Swiss Monetary Policy:
Current Challenges and Future Prospects

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1. The New Millennium: A letdown so far

The New Millennium was announced with bells and whistles, but so far it has been a major letdown. As any purist will tell you, it begun on January 1st, 2001. Its first quarter coincides almost exactly with the beginning of the long period of economic stagnation to which we seem to be confined ever since. The start of the youngest U.S. recession has been dated March '01, and its end has not yet been officially announced. From a macroeconomic perspective, the last couple of years have been very disappointing. Expectations of an imminent recovery have been repeatedly deceived. And the prospects, for the time being, remain highly uncertain. This raises many challenges for policymakers.

At the Swiss National Bank (SNB) too we were surprised by this lack of conviction, and we have had to keep revising our projections downwards. Just over one year ago we were still expecting a gradual recovery to take place in '02, mostly during the second semester, to produce an average growth rate of about 1%. By early summer it became increasingly clear that this was not going to happen. Indeed, economic growth, last year, was essentially nil.

What went wrong? There are several causes that can explain this lackluster performance. First, the worldwide recovery has been repeatedly delayed. The U.S. economy has been very hesitant and, even though U.S. growth has remained positive, it has been less than potential. Positive signals kept alternating with bad news. The stock market performed dismally. Corporate scandals have fed mistrust. The capital overhang kept investment at depressed levels. The U.S. budget deficit has been rapidly increasing. Geopolitical uncertainties have been rising throughout last year. The only bright spot was personal consumption, although consumers are now exhausted and confidence has declined.

Europe too has suffered. Hopes that it would remain little affected by a U.S. economic slowdown were ill founded. Investment and consumption have been weak. Inflation has remained stubbornly above the 2% upper limit set by the European Central Bank (ECB). This has made it difficult for the ECB to lower rates.

In the past, Europe and its neighbors have come to rely on the “German locomotive” to pull them out of weak spots. Unfortunately, this time around, the German engine is stalled. Germany has become a drag on European growth. Domestic demand is weak. Unemployment is rising. To make things worse, Germany is facing a growing budget deficit. It is in violation of the Maastricht Growth and Stability Pact. Consequently, tax reductions have been delayed, and new taxes might be on the horizon.

Against this backdrop, the Swiss economy has been hard pressed to take off. We had always said that a Swiss upturn was unlikely until a decisive U.S. and European economic recovery was under way. In a sense, Switzerland has been hit by a double, or even a triple, whammy. Like elsewhere, investment in equipment has collapsed. Furthermore, because its exports contain a large proportion of capital goods, net exports fell significantly. This was made even worse by the fact that Switzerland's main trading partner is Germany. Nonetheless, the '01-'02 recession was weak. Unemployment, although too high and rising, remains low by international standards. On a brighter note, inflation remains very low. The SNB's objective of price stability has been achieved for the fifth year in a row and our currency has thus kept its purchasing power intact.

2. '03: A recovery waiting to happen

In many ways, '02 was a wasted year, and we are now standing where we were 12 months ago. Our current forecast looks almost like a Xerox copy of last year's. We expect Swiss growth to remain subdued until the middle of the year, and then to pick up steam during the second semester. In view of the huge remaining uncertainties and of our deceived expectations of last year, we must, however, remain very cautious.

Nonetheless, we believe that the U.S. recovery is on its way, and that it will strengthen throughout '03. Once that the U.S. recovery will be firmly established, we expect Europe to follow suit. The worldwide capital overhang is being progressively absorbed, in parts through economic and technological obsolescence. Monetary and fiscal policies remain very expansionary. In fact, the amount of monetary stimulus in the pipeline is considerable. Interest rates are very low, and yet price stability is not being threatened. With the exception of Japan, banks are in reasonably good shape and are in a position to fulfill their role.

Everything in Switzerland is in place to take advantage of a worldwide — and particularly a European — recovery. A lot of restructuring has taken place in the 1990s and it has left us with a more flexible and efficient economy. The fiscal position remains satisfactory. Inflation and interest rates are extremely low. Monetary policy remains decisively expansionary, and the Swiss franc has weakened considerably against the euro. If our scenario for a U.S. and a European upswing proves correct, we should see a gradual revival of the Swiss economy as the year progresses, led by rising exports and investment. Inflation should remain low, at somewhat less than 1% on average, but, unfortunately, unemployment will keep increasing for a while yet.

