

Ten years of experience in steering interest rates

Assessment of the SNB's monetary policy strategy

Speech by

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1. Historical survey: The shift from steering monetary aggregates to steering interest rates

When fixed exchange rates were abandoned in 1973, the SNB was faced with a completely new operating environment. Until then, monetary policy had been dictated by the interventions in the foreign exchange market needed to maintain the parity of the Swiss franc against the US dollar, and Swiss inflation was mainly affected by increases in foreign prices. The switch to a floating exchange rate regime removed this link and provided the SNB with an entirely new mandate – that of maintaining price stability on a completely independent basis. It needed to formulate a monetary policy strategy, taking the new exchange rate regime into account.

Given the extensive creation of money and the rapid increase in prices, the ideas of monetarist thinkers dominated monetary theory at that time. Thus, it is not surprising that the SNB began by adopting a monetary policy strategy which drew heavily on Milton Friedman. In part, the strategy was based on the quantitative theory of money, which states that inflation is essentially a monetary phenomenon. As a result, control of the quantity of money – as measured by the monetary aggregates – must play a key strategic role, serving as the nominal anchor for the economy. The new strategy was also founded on the conviction that an excessively interventionist monetary policy could prove inopportune and damaging, in view of the long lags and variables inherent in the mechanisms transmitting monetary stimuli to the real economy and to prices.

In accordance with these theoretical principles, from 1975 the SNB implemented policies that centred around a growth target for monetary aggregates. As I will show you very briefly, it has been able to adjust its policies pragmatically, in line with the circumstances and the technical innovations that have affected the demand for money. Initially, the annual growth target was defined in terms of the M1 aggregate.¹ In 1978 and 1979, major turmoil on the exchange rate market prompted the SNB to temporarily suspend this target in order to limit the appreciation of the Swiss franc. Since M1 no longer appeared to be a relevant indicator, it subsequently decided to switch to a growth target for the monetary base.² However, demand for the monetary base also became increasingly unstable as a result of major technical innovation and changes in the behaviour of commercial banks and households. Consequently, in 1991, the SNB adopted a multi-annual operational monetary target in order to increase its flexibility and, in 1997, it chose to target the broadest monetary aggregate (M3) to limit the impact of transfers between different forms of money. This latter decision, however, did not prove to be a satisfactory solution. Although price stability was ensured, the SNB was unable to exercise sufficient control over the monetary aggregates.

This led the SNB Governing Board to appoint, in November 1998, a working group charged with a comprehensive review of monetary policy. The group concluded that a simple

¹ M1 is defined as total coins and banknotes in circulation plus sight deposits held by the non-bank public at commercial banks.

² The monetary base is made up of banknotes in circulation held by members of the public and commercial banks as well as commercial bank sight deposits at the SNB.

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reworking of the existing strategy would serve no purpose. On the contrary, it was necessary to adopt a completely new approach, taking into account both the experience already gained by the SNB and the latest economic research findings. This new approach was the strategy that has been in place since December 1999, the strategy that I will now present to you.

2. Main elements of the current strategy

The strategy reform carried out in December 1999 was the most substantial change in monetary policy since the switch to floating exchange rates in 1973. The main objective of monetary policy, i.e. the maintenance of price stability, remains unchanged, thereby assuring continuity with the previous strategy of steering monetary aggregates. However, the new approach is founded on a more comprehensive and more rational analytical framework than its predecessor.

The strategy is based on three elements: (i) an explicit definition of price stability, by way of a long-term anchor, (ii) an inflation forecast as main indicator for monetary policy decisions and (iii) a range for the three-month Libor as operational target for the implementation of this policy.

Allow me to spend a little more time on each of these elements.

First element: an explicit definition of price stability, by way of a long-term anchor

In deciding not to pursue a growth target expressed in terms of the money supply, the SNB simultaneously abandoned the concept of a 'normal inflation rate', which had been systematically included in its calculations of the monetary growth target up to that point. In order to provide the market and the general public with a point of reference on the direction of the SNB's medium and long-term policy, we had to come up with an explicit definition of what we understood price stability to be. An explicit definition of price stability allows for the anchoring of both long-term inflation forecasts and the nominal movements in certain economic variables. In addition, the performance of monetary policy can be measured.

