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Remarks by Ernst Baltensperger

The SNB's monetary policy: evaluation of policy framework and performance

The article reviews the Swiss National Bank's monetary policy over the last few decades and looks at the principal phases of central bank policy in this period, as well as the SNB's conceptual framework for monetary policymaking and its evolution over time, its implementation in monetary policy practice, and the successes and failures of the National Bank's actual policy decisions.

Shaped by changes in the economic and monetary environment, not least in the prevailing views on decision mechanisms and monetary policy possibilities, the SNB's approach to monetary policymaking has changed a number of times in the past few decades. At times, the bank even contributed significantly to the intellectual debate on monetary policymaking and its development.

This was particularly the case when the system of fixed exchange rates was abandoned and the transition to flexible exchange rates was made. Not only was the SNB one of the first central banks to turn its back on fixed exchange rates, it was also a pioneer, alongside the Deutsche Bundesbank, in the development of money growth targeting and its application in bringing down the high inflation to levels consistent with price level stability.

During the 1960s, Swiss monetary policy was bound by the obligation to maintain Swiss franc parity, and characterised by speculative capital inflows and imported inflation. It was not until the system of fixed exchange rates was abolished in January 1973 that the National Bank was given the freedom to pursue an autonomous monetary policy geared to maintaining price stability. The opportunity to pursue a more independent monetary policy was used decidedly by the SNB; in fact, it reacted far faster than most other central

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banks. Based on the advice of leading monetarists at the time, the National Bank started to use monetary targeting procedures, as did the Deutsche Bundesbank. Karl Brunner was particularly influential both in Switzerland and Germany in this regard.

The framework of monetary targeting provided a coherent and structured approach to monetary policymaking, which was based on established theory and which lent itself equally to the internal decision-making process and the external communication of the central bank's monetary policy. Compared with the standard practice of the time, the concentration on monetary targeting, in other words on a relatively easily and 'objectively' observable variable, enhanced both transparency and accountability in central bank policy. While such a 'structured' approach to monetary policymaking is commonplace today, it was unusual and progressive back then.

The SNB never pursued its money growth targets mechanically. The targets were understood as conditional and the need for flexibility and pragmatic responses in times of difficulty of any sort was stressed from the outset. Price stability always remained the primary objective. It is for this reason that authors, such as Bernanke, have expressly described the monetary targeting pursued by the SNB and the Bundesbank as the forerunner to today's inflation targeting.

The monetary targeting framework proved to be an efficient instrument in actively bringing down inflation from a high level to levels consistent with price stability. It nevertheless proved less helpful in maintaining this re-established price stability in an environment characterised by different shocks. At various stages, exchange rate problems, volatile financial markets and unforeseen cyclical developments led to disruptions and undesirable trends, such as the exchange rate shock in 1977/1978 and the subsequent inflation surge in 1980/1981, the instability of bank reserve demand and the monetary overexpansion of 1987–1990, which resulted in inflationary impulses and monetary restrictions in the early 1990s, and the incorrect assessment of the economic cycle and monetary overrestriction of 1994.

After 1987, the frequency of pragmatic adjustments and deviations from the target path undermined the informational role played by monetary aggregates to such an extent that the SNB decided to make the transition to a medium-term (five-year) target line for the development of the monetary base. Yet, in the end, the instability of base money demand and the difficulties in conveying the concept – which in itself made a great deal of sense – to the public were the reasons for the concept's failure.

Thus, at the beginning of 2000, the National Bank adopted its current monetary policy framework. This framework is characterised by the use of inflation forecasts, a clear definition of what is meant by price stability and the implementation of the monetary policy by setting a target range for the three-month Libor. As a natural progression from the SNB's earlier monetary policy concepts, this new framework needs to be viewed in the light of new findings and previously unavailable innovative instruments for inflation forecasts. It allowed the National Bank to make the move to a modern framework representing today's best practice monetary policy, without disrupting the continuity of

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its largely successful past. The new framework has certainly worked well to date. However, as is the case with every framework, it will have to prove itself continually. It would be foolish to believe that it can protect monetary policy from incorrect assessments and undesirable trends, as no strategy is immune to such problems. Monetary policy will always remain an art.