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The historical rise of the Swiss franc as an international reserve currency

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During the COVID-19 pandemic, the Swiss franc acted as a safe haven asset, against the stock market losses. It was even more effective than the US dollar for the majority of stock markets.[1] Multiple economic studies observed a similar pattern in other periods of stress on the financial markets such as the September 11 attacks, or the Great Financial Crisis of 2008. The Swiss franc appreciated during these risk-off episodes.[2] This power of attraction of international investment has been an historical feature of the Swiss currency.

The creation of the Swiss monetary system has been a relatively recent process.[3] The Swiss franc was first circulated in 1848 when Switzerland was a free banking system. The Swiss National Bank (SNB) was created in 1907 and operated within a bimetallic system within the Latin Monetary Union until 1927. Switzerland then operated under a gold standard system until 1999.[4] Despite a devaluation in 1936 when the gold bloc collapsed, the Swiss franc stayed linked to gold including during WWII and during the Bretton Wood era.[5] In this essay, I study the internationalization of the Swiss franc in the 20th century and discuss the potential drivers of the internationalization of the Swiss franc as a reserve currency.

One way to investigate the historical origins of the internationalization of the Swiss franc is to observe its presence in central banks' foreign exchange reserves. Indeed, the first characteristic of a safe haven currency is to be traded globally and be observable within reserves portfolios. Such data is available in the central banks' archives and has been collected for the 20th century for large European countries.[6]

In this paper, I discuss a new measure of Swiss franc holdings in European central banks during the period 1948-1971 which corresponds to the Bretton Woods system. I use a new dataset originated from my doctoral research, on the composition of foreign exchange reserves of European central banks that I reconstructed from central banks' archives. As the Swiss franc was the third most important reserve currency in the early 70s[7], identifying the timing of its internationalization in central banks' portfolio allows to better understand why some investors chose to hold Swiss francs.

The debate on the historical origins of the safe haven status of the Swiss franc

A first factor explaining the historical origins of the safe haven status of the Swiss franc is the importance of the Swiss environment of low interest rates and stable exchange rates dating from the interwar period.[8] As Switzerland displayed a better resistance to the post first world war monetary instability, the country attracted investors and its currency experienced a trend of appreciation against the British pound and the US dollar. After WWI, the Swiss National Bank (SNB) distinguished itself by resuming the convertibility of its currency with gold and silver at pre-war parity as soon as 1924. By contrast, the United Kingdom and the

Scandinavian countries waited until 1925 and France, Italy and Belgium resumed convertibility even later and at a lower parity compared with the pre-war period.

A second important feature of the Swiss franc during the interwar period is when the SNB sold its foreign exchange reserves against gold during the interwar period. Some argue that investors then started to consider Switzerland as a small but solid monetary island, in as ocean of international troubles.[9] The share of the SNB foreign exchange reserves in the total of its reserves decreased from 33% to 4.4% while its stock of gold tripled between the ends of 1930 and 1931.[10] The SNB managed to guarantee the value of the Swiss franc notes in circulation by always covering at least 100% of the value of these notes with its gold, silver and foreign exchange.

However, when looking at the decomposition of central banks' foreign exchange reserves, the Swiss franc does not appear as an important reserve asset for the interwar period, except for the year 1929, see figure 1.

