The Swiss Sovereign Fund

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On September 6, 2011, the Swiss National Bank (SNB) enforced a minimum exchange rate of 1:20 Swiss francs (CHF) per euro (EUR), in response to the European debt crisis and a continuously weakening euro and corresponding large demand for the Swiss franc. With a level around 1.6 CHF at the introduction of the euro in 1999 and a peak above 1.67 CHF on October 2007, the CHF has been floating freely until it skyrocketed to the record high of CHF 1.0070 per euro on August 9, 2011. The SNB intervened massively leading to a fast rebound of the euro. On September 6, 2011, the SNB announced officially that it would defend the minimum exchange rate of CHF 1.20 by all means (buying euros and selling Swiss francs in unlimited amounts as deemed necessary). The SNB held this policy until January 15, 2015, leading to an exchange rate leveling between 1.20 and 1.24 CHF per euro. In January 15, 2015, this policy was abandoned to the surprise of most participants, leading to the Swiss franc soaring to an intraday peak 0.85 euros per CHF followed by a stabilisation between 1.04 and 1.08 (at the time of writing), clearly helped by further regular interventions of the SNB.

As a consequence of its cumulative actions to control the Swiss franc exchange rate against the euro in particular, the SNB has accumulated a portfolio of foreign currencies of a size comparable to the annual Swiss GDP, and it continues to grow. By its very nature of buying weak currencies to hinder the appreciation of the stronger Swiss franc, it is facing accounting losses in the range of tens of billions of CHF. There have been suggestions, as well as counter-propositions, that this could be the opportunity to create a Swiss Sovereign Fund (SSF).

Here, I would like to flesh out the arguments supporting the concept that indeed the Swiss model together with the systemic structural weakness of Europe in particular warrants the creation of a SSF. I also outline how this could work.

First, let me address the argument that the portfolio of the SNB is not the result of “true” savings, for instance due to excess oil revenues as for the Norwegian sovereign fund. To sum up my diagnostics, the portfolio of the SNB can be seen fundamentally as the result of the resources of Switzerland created collectively by its economic and political success. Let us see how this comes about.

The growth of the SNB portfolio is in fine due to (i) the excess of the balance of trades together with (ii) the perception by foreigners of the Swiss franc as a safe haven as well as the reluctance of Swiss investors to place their precious CHF in uncertain ventures located in unreliable economies abroad, especially given the European crisis. Without (ii), the excess of the balance of trades (i) has been historically compensated by (iii) a deficit in the balance of the capital account, namely by a net flow of capital from Switzerland from private investors, firms and pension funds to other countries to invest Swiss’ excess cash.

Thus, in absence of (ii), the franc can be more or less stable via the equilibrium created between (i) the positive balance of trade and (iii) the negative balance of capital account. I wrote “more or less”, because, over the last fifty years, the Swiss franc has systematically appreciated against international baskets of currencies at an average rate of about 3% per year against the US dollar and the euro, which is readily explained by the difference in inflation (roughly 0.5% versus 2-3% per year) and growth productivity (about 1-1.5% per year). This has made overall the Swiss people endowed with more buying power compared with an international basket of countries. In other words, the slow secular appreciation of the Swiss franc reflects the success of the Swiss economy and its political system and embodies the increase in wealth of the Swiss people compared to the rest of the world.

A key part of the argument for the SSF relies on the diagnostic that the deep structural problems of Europe have not been addressed at all and the so-called European crisis will continue for a long time, in a latent chronic stage punctuated by intermittent bouts of crises. We are speaking of time scales of a decade or more for the travails of Europe. In this situation, the natural counterweight in the form of a negative balance of capital account to the performing Swiss economy with an excess balance of trade is no more present, as can be witnessed since 2010. Swiss investors, pension funds, large firms and private persons find less attractive to invest abroad amid political and economic risks. Foreigners on the other hand find very attractive the safe haven role of the Swiss franc. These two factors have put and continue to exert immense upward pressure on the Swiss franc. I expect this to continue for a decade or more.

The natural market response is the appreciation of the Swiss franc. But politically and socially, it can be painful and would amount to importing the unemployment and crises of Europe and other countries to Switzerland. A first solution is then to adopt the euro, thus benefiting from an apparent costless pegging of the CHF to the euro for the great benefits of exporters. Similarly to Germany, Switzerland would likely gain much economically from such an adoption. But in absence of political will to become part of the eurozone, the alternative and diagnostic are clear: the hard work and excellent management of the Swiss economy and political system lead to a persistent revenue in the form of the excess balance of trades. In absence of (iii) due to the presence of (ii), the Swiss find that, in addition to all their exports, they can also export their currency, which plays a role similar to a commodity like oil or gold in great demand by foreigners. The analogy goes quite far: while oil or gold comes from the geology, the wealth in the form of "CHF ore" comes from economics and geopolitics. The Swiss franc can thus be considered as the almost unlimited national wealth over the long term, similarly to oil reserves stored underground in oil producing countries. Globally as a country, we have created a CHF-mine, a kind of virtual commodity resource that should be shared with all citizens. It is a growing part of the wealth of the nation. And the SNB possesses a real monopoly for mining the CHF "commodity", similarly to the cartels of oil producing countries.