We equate price stability with an annual rise in the Swiss consumer price index of between 0% and 2%. We give preference to a target range rather than an exact target level – as in the case of many central banks – because of the uncertainty related to the mechanisms that transmit monetary policy to prices. The wish to maintain inflation at a very precise level would not only be illusionary but would also induce us to engage in excessive monetary activity.

Another special feature of our definition of price stability is that it relates to the consumer price index without excluding the prices of certain components, such as oil. We consider that price stability must be measured in terms of an index which covers all goods and services that really matter to consumers, without arbitrarily excluding certain components. Consequently, our measure of inflation displays a short-term volatility

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resulting from the rapid and temporary fluctuations in the prices of certain goods – a volatility that does not show up in core inflation. It is thus quite plausible that inflation will deviate from the definition in the short term without threatening the stability of prices, as long as it returns to the 0–2% range in the medium term.

Second element: an inflation forecast as main indicator

In view of the relatively long lag of up to three years between a monetary stimulus and its impact on the business cycle and prices, it is essential that our monetary policy decisions be based on the inflation outlook rather than the events occurring at the time of our decision. Previously, it had been possible, to some extent, to consider movements in the money supply as a rough forecast of inflation. However, experience had shown us that it is difficult to base monetary policy on one variable alone. In addition, the inflation forecast needed to be more broadly-based, including a greater range of relevant information. We draw up the inflation forecast on the basis of various econometric models as well as individual indicators including, for example, movements in monetary aggregates and credits, exchange rates and excess liquidity. This information is then synthesised in an appropriate manner to arrive at a consensus forecast. The significance and the weighting of the different models depend on the horizon of the forecast, and may change over time.

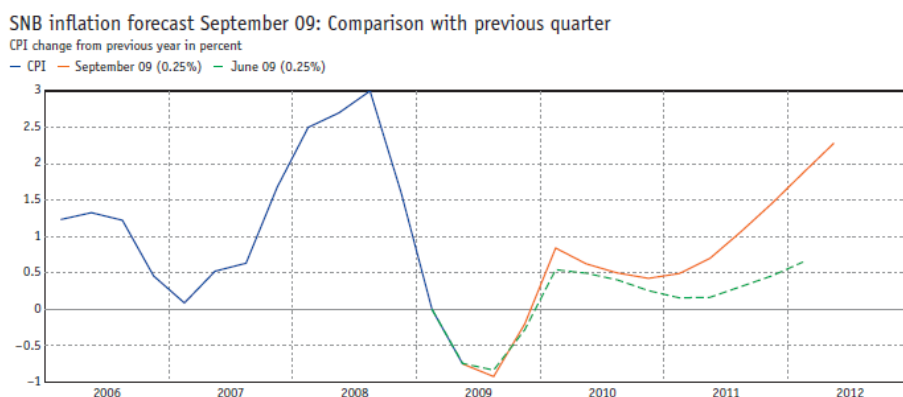


Chart 1. SNB inflation forecast

In our forecasts, we specify a constant three-month interest rate for the entire forecast period. Clearly this hypothesis is unrealistic. However, it allows us to present the long-term consequences of the policy in force at the time the forecast is drawn up. Thus, the inflation path gives an indication of the adjustments that need to be made to monetary policy in order to contain inflation. If, for a given interest rate, the inflation forecast indicates a long-term deviation from the range of price stability, monetary policy will need to be adjusted. Nevertheless, monetary policy decisions are not reached in a mechanical way. On the contrary. When deciding on the period over which we will adjust the rate of interest, the SNB is governed by the economic context.

In addition to its role as an aid in monetary policy decisions, the inflation forecast plays a key role in our communication policy. The inflation forecast is closely linked to the quarterly monetary policy assessment and is published as a matter of course on each such occasion. Thus members of the general public are in a position to deduce the probable

direction of future monetary policy decisions and form their own expectations with regard to the rate of interest.