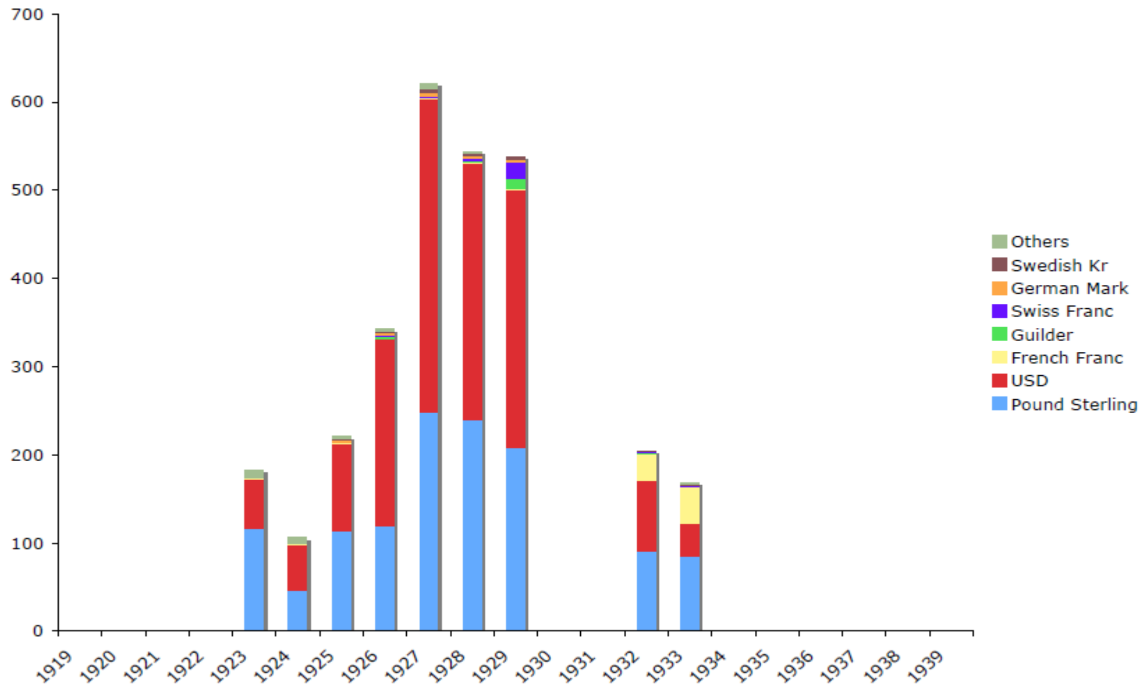

Figure 1: Composition of foreign exchange reserves (million USD) 10 countries.
Source: Eichengreen & Flandreau (2009)

Switzerland and the Swiss franc in the Bretton Woods era

The immediate post-war situation of Switzerland was one of political isolation so the country did not participate directly in the reconstruction of the international monetary system. Switzerland was not invited at the Bretton Woods conference in 1944 since only the countries which formally declared war on the Axis were invited.[11] The Allies resented the Swiss for the profit they made by selling war materials to both sides and for accepting to purchase large amount of gold from the Reichsbank, especially as the amount of gold sold was higher than the prewar gold stock of Germany.[12]

To rebuild the economic relations with its European neighbors, Switzerland opened fourteen credit lines between 1945 and 1946, with European countries as France, Belgium or the United Kingdom amounting to 642 billion Swiss francs.[13] Those lines eased the liquidity crisis experienced in the postwar years in these countries. They also fostered Swiss exportations at a time when protectionism, capital and exchange were prevalent as these lines were conditioned to the openness of European markets for Swiss exports. Swiss francs thus became largely available during the reconstruction of Europe and an important competitor for the dollar. Figure 2 displays the share of Swiss franc in the reserves of the Bank of France in 1945. It was the most important reserve currency.

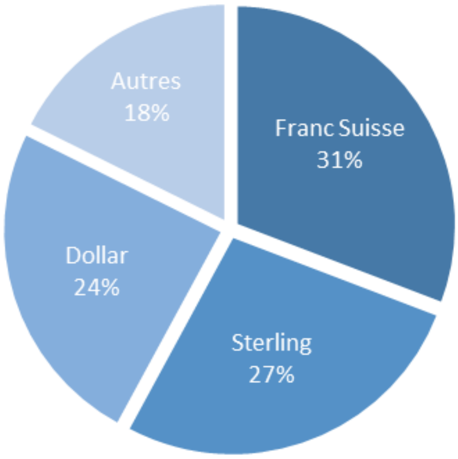

Figure 2: Composition of foreign exchange reserves of the Bank of France in 1945
Source: Avaro (2020)

