

# The Swiss National Bank 1907–2007

## Summary

### Overview

The Swiss National Bank's commemorative publication to mark its 100-year anniversary is divided into three parts. Part 1 looks at the first seventy-five years of the SNB's history, Part 2 addresses the past twenty-five years and Part 3 presents a résumé of Swiss monetary policy since the 1980s followed by seven articles on current monetary policy issues. Parts 1 and 3 were written by leading international economist, while Part 2 was penned by members of the SNB's own staff. All contributors were given unrestricted access to the SNB's archives.

### Part 1

The first of the two chapters, written by Michael Bordo and Harold James, spans the period from the establishment of the SNB to the end of the Second World War. The fledgling bank adopted the internationally prevailing monetary policy concepts of that time, which were based on the real bills doctrine and the gold standard. As with the other European central banks, the SNB was forced to abandon the convertibility of banknotes into gold upon the outbreak of the First World War and had to contend with high inflation during it. After the War, the SNB managed to reduce the level of inflation relatively quickly, however. By the end of 1924, it was one of the first central banks to have returned to pre-war parity and thus effectively to the gold standard. While a great many other countries grappled with instable monetary conditions in the 1920s, Switzerland developed into an island of political and economic stability, establishing itself an important financial hub.

Owing to the positive experiences made with the gold standard, Switzerland remained on it longer than most other countries after the devaluation of the British pound in September 1931. In order to assess the economic impact of the late devaluation, Bordo and James conduct the first ever econometric simulations for Switzerland on the consequences of an alternative monetary policy. The authors conclude that an earlier devaluation would have had a positive effect on economic activity. The decree to devalue the Swiss franc by 30% which, in the end, was issued by the Federal Council, did not mean an abandonment of gold convertibility for Switzerland. The gold peg continued to be the key to currency stability during World War II, and, unlike in most other countries, Swiss authorities regarded the restrictions on capital movement as undesirable.

On the whole, Bordo and James are quite positive about the policies pursued by the SNB, although they do consider the National Bank's gold transactions with the Deutsche Reichsbank during the Second World War as morally and legally dubious as well as politically unwise. The greatest monetary policy mistake was to delay the devaluation of the Swiss franc, which led to the prolonged economic crisis in Switzerland. After devaluation, the country changed course, pursuing instead a stability-oriented monetary policy, which did not embrace macroeconomic stabilisation attempts. It was not until the 1980s, however, that this policy approach was to become the international standard.

In the second chapter, Peter Bernholz shows how the SNB's policy in the period after the Second World War until the transition to flexible exchange rates in 1973 was shaped by two dominant themes. Firstly, the National Bank maintained both the gold parity that had been fixed after the 1936 devaluation and the convertibility of the Swiss franc; secondly, it made every effort to allow the money supply to rise only in line with the growth of the economy.

Even during World War II, the high demand for goods coming from the United States resulted in a dollar overhang in Switzerland. The SNB reacted to this by splitting the dollar market and imposing quotas on exports, the proceeds from which could be settled at the official dollar exchange rate. After the War, it successfully resisted a rapid reduction of market interventions in the interests of a control of the money supply, despite the considerable criticism of the distorting effects this could have on the market as well as the abuse of such measures. Accordingly, liberalisation was a gradual and slow process.

The liberalisation of trade and the general transition to convertibility at the end of 1958 caused the balance of payments surpluses to increase, which in turn led to a rise in the money supply in Switzerland; as a result, inflation began to accelerate in the early 1960s. Since neither the appreciation of the Swiss franc nor the transition to flexible exchange rates were given any consideration, the SNB and the Confederation tried to slow the increase in the money supply by introducing lending limits and administrative measures to deter the inflow of foreign funds into Switzerland. In addition to these foreign funds, which Bernholz views critically, the SNB began to participate in international lending operations in the 1960s. This not only contributed to slowing the growth in the Swiss money supply, but also to reducing the outflow of gold from the United States. Using sources from the SNB, the Bank of England and the Bank for International Settlements, Bernholz brings to light the prominent role played by Max Iklé, Head of Department III, with regard to these financial innovations.