3. Risks and uncertainties

Risks, however, remain considerable, and many of them point to the downside. Although one cannot exclude that the U.S. recovery will be stronger than expected, the danger is rather that it will be delayed once again. A double-dip recession in the United States seems increasingly unlikely, but it cannot be excluded entirely. It may also be that Europe will go through a period of stagnation. Germany is particularly worrisome. A further drop in the stock market and additional accounting scandals remain possible. In spite of the rapid resolution of the war in Iraq, geopolitical uncertainties remain large. Fortunately, oil prices have receded in recent weeks, and consumer confidence might again be rising. And as if this were not enough, new risks can pop up almost any day: SARS is an acronym that was unheard of only three months ago.

Although the Swiss economy today is much more flexible than ten years ago, much remains to be done. It is important, in particular, that efforts directed at liberalizing the internal market do not subside. Like many other European nations, Switzerland is suffering from excessive rigidities and over-regulation. More competition in domestic markets would undoubtedly contribute to increase the efficiency of the Swiss economy and to improve its growth prospects.

4. Real growth: A digression

Allow me a short digression on the topic of growth. Switzerland has the reputation of being a laggard when it comes to real growth. In almost every international GDP comparison, Switzerland is found to have a growth rate that is significantly lower than that of other industrialized nations. Nonetheless, when one looks at average living standards, Switzerland always ranks among the top nations. How can Switzerland go slower than everybody else, and yet stay ahead?

One could of course argue that this has to do with convergence. If Switzerland has a relatively high living standard initially, it is perfectly possible that it grow less rapidly than its neighbors, and nevertheless that it maintain its leading position for a while yet. Sooner or later, though, it will be caught up. It turns out, however, that the Swiss growth paradox is not new. On the basis of an international comparison expanding from 1880 to 1995, one finds that Switzerland occupies the second-last position. Knowing that in the 19th century Switzerland was a poor country in European comparison, and that apparently growth there

was lower than elsewhere, how can one explain that today it is one of the countries where real income is highest?

There might be many partial answers to this puzzle, but my own work leads me to believe that real GDP underestimates the growth of real value added in Switzerland by about half a percentage point per year. The reason is that the Swiss terms of trade have improved steadily over the past few decades. An improvement in the terms of trade is similar to a technological progress, in that it allows you to get more for less. But unlike technological progress, the terms of trade effect it is not captured by real GDP data. Instead, it is viewed by the national accounts as a price effect. A drop in the price of imports, which must unambiguously increase welfare, will lead to an increase in the GDP price deflator (because imports enter the calculation with a negative weight), whereas it has clearly no inflationary impact, quite the contrary. This also shows that the GDP price deflator is a poor indicator of a country's general price level. Yet, many international comparisons are based precisely on this index.

A second reason why real GDP growth underestimates the increase in the Swiss purchasing power is that Switzerland traditionally is a capital exporter. It thus invests much of its savings abroad. The income earned on these investments is captured by GNP, but it is left out from GDP. It is interesting to note that in recent years, Swiss GNP has grown much more rapidly than GDP. Over the past decade, the difference has averaged about 0.7% annually.

Yet another factor that might hold measured economic growth back in Switzerland is the tendency that we have to invest in projects that yield very intangible, if not dubious, returns. The systematic building of bomb shelters, for instance, or perhaps more importantly at the moment, the construction of major new alpine railway tunnels mobilize considerable resources at a very high cost, without increasing the Swiss production potential in any visible way.

5. What monetary policy can do

Nonetheless, the Swiss growth performance is far from stellar, and this raises the question as to what monetary policy can do. Most economists today would agree that in the long run, monetary policy has little hold on real variables. Or perhaps, I should rephrase this, for there is an asymmetry in what monetary policy can do or not do. Indeed, a poorly-run monetary policy can have devastating effects on the economy, whereas a well-run policy is

quite unspectacular. In particular, it cannot increase the long-run growth potential of the economy.

In our view, the most important contribution monetary policy can make to economic welfare is price stability. Price stability enables the economy to reach its full potential. Inflation has many perverse effects on the economy. It distorts signals and leads to a misallocation of resources. It tends to hurt most the economically weakest members of society. Even an apparently harmless inflation rate of 3% will lead to a doubling in the price level in less than 24 years. A worker retiring on a fixed pension at age 60 would see his/her purchasing power reduced by half before having reached the age of 84. Over the course of a century, a 3% rate of inflation would result in the price level being multiplied by a factor of 19. In other words, in terms of purchasing power, a franc would be worth little more than 5 centimes, a dollar little more than a nickel. This cannot be defined as price stability by any stretch of the imagination.