Third element: a range for the three-month Libor as operational target

We implement our monetary policy by fixing a range for the three-month Swiss franc Libor (*London Interbank Offered Rate*), as our operational target. The range is generally 100 basis points. Moreover, we specify which part of the target range we will aim for. The Libor target range, as well as the level being aimed for, constitutes the monetary policy decision.

A peculiarity of our operational target is the fact that the SNB does not directly control the three-month Swiss franc Libor. The Libor is an indicative rate fixed daily by the British Bankers' Association in London. It reflects the price paid for an unsecured loan by a first-class bank. Thus the Libor reflects money market forces – liquidity and perceptions of interbank credit risk.

We steer the Libor by means of loans which we grant to commercial banks in the form of repurchase agreements, referred to simply as repos. Our operational target, the Libor, and our operational instrument, repos, can be distinguished from one another in two significant ways. First, repo operations are loans secured by high quality collateral while the Libor represents the price of an unsecured loan. Consequently, a rise in banks' credit risk will cause the Libor rate and the repo rate to move apart. Second, the repo operations which we conduct with commercial banks are generally very short-term transactions (one day to three weeks), while the Libor rate which we are targeting has a three-month maturity.

The choice of an operational target presents central banks with a dilemma. It is natural that a central bank will wish to influence long-term market rates, since these play a vital role in economic developments. Yet, it is only the very short-term rates which it is able to determine directly, through its repo operations. Whereas most central banks define their monetary policy by fixing a very short-term reference rate as their operational objective, we pursue an intermediate route in opting for the three-month Libor. As we shall see in a moment, experience has shown that we are able to control the three-month Libor without any great difficulty.

3. The main stages through which monetary policy has passed since the introduction of the current strategy

We will now examine the implementation of the strategy since its introduction ten years ago. Over this period, our policy has passed through four distinct stages.

First stage: tightening, from end-1999 to spring 2001

When the strategy was introduced in December 1999, we set the three-month Libor target range at 1.25–2.25%, with a slight tightening in monetary policy for the year ahead to be

expected. Gauging the initial level was difficult due to our lack of any prior experience or reference values. From January 2000, it became clear that the economic recovery in Switzerland would be considerably stronger than had been anticipated due to the strong growth in the global economy and the relative lack of movement in the Swiss franc. We therefore allowed the Libor to find its own position within the upper part of the target range before raising the Libor target range by 50 basis points in February, which was before the date planned for the first quarterly assessment. The upward revision in the inflation forecast and the faster pace of economic growth then prompted us to raise the Libor target range twice in succession at the assessments of March and June 2000, on the first occasion by 75 basis points and on the second by 50.

Thus, in the six months following its introduction, the strategy was very rapidly put to the test, with the need to increase the Libor target range in three steps by a total of 175 basis points. This monetary tightening made it possible to contain the unexpected increase in inflationary pressure and convince markets right from the outset that the SNB intended to conduct a monetary policy independent of the European Central Bank (ECB). We were pleased to find that implementation of the monetary policy did not pose any special problems and that it was possible to stabilise the three-month Libor at the level we were aiming for.