Another important step fighting against the isolation of Switzerland after WWII is the Washington Treaty of 1946.[14] This negotiation gathered the Allies and Switzerland on the question of the Reichsbank gold. The Allies threatened to seize Swiss assets held in the U.S. until the Swiss accepted to recognize that some of the Reichsbank gold may have come from Belgium and agreed to pay reparations amounting to 250 billion Swiss francs. In exchange, the U.S. suppressed the freezing on Swiss assets held abroad and the 'black lists' of Swiss companies.[15]

But Switzerland did not subscribe to the multilateralism promoted by the US and did not sign the Bretton Woods agreement. Swiss officials feared discrimination from the IMF (International Monetary Fund) at a time when the country needed a liberal regime of commerce and payment to support its exports.[16] Indeed, the IMF had the power to declare a currency as 'scarce', which allowed all member countries to impose capital and exchange controls on transactions within 'scarce' currency countries.[17] Other motivations included fear of inflation if IMF countries drew on the Swiss francs potentially available at the IMF, the fear of a loss of independence for the SNB and the refusal to share detailed information on the financial and economic situation of the country to the IMF.[18]

The Swiss franc was thus an outsider of the Bretton Wood system. The U.S. dollar was the key currency of this system: it was the only one pegged to gold whereas other currencies were pegged to the dollar. It was used as an international currency for medium of exchange in international transaction and as a reserve currency, being accepted for settlement in international balances. Throughout the fifties and the sixties, it represented more than 80% of the foreign exchange reserves of European central banks.

The Swiss franc was seen by some investors as an alternative to dollar, notably because of SNB efforts to cover the circulation of the franc with the equivalent value in gold. The example, Iraq, illustrates postwar attraction of the Swiss franc in comparison with sterling and dollar, which were the key reserve currencies of the prewar period. In the early fifties, the foreign exchange reserves of Iraq were mostly composed of sterling. Because of the devaluation risks weighting on sterling, Iraq wanted to diversify the currency cover and acquire gold and foreign exchanges. They approached Swiss banking officials with a proposal to maintain their foreign exchange reserves in Swiss francs instead of sterling. The Swiss refused the proposal with the argument that they wished to avoid the establishment of a "Swiss franc area".[19] At a time when dollar was scarce, the Swiss franc attracted investors in quest of an alternative reserve currency.

European central banks accumulated Swiss francs in their reserves at a steady rhythm during the fifties and the sixties. Figure 3 displays the total volume of Swiss franc held in the central banks of Austria, Belgium, France, Italy, Norway, Portugal, Spain the United Kingdom and West Germany. These central banks progressively increased the volume of their Swiss francs. They started investing significantly in the Swiss currency the late fifties, a period marked by the end of the European Payment Union and the return to convertibility of European currencies.