The fight against inflation, however, must not be dogmatic, and the central bank must take into account the short-run effects of its policy when setting its course. In particular, it should use its available degree of freedom to support activity whenever possible.

At the SNB, we define price stability as an inflation rate of less than 2%. Our operating target is the 3-month Libor interest rate. Since this is an interest rate that we do not control directly, we aim at maintaining the Libor within a range 100 basis points wide. The position of the range itself is set on the basis of a 3-year inflation projection. Given the current economic situation, and given that price stability is not threatened, we have used our leeway in full, and we have lowered interest rates aggressively. Since March '01, we have taken the range down a full 325 basis points, moving its mid-point from 3.5% to 0.25%. This low level is unsustainable in the long run. Interest rates will sooner or later to have been raised. The challenge for monetary policy will be to do so at the right time, neither too early — for this might choke off the recovery —, nor too late — for it would fuel future inflation.

6. The asset-price challenge

Many economists argue that central banks define price stability too narrowly. Instead of focusing on the consumer price index alone, they should also include asset prices in their definition of price stability.

I see many difficulties with this argument. Asset prices are very complex animals. They are essentially equal to the present value of an expected future income stream. Many factors can affect asset prices, some of which are real and some of which are nominal. A drop in the discount rate or a positive productivity shock, for instance, will tend to lead to an increase in asset prices, and yet such shocks can hardly be viewed as inflationary. Stable asset prices are neither necessary nor sufficient for price stability. In my view, it therefore would be pointless, and even counter-productive, to use monetary policy to try to regulate asset prices. Stabilizing the price level, period after period, on the other hand, would go a long way in enhancing the stability of the financial system and reducing the risk of asset price bubbles developing.

A further obvious difficulty with asset price targeting concerns the choice of the relevant assets. Should one look at money, at bonds, at equities, at foreign exchange, at real estate, at commodities, at human capital? Very often the prices of these assets move in opposite directions, which makes it impossible to target them all at the same time.

Money is the only asset that central banks control. If they are to target asset prices, it would therefore make sense to focus on money; that is, to target the real price of money, which is simply equal to the inverse of the cost of living. One is thus led back full circle at aiming at stabilizing consumer prices. Let us not forget also that assets are a way to transfer purchasing power through time, and that the purpose of income is ultimately to finance consumption, which is what yields utility. This too argues in favor of safeguarding the purchasing power of money in terms of consumption.

Nonetheless, asset prices do convey much information, and therefore they must be watched carefully. A rapid change in asset prices may or may not have any direct implications for price stability, but it almost always has an indirect impact that can materialize through many different channels. Central banks are well aware of this, and they therefore follow asset market developments with great attention.

7. The D-challenge

As you know, Switzerland has a very low rate of inflation. Interest rates are very low as well. The D-word has recently become more prevalent in the public discussion. Is deflation another threat that we have to deal with?

The pursuit of price stability means the fight against inflation as well as deflation. Deflation has a particularly sinister reputation, for it reminds us of the great Depression — another

D-word — of the thirties. One must be careful, however, the example of China, that currently experiences astronomical growth and a falling price level, is here to remind us that deflation is not synonymous with depression, just like inflation does not rime with economic boom. Nonetheless, a steady decrease in the price level leads to many of the same problems as inflation does. It must be fought off decisively and pre-emptively. Indeed, things are not quite symmetrical when it comes to price and interest-rate dynamics. As we all know, nominal interest rates tend to increase with inflation, but the reverse is true only up to a point. This is because nominal interest rates cannot fall below zero. Once the zero lower bound has been reached, any increase in the rate of deflation implies an increase in the real rate of interest that cannot be countered by monetary policy. That is, one of the main channels of monetary policy, the one that works through short-run interest rates, becomes out of order. This is not to say that monetary policy becomes incapable of influencing prices and activity. Deflation, like inflation, is a monetary phenomenon after all, and monetary policy can do something about it. There are other channels remaining, including those that operate through long-run interest rates, the exchange rate and expectations, as well as quantitative measures. Nonetheless, the central bank should do it utmost not to find itself deprived of its main instrument.

All in all, however, we do not view deflation as a serious menace for Switzerland at the moment. Monetary policy remains very expansionary, and our inflation projection points decisively upwards towards the end of our forecasting horizon. This does not mean that we could not occasionally observe a monthly drop in the price level, or that the prices of certain goods might not decline, but, short of a brutal external shock, the likelihood of a sustained fall in the price level is very remote. In any case, we monitor the situation very closely and would not hesitate to take resolute countermeasures if needed.