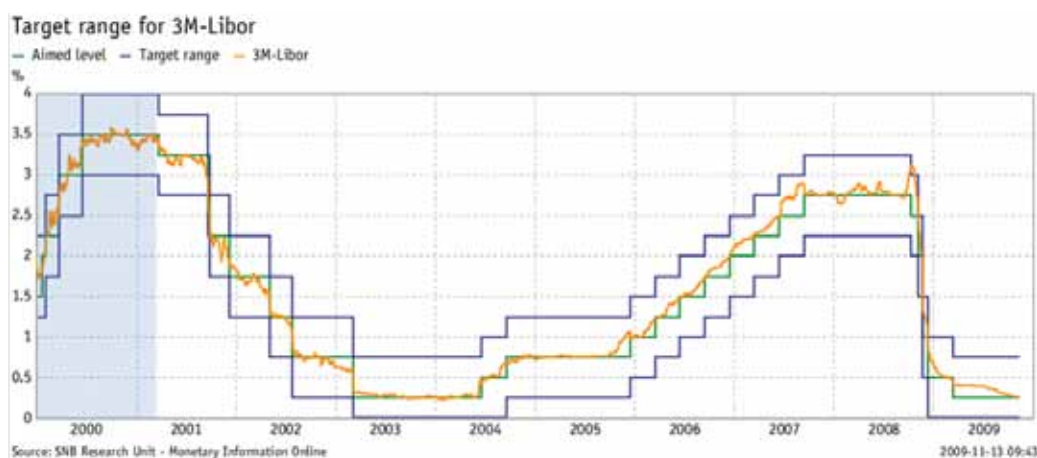


Chart 2. Libor target range; first stage in the implementation of monetary policy

Second stage: Relaxation and low-rate policy, from spring 2001 to mid-2004

The second stage in the implementation of our monetary policy saw a series of negative shocks to the economy and presented us with a major challenge. During the first quarter of 2001, cyclical risk increased substantially due to a slowdown in the US economy which was as sharp as it was unexpected, the bursting of a global stock exchange bubble and a slowdown in economic activity in Asia. The terror attacks of September 2001 exacerbated the uncertainty on financial markets, triggering pressure on the Swiss franc to appreciate. At the beginning of 2003, the economic situation again deteriorated to the point that there were fears of the US and Europe slipping into deflation, with the war in Iraq serving to accentuate these worries.

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We reacted rapidly and firmly to this series of shocks by reducing the Libor target range in six stages between March 2001 to March 2003, by a total of 325 basis points. From March 2003 to June 2004, the Libor target range was maintained at 0–0.75%, aiming for a level of 0.25%. In a situation that was extremely difficult for the Swiss economy, we managed to quell the tendency of the Swiss franc to appreciate without jeopardising price stability.

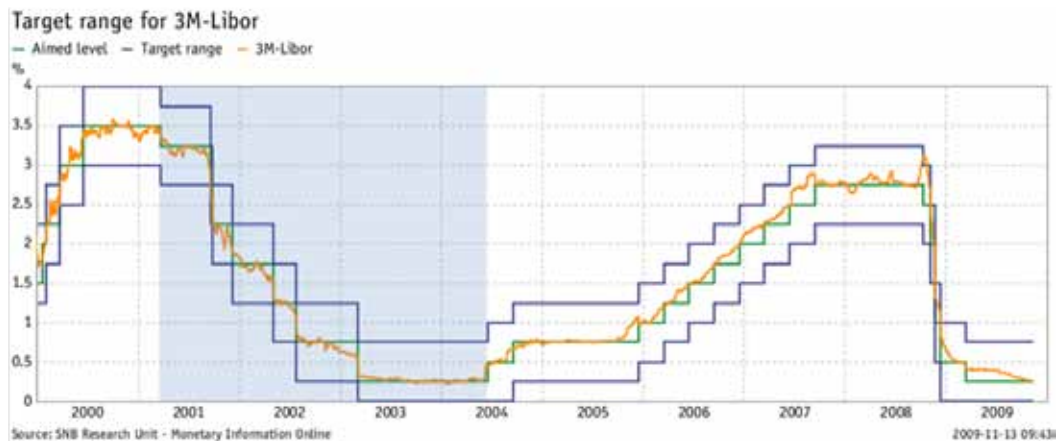


Chart 3: Libor target range; second stage in the implementation of monetary policy

Third stage: gradual normalisation, from mid-2004 to autumn 2007

This extremely expansionary policy could not be maintained as the risk of deflation waned. From June 2004, we initiated a process of gradual normalisation of the three-month rate. Consequently, we increased the Libor target range in two steps in 2004, before instituting a break lasting some five quarters due to the slowing of the economic recovery and the easing of inflationary pressure in Switzerland. During the second half of 2005, signs of a stronger economic recovery and growing risks of inflationary pressure prompted us to resume normalisation of our monetary policy. We gradually adjusted the Libor target range over the eight quarters that followed, until September 2007, to ensure that the economic recovery did not jeopardise medium-term price stability. In September 2007, the Libor level being targeted had risen to 2.75%.