To manage the wealth created by this "CHF ore", I propose the creation of a Swiss Sovereign fund (SSF) to capitalise on the Swiss successes. This achieves several goals at the same time. First, the SNB "mines" CHF in amount determined to achieve a Swiss consensus on the target band of the CHF exchange rate with respect to a basket of currencies, similarly to the monopolistic cartels that decided how much oil to extract as a function of global market prices. By buying US dollars, Euros, Yen, Yuan and other currencies, the SNB manages the level of the CHF to a reasonable level, which is obtained by a political consensus within the different Swiss parties. This achieves the goal of ensuring continuous employment and good economic growth in the Swiss economy. As a rule of thumb, the rate of CHF "mining" should be adjusted to follow the long term appreciation based on fundamental value, perhaps at the historical rate of 3% mentioned above. This CHF "mining" is the first step to ensure that the CHF does not rise too much, so as not to hurt the Swiss economy. Second, a part of the "mined" CHF is used to pay civil servants and for investing in education, innovations and infrastructure. This allows the Federal Government and the Cantons to lower taxes and thus empowers the private sector by increasing its ability to invest in growth opportunities, thus reinforcing the positive virtuous circle. Third, the other part of the CHF mining wealth is invested abroad. A priori, investing in euro or US dollars seems counter performing, since that would mean to invest in the weak currencies that continuously depreciate in CHF, not a promising proposition from a Swiss perspective. But these investments should be in hard assets with a long-term view, such as private and industrial real-estate, forests, farming, production units, foreign blue chip companies, private equity, hedge-funds, commodities, stock markets abroad, with portfolios similar to those of the large university endowment funds with at least a century long investment horizon. Notwithstanding the progressive loss due to the depreciation of the foreign currencies when counted in CHF, the overall diversification and long-term access to international resources is a plus. This achieves the storage of value in the real economy, with typical large potential growth, which has been historically better than 10% per year, when well managed and highly diversified. Thus, the hard work and exemplary management of Switzerland translates into a reward in the form of substantial yearly returns that can be shared with the citizens, allowing to lower taxes and promote more investments, leading to a stronger virtuous circle.

There is however one risk that distinguishes the SSF from a sovereign fund based on oil for instance. Because oil is burned in engines or for heating, there is no long term liability at it disappears (except in the form of CO2 released in the atmosphere, but this is another story). In contrast, the CHF "commodity" in the hands of foreigners is a liability of the SNB, and of Switzerland more generally. A weakening of the economic health of Switzerland would make the CHF less attractive to foreigners. The risk is thus that the Swiss people become indolent rentiers of their CHF mining, leading to the demise of the very mechanism at the origin of the value of this ore, as Switzerland starts to underperform. Indeed, our key national resource is our persistent over-performance and the resulting attraction of the Swiss franc. As long as Switzerland continues its long term track record of innovation, pro-business atmosphere, low tax policy and strong democratic legal and political structures, we can double on it by selling our CHF "commodity" for a stabilisation of the CHF that is in line with our internal objectives for economic stability, thus mining wealth to lower tax, invest in education, innovation and infrastructure, and diversify actively internationally for higher global returns. But there is indeed the risk that, if we would become under-performing compared with the rest of Europe and the World, then, there will be redeeming pressure on the Swiss franc and the possibility of a bank run on the Swiss franc, leading to a strong depreciation and many other cascading problems.

Can we trust the SNB or the government to manage the SSF? Could we not design ways to encourage the Swiss investors and citizens to put their CHF abroad by tax breaks and other incentives, therefore alleviating the need for the SNB to continuously intervene and grow its balance sheet? Perhaps. But this does not solve the problem of the pressure exerted by foreigners eager to invest in CHF. Another alternative to a SSF is to engage in big spending of the mined CHF ore (as long at the foreigners buy it), for instance by contributing significantly to Europe military forces and other pan-European projects, or by launching ambitious super-innovation projects in the energy and information sectors. The decision for a SSF is a political action to delay spending, to store and to grow wealth for future generations. The governance of the SSF should then be done according to the lessons learned from the large university endowment funds having a centennial time scale horizon.

In life, there is no free lunch and we need to have the courage to accept the above diagnostics and capitalise on it. We will achieve two great outcomes with a well managed and highly diversified SSF: 1) ensure a reasonable exchange rate for economic stability and growth and 2) augment our wealth even faster, with lower taxes and strong positive feedbacks and virtuous circles, making Switzerland and the Swiss franc even more attractive, therefore our national "commodity" even more valuable and all of us in the end richer and more economically dynamic.