However, neither international monetary cooperation nor administrative measures in Switzerland were successful in solving the fundamental problem of the overly relaxed US monetary policy or eliminate the related dollar overhang. On 23 January 1973, the SNB ceased to intervene in the dollar market. Originally intended to be a temporary measure, this in fact marked the end of the system of fixed exchange rates. As a small open economy with an important financial centre, Switzerland was nonetheless periodically confronted with speculative inflows of capital. The resulting revaluations were

particularly problematic for the export industry. Up to the end of the 1970s, the SNB tried – albeit in vain – to take administrative measures (as in the 1960s) to restrict the inflow of foreign funds and the concomitant strong upward pressure on the Swiss franc. In 1975, in view of exchange rate developments, it even wanted to join the European currency ‘snake’, which it hoped would help to create a local zone of fixed exchange rates. Since Swiss accession was thwarted by France’s resistance, the SNB was forced to temporarily replace the money supply target with an exchange rate target in 1978 due to the exchange rate movements.

## **Part 2**

In addition to looking at the SNB’s monetary policy of the last twenty-five years, Part 2 describes the role of the National Bank in payment transactions, international monetary policy issues and the maintenance of financial stability. Other topics include the SNB’s asset management, the reform of the monetary constitution as well as a number of corporate policy issues, such as the National Bank’s role during the Second World War.

Until the end of the 1990s, the SNB’s monetary policy was based on a strategy of money supply management and thus committed to monetarism. The National Bank assumed that a certain level of growth in the monetary base would result in balanced economic growth and price stability. Until 1986, the money supply targets were more or less met, and inflation was brought down to the projected level. However, a series of events in 1987 disrupted monetary policy (the rapid depreciation of the US dollar, the stock market crash in October, the introduction of an electronic interbank payments system, and changes to the provisions on liquidity for banks at the beginning of 1988). In an attempt to absorb these shocks, the SNB reacted with a monetary policy, which was, in retrospect, too relaxed. Although it later tried to withdraw excess liquidity, it was no longer able to prevent the rise in inflation or the development of a real estate bubble. To achieve greater flexibility, the SNB changed its strategy and set a multi-annual target for the development of the monetary base. While this did succeed in bringing inflation back down to below 1%, the target for monetary expansion was missed by a wide margin. Despite the fact that, for a number of reasons, the importance of central bank money as a reliable indicator continued to decline, the SNB waited until 1999 before introducing a new monetary policy strategy, so as to allow the changes brought about by the European single currency to take effect in Switzerland.

While the objective of the new and still applicable monetary policy strategy remains unchanged – maintaining price stability – it is now based on three main elements: a definition of price stability as a long-term anchor, an inflation forecast as the main indicator for monetary policy decisions, and a target range for the three-month interest rate (Libor) as an operational objective. The relevant subchapter analyses the new strategy and describes the process by which monetary policy decisions are made. Following this rather theoretical section, the decisions that were taken between 2000 and 2006 within the context of this new strategy are outlined. Finally, a look at the

monetary policy instruments and the significance of communications for monetary policy conclude this chapter.

With regard to payment transactions, the SNB not only plays a central role in relation to the supply and distribution of cash, but also contributed actively to the development of the electronic interbank payments system, SIC, which was initiated by the big banks and entered into operation in 1987. The SNB is also involved in the management of the system.

The most notable event of the past twenty-five years in the SNB's international monetary relations was Switzerland's accession to the Bretton Woods Institutions in 1992. This chapter describes the many stumbling blocks encountered on the path towards membership as well as Switzerland's policy in the International Monetary Fund (IMF) since joining. Even before becoming a member, the SNB provided international monetary assistance. This involvement helped contribute to the stability of the global financial system, in which Switzerland – as a small open economy with a highly developed financial market – had a vested interest. Occasionally, however, the SNB's principles came into conflict with national and international policies.

The growing complexity and significance of the financial system and markets in recent decades prompted the SNB to play a more active role in securing the stability of the financial system. In the early 1980s, it therefore set up a special unit for banking and regulatory issues and also extended its banking statistics. Towards the end of the 1990s, it developed capacity to oversee the financial system, which, in addition to overseeing the risks inherent in the banking system, also includes the oversight of the relevant payment and securities settlement systems. This new risk awareness finally resulted in the SNB reviewing its policy as lender of last resort.