8. The €-challenge

Over the past four years, the Swiss monetary environment has been transformed. The Swiss monetary zone, which includes Liechtenstein, is now surrounded by the euro-area. It is like an island in the euro-ocean.

Monetary integration brings many benefits to its members. Transaction costs are sharply reduced. Exchange-rate volatility and uncertainty vanish within the union. Price comparisons are facilitated and transparency more generally is enhanced. Monetary integration under the Maastricht Treaty also promises price stability to those countries that, in the past, had been incapable of achieving it on their own.

Naturally, monetary integration has its costs too. The most important one is the loss of monetary sovereignty. That is, member countries are no longer able to pursue a monetary policy of their own. There is now just one monetary policy for the entire euro-zone. The motto is "one size fits all". This could lead to severe problems in case of asymmetrical shocks; that is, if one country, or one group of countries, is affected by specific external events. Thus, today, one could argue that Germany needs lower interest rates, whereas Ireland, for instance, requires higher ones.

Under monetary union, adjustments that would otherwise occur through changes in the exchange rate and domestic interest rate conditions must imperatively take place through changes in prices and wages, and through adjustments in quantities, all of which can be very painful.

9. What course for the Swiss franc?

The Swiss franc has shown a tendency to appreciate against the euro. This has led to calls for the Swiss National Bank to fix the exchange rate between the franc and the euro. Our critics argue that the appreciation of the franc against the euro is undermining the Swiss export industry. By targeting the exchange rate, they say, the SNB could eliminate an important source of uncertainty and safeguard the international competitiveness of our export industry. One must remember that about two thirds of Switzerland's foreign trade is with countries from the euro-zone.

One should put things in perspective, though. Over the course of the past four years, the appreciation of the Swiss franc against the euro has not exceeded 5% in real terms. In fact, using today's exchange rate, the figure is closer to 2 or 3%, which, over a four-year period, is not extraordinary by historical standards.

In any case, fixing the nominal exchange rate against the euro, even if it were possible for a while, would not solve many problems, and it would create a number of new ones. For a start, only the exchange rate against euro-area countries would be fixed, but the policy would do nothing to stabilize the exchange rate against the U.S. dollar, the Japanese yen or the British pound.

More importantly, as I argued earlier, monetary policy has no lasting impact on real variables. The real exchange rate, which is the only one that matters for production decisions and trade flows, cannot be manipulated by monetary policy over the long run. Pegging the franc against the euro would bring no lasting relief to our export industry. The

long-run real appreciation of the Swiss franc against most other currencies would continue, but it would take the form of a rate of inflation that would be higher in Switzerland than in the rest of Europe. This in itself would stretch the credibility of such a policy.

Even more seriously, nominal interest rates would necessarily increase to the same level as in the rest of Europe, which would mean that Switzerland would lose its interest-rate advantage. The user cost of capital would increase even though labor costs would remain unchanged. This would put additional pressure on the competitiveness of our industry. This rise in interest rates would also have serious repercussions for the Swiss financial center and it would lead to a drop in Swiss asset prices. Real investment would most likely collapse, depressing aggregate demand, possibly for many years. Given that we would have lost our ability to charter our own course, there is nothing the SNB could do about it.

We firmly believe that we are best off pursuing an independent monetary course. Unavoidably, this occasionally means undesired developments on the foreign exchange market, but this is a small price to pay to be able to continue to offer Switzerland a monetary policy that is custom-made, so to speak. In this regard, it was gratifying to see that the war in Iraq has not led to a sudden surge in the franc. On the contrary, our currency has weakened significantly against the euro over the past two months. The franc seems to have lost some of its safe-haven luster, which will not lead us to shed any tears. Similarly, the fall in the value of the dollar, which had been long announced, yet repeatedly delayed, has been orderly, and it has not led to severe turbulence of foreign exchange markets.

In conclusion, I would like to make it clear that the SNB is fully aware of the pain that sudden moves in the exchange rate can inflict. Exchange-rate movements are closely monitored, and they play an important indirect role in the formulation of our policy. A sudden appreciation of the Swiss franc is equivalent to a tightening in monetary conditions. In the current economic situation, any such tightening is clearly undesirable. The Swiss National Bank has demonstrated several times in recent months that it does not hesitate to take decisive policy measures in such a case. It is true that our interest rates are extremely low at the moment, but, even if there is little scope for further cuts, there are other instruments at our disposals that we can use if necessary.