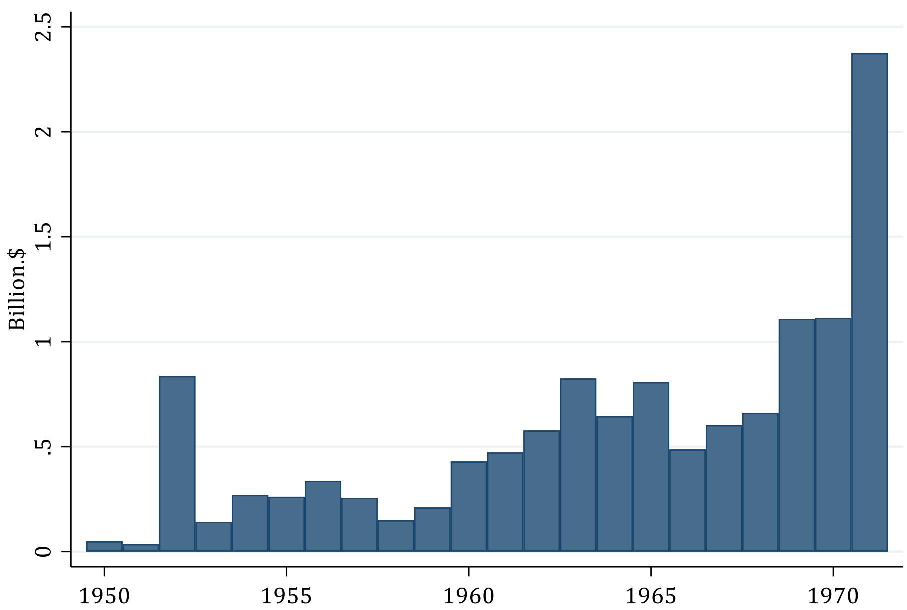

Figure 3: Total volume of Swiss franc held in European central banks, in US dollar at constant exchange rate.
Source: Avaro (2020)

When looking at country-level, see figure 4, it appears that European central banks had different reserves strategies. Some, such as France, the UK or Norway hold nearly no Swiss francs throughout the period. Others, such as Austria, Italy, Portugal and to a lesser extend Germany were the ones increasing their holdings in the late sixties and early seventies. Spain started to hold a significant number of Swiss francs only in 1971. The high volume of Swiss francs in the first year of the reconstruction of the Deutsche Bank during the early fifties reflects the fact that Germany used Swiss franc as international currency through the war.[20]

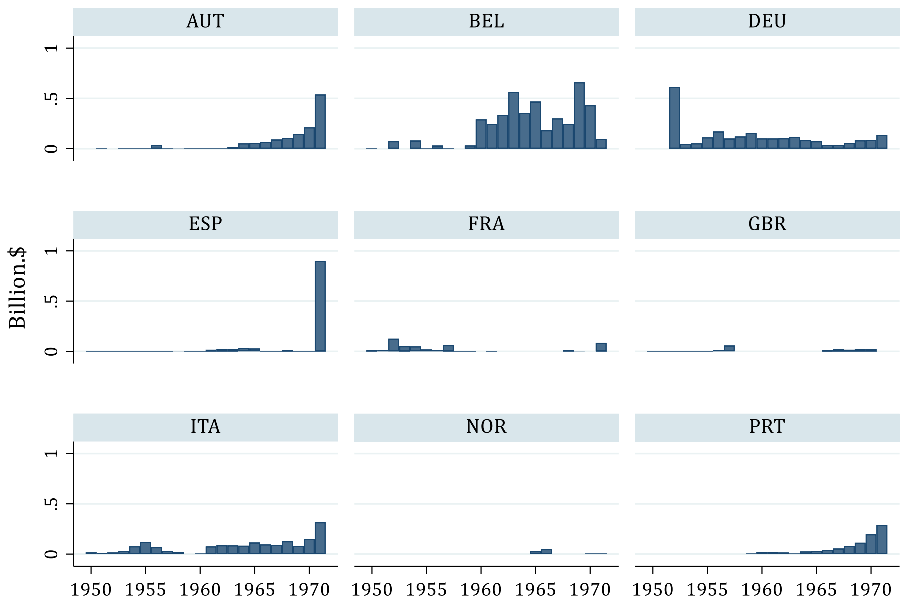

Figure 4: Volume of Swiss franc held in European central banks at country level, in US dollar at constant exchange rate.
Source: Avaro (2020)

When comparing the volume of Swiss francs to the size of the reserves, Swiss francs appear as an important secondary reserve currency, next to the Deutschmark. European central banks held the majority of their reserves in dollars but kept 15% on average of their reserves in other currencies. Figure 5 displays the share of Swiss franc compared with the other main secondary reserve currencies: sterling and Deutschmark. The share of the Swiss franc increased progressively between 1958 and 1971, paralleling the Deutschmark while the share of sterling decreased. At the end of the Bretton Woods era, the Swiss franc represented 5% of the foreign exchange reserves of European central banks, making it the 3rd currency after the Deutschmark and the dollar.