Even after the transition to floating exchange rates, the SNB's currency reserves remained mainly in gold and US dollars. This was attributable to the fact that there was still a statutory link between the Swiss franc and gold and that the SNB needed foreign exchange reserves for interventions. The role of gold did not change dramatically until the beginning of 2000, when its link to the Swiss franc was abolished and the sale of gold reserves no longer required for monetary policy began. Efforts to improve the management of the currency reserves led to a partial revision of the National Bank Act (NBA) in 1997, which increased the SNB's investment scope and attached greater importance to generating returns. Furthermore, owing to cantonal motions towards the end of the 1980s, the profit distribution policy was adjusted and the Confederation and cantons received higher distributions. Then, in 2005, the proceeds from the sale of the gold reserves were included in the distribution. The total payment of around CHF 24 billion or 5% of Switzerland's gross domestic product was the highest in history.

In Switzerland, it was a long time – in fact longer than in any other industrialised country – before the end of the gold exchange standard had any effect on the constitutional and statutory provisions that regulated the monetary order. The chapter in question explains how the relevant constitutional provision was finally changed, how the Federal Act on Currency and Payment Instruments came into being, and how the

revision of the NBA became a reality. It also takes a look at the most important elements of this new order. Consensus was reached on a number of issues: the statutory link between the Swiss franc and gold should be severed, the SNB's independence should be enshrined in the Constitution, and – as a means of replacing the link to gold – the SNB should be required to hold sufficient currency reserves. However, the guiding principle for the monetary order remained a bone of contention. The Federal Council and the SNB would have liked to see monetary stability as the primary objective written into the Constitution, but they were unable to push it through Parliament. In the end, the revised Constitution obliged the central bank to pursue a monetary policy that serves the general interest of the country. As was the case with the constitutional article, the debate over the new NBA centred on the National Bank's monetary policy mandate. In the compromise finally reached, the NBA mandates the SNB to pursue its primary aim of ensuring price stability while, at the same time, taking due account of business cycle conditions.

The chapter that addresses corporate policy issues includes a review of the SNB's corporate governance, which took on a greater significance following the entry into force of the new NBA. In particular, the Bank Council was reduced from forty to eleven members and its professionalism was enhanced. A reorganisation of the supply and distribution of cash, which had been ongoing since the end of the 1990s, had far-reaching organisational consequences, ultimately resulting in the number of SNB cash offices being reduced to three (Zurich, Berne and Geneva). To replace the branch offices, the SNB set up representative offices, which were charged with the task of gathering information outside the areas covered by the main offices. The discontinuation of non-core business began hesitantly at the end of the 1970s, but was subsequently pursued more decisively and concluded in the 1990s. The non-core businesses were either abolished altogether (supporting ailing industries, financing compulsory stocks, business with non-banks) or were placed on new legal footing (banking business on behalf of the Confederation). Discussions which flared up in the 1990s surrounding Switzerland's role in the Second World War also impacted on the SNB. Criticism was focused on the gold purchases from the Deutsche Reichsbank. The SNB supported the Bergier Commission in its investigations, by preparing statistics and historical documentation, as well as publishing an academic study about the exchange rate policy background to the gold transactions. Furthermore, it paid CHF 100 million into the Swiss fund for the victims of the Holocaust, but was unyielding in its opposition to the class actions prepared against it in the United States.

### **Part 3**

Given the technical nature of the material, the articles in Part 3 primarily address a specialist readership. The chapter by Ernst Baltensperger looks at how the SNB's monetary policy strategy has developed over the last twenty-five years and examines both its strengths and weaknesses. The other articles in Part 3 address issues relating to monetary policy from today's perspective. Frederic S. Mishkin examines the history of

inflation targeting and how it is likely to develop in the future, Marvin Goodfriend gives us his thoughts on the optimum rate of inflation, while William R. White analyses whether or not central banks should pursue other goals in addition to price stability. Manfred J. M. Neumann looks at the significance of the transition to flexible exchange rates, Peter B. Kenen explains the purpose of foreign exchange reserves and proposes how best to manage them. Martin Hellwig takes us through Switzerland's relationship with the European Monetary Union and, finally, Alexander K. Swoboda provides us with an overview of how the international monetary and financial architecture has evolved since the Second World War.