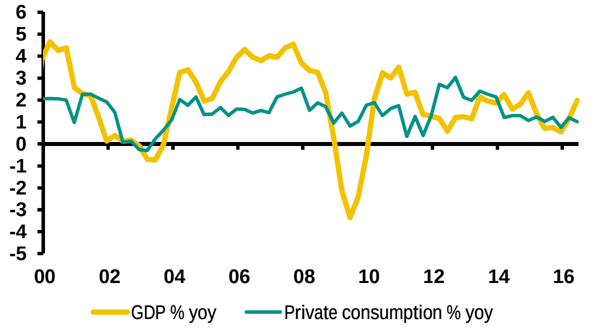
Source: Bloomberg

…against the background of a strong pickup in the economy…

Switzerland is a small open economy that is highly dependent on exports. Exports are 74% of GDP and net exports account for roughly 15% of GDP. Next to exports, private consumption is also an important contributor to GDP. Recent GDP data show that the Swiss economy has performed strongly this year. Economic growth in the second quarter came in at 2.0% yoy which was far above market consensus of 0.8%. The main contributor to the stronger economic growth has been exports (see graphs below).

Economic growth has surprised on the upside in Q2…

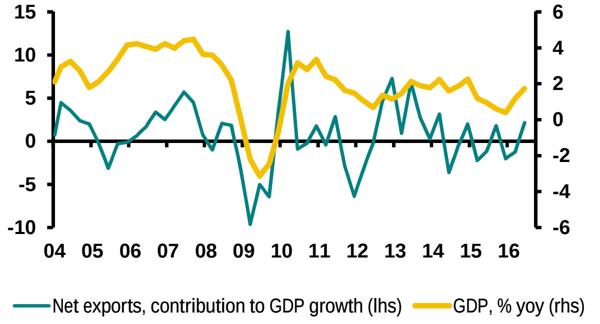
%



Source: Bloomberg, ABN AMRO Group Economics

…mainly because of strong exports

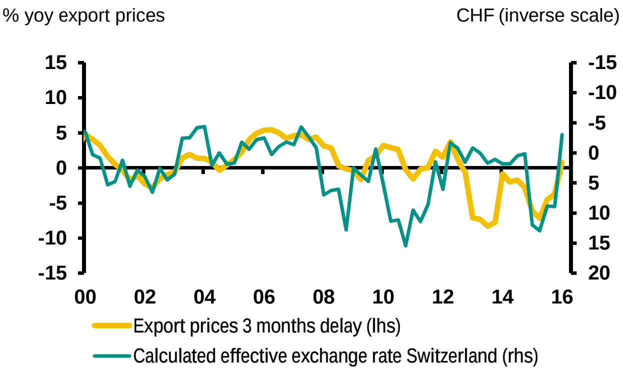
%



Source: Bloomberg, ABN AMRO Group Economics

During the months following the sharp appreciation of the Swiss franc (last year), signs of a considerable future drop in Swiss exports emerged. In the end, the impact on exports was modest, mainly because Swiss exporters lowered their prices as well. The graph below shows that there is a tendency to adjust prices in reaction to a strengthening Swiss franc. Recently, the franc has weakened and export prices have increased with a lag of around 3 months.

Export prices follow the franc with a 3-month lag

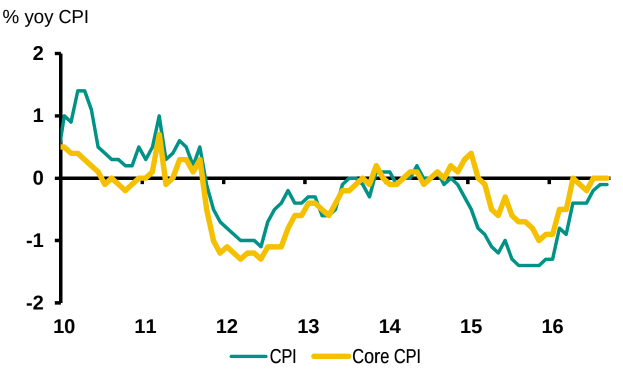


Source: BoE, Bloomberg, ABN AMRO Group Economics

…but deflationary forces are still present

Deflationary pressures are still present. Consumer price inflation is rising gradually towards zero, while core inflation yoy is zero. Swiss single family house prices are rising but at a considerably slower pace than some years ago. On the other hand, the unemployment rate has been stable at 3.3% for some months now. The overall picture is some cooling in the housing market, a stabilisation in the labour market while consumer price inflation is slightly picking up.

Consumer prices are rising gradually

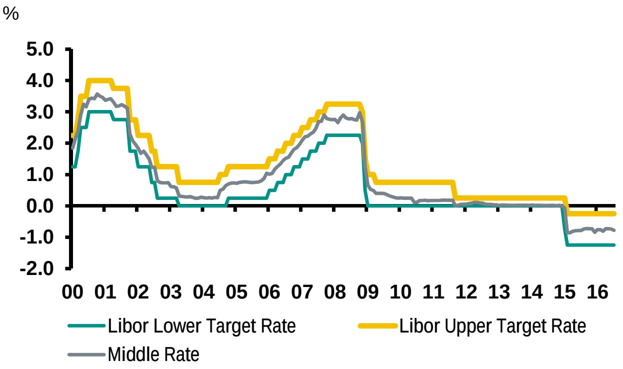


Source: Bloomberg

Why continuing building up FX reserves?

The main question we ask ourselves is the following: does the current state of the economy justify FX interventions? We are inclined to say “no”. First of all, the Swiss franc remains in overvalued territory in nominal terms, while Swiss exports are nevertheless doing relatively well. The flexibility to adjust export prices with a lag to developments in the franc is an important reason for this. It looks like the private sector has shown more resilience than that was expected initially. Second, if the vast amount of FX reserves was an important reason to abandon the floor in EUR/CHF on 15 January 2015, it is surely a good reason to stop building up foreign exchange reserves now. However, deflationary forces continue to be an important reason to continue the current monetary policy mix. As soon as CPI (core and headline) start to move convincingly above zero again and the labour market continues to stabilise, we think that there is less incentive to intervene unless a wave of sharp risk aversion were to occur. In an environment of more constructive investor sentiment and no step-up in the pace of ECB monetary policy easing, the franc will likely slowly weaken on its own. We foresee a modest depreciation of the Swiss franc this year and next year. Our new year-end target for 2016 and 2017 in EUR/CHF are 1.10 (from 1.09 previously) and 1.14 (1.12 before), respectively. However, we expect the SNB to keep negative rates in place as long as the ECB continues monetary policy easing.

SNB 3-Month Libor Target Range to remain negative



Source: Thomson Reuters Datastream

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