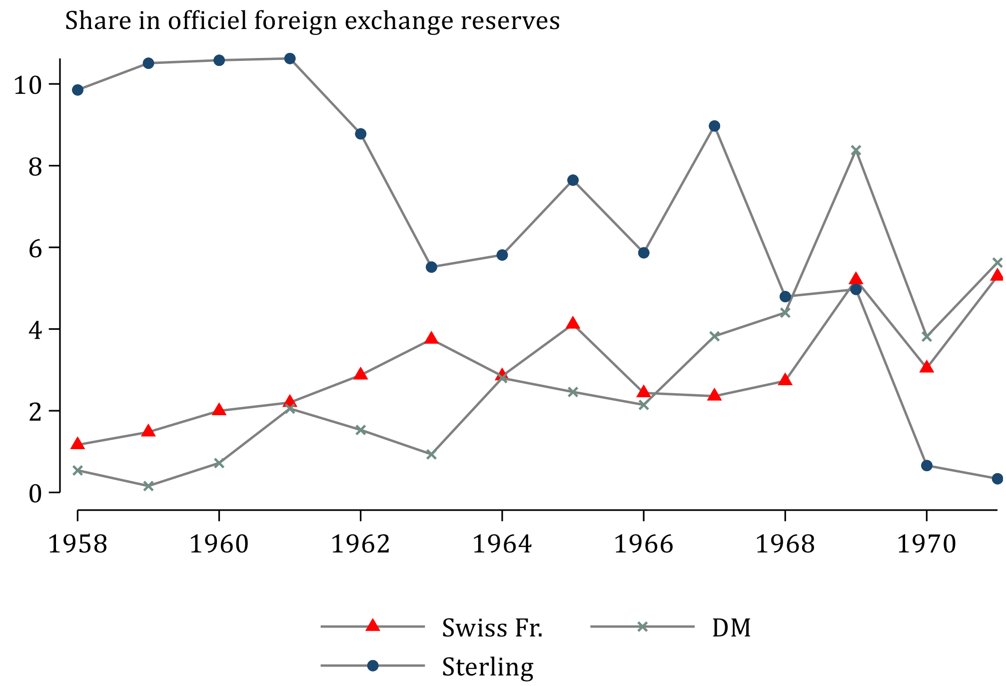

Figure 5: Share of currencies in foreign exchange reserves of European central banks.
Source: Avaro (2020)
Note: Dollar represents more than 80% of reserves for the period and is thus excluded for visibility.

After the demise of the Bretton Woods system, the Swiss franc stabilized at around 5% of the foreign exchange reserves at the world level until the late eighties, as displayed in figure 6. However, it lost its rank of 3rd reserve currency in the international monetary system to the Japanese Yen in the mid-seventies.

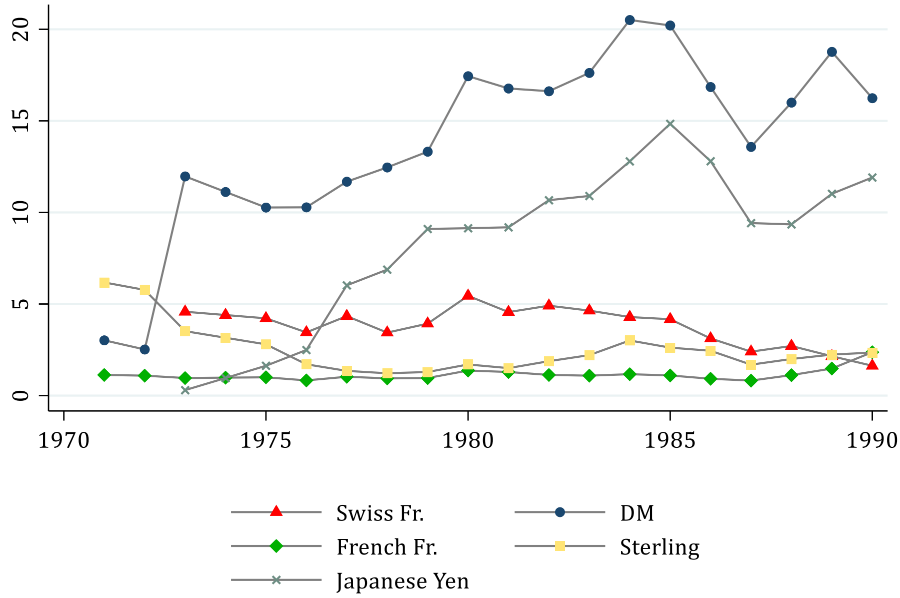

Figure 6: Major currency share of world reserves, excluding dollar, % of world reserves at constant exchange rate.
Source: Eichengreen et al. (2018)
Note: Dollar represents the largest share of reserves for the period and is thus excluded for visibility.

The strengths of the Swiss franc

The existing economic literature on the theory of demand of reserves currencies unearths several drivers which can serve to explain the choice of Swiss francs in European central banks reserves.[21] Some of these drivers are related to the characteristics of the issuing countries such as the credibility of its monetary policies, its economic size and its financial depth. Other drivers are related to the bilateral relationships between the issuing country and the reserve holder, such as their trade relations or military alliances.

In terms of monetary credibility, a key characteristic of the Swiss franc is the long-term stability of interest rate and exchange rate.[22] The Swiss franc devalued only once between 1918 and 1971, in 1936, following the French devaluation. Switzerland also benefited from its large gold stock held by the SNB. Among the main currencies of the international monetary system (the US, the UK, Germany, and France), Switzerland had the highest ratio of gold to money supply (M2), and of gold to GDP during the postwar period. There was thus little doubt on the abilities of the SNB to resist market pressure. The tendency of the Swiss franc was more toward reevaluation, which happened in 1971.

Swiss francs were also held to cover trade payments to Switzerland. This was notably the case for Austria where Swiss francs represented up to 25% of Austrian reserves in the early seventies while Switzerland was the main trade partner of Austria. 54% of Swiss franc Austrian holdings were deposited in banks outside Switzerland, which reveal the circulation of the Swiss currency in the Euromarkets.

In terms of financial depth, the Swiss stock markets presented the advantage of being less constrained by capital controls than the other main European financial center, the City of London. It notably attracted a large share of the gold and foreign currencies markets, from which it received its long-lasting surname of 'Zurich gnomes'.

The Swiss francs also benefited from the difficulties of the Bretton Woods system, as an outsider. From the late fifties, the ongoing deficits in the US balance of payments and depleting gold stock fueled doubts about the capacity of the US to maintain a set parity with gold.[23] After sterling's devaluation in 1967, speculation increased on the dollar, with investors anticipating a devaluation. Despite the efforts of the G10 countries, the US stopped selling gold to foreign central banks from March 1968 onward and Nixon officially closed the gold window in 1971.[24] These periods of tension around dollar convertibility are associated with an increase of Swiss franc holdings, especially in countries that were not part of the G10 effort to stabilize the dollar, such as Austria and Portugal. The Swiss francs offered an alternative asset to diversify a reserve portfolio away from the dollar when risks of a dollar devaluation were increasing.

Conclusion

In this essay, I show that the international dimension of the Swiss franc was not a given in the first years of the Bretton Woods era. The Swiss franc's rise in central banks portfolios happened mostly in the sixties when sterling and then the dollar suffered from crisis of confidence. The Swiss neutrality during the Cold War had repercussions on its currency. The Swiss franc was never submitted to the rules of the Bretton Woods system and remained directly convertible into gold throughout the whole period. This position of outsider relative to the Bretton Woods system, combined with a high gold coverage ratio and liquid financial market allowed the Swiss franc to become a key diversifying asset when troubles arose for the core currency of the international monetary system.

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