In this third stage, we were able to normalise our monetary policy – which had become expansionary – without stifling the economic recovery that was underway. Our scope for manoeuvre was enough to allow us to temporarily interrupt this process in view of the weakness of the economy in spring 2005, even though the inflation forecast indicated the risk of price escalation in the medium term. By means of a well-considered information strategy and consistency in our money market operations, we were able to convince the market that we wished to adjust the monetary framework in a pragmatic but decisive manner in order to maintain price stability in the medium term. The market understood our strategy, and the three-month interest rates always moved in the direction of the policy that we had publicised.

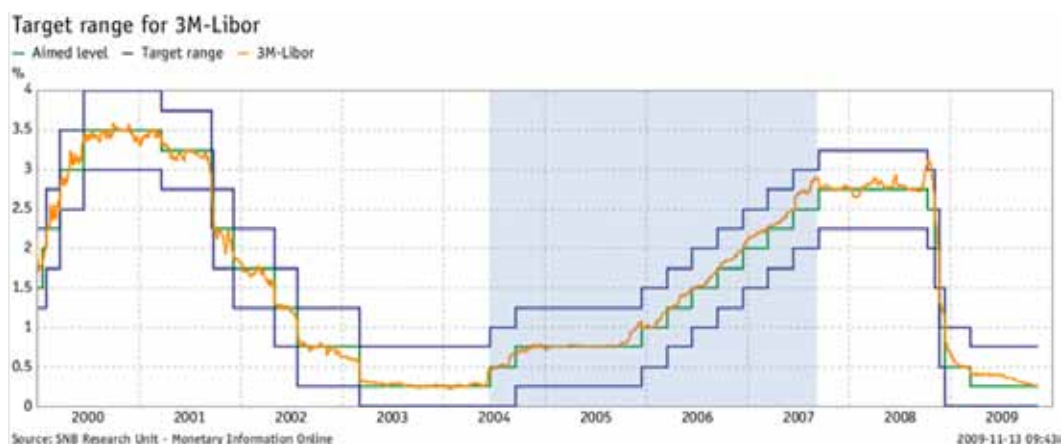


Chart 4. Libor target range; third stage in the implementation of monetary policy

Fourth stage: response to the financial crisis, from autumn 2007 to the present

The bursting of the speculative bubble on the US real estate market at the beginning of 2007 spread to the entire banking sector and, in September 2007, triggered a global crisis in financial markets. The crisis of confidence at large banks profoundly changed operations on the interbank money market - on which banks exchange liquidity with one another on a daily basis, in the form of unsecured deposits. It led to a major increase in the perception of banking risk and, as a consequence, a considerable rise in credit spreads, inciting an unwelcome augmentation in Libor rates. At that time, the crisis gave rise to problems of a monetary nature. In the early stages, the Swiss business cycle was not affected by the crisis, and inflationary pressure was intensified due, in particular, to the substantial rise in oil prices.

Pressure on the Libor as a result of the increase in risk premia led to an artificial tightening in our monetary policy. In order to alleviate these pressures and keep our monetary policy course unchanged, we rapidly lowered rates for our repo operations and lengthened maturities to three months in order to provide liquidity to the market in the areas where the demand was strongest. Throughout the entire early period of the crisis, from September 2007 to September 2008, it was thus possible to maintain the three-month Libor at a relatively stable level. Our policy allowed us to shelter the Swiss credit market from the turmoil emanating from the malfunctioning international markets.

In September 2008, the collapse of Lehman Brothers investment bank and the sudden deterioration in the economy gave rise to an alarming development in the financial crisis. The Swiss economy moved into deep recession in the second half of 2008 and inflationary pressure waned. The increase in credit risk premia accelerated in the financial sector and spread to other sectors of the economy. Having already plunged from September 2007 onwards, international stock exchanges again recorded major losses. At the same time, the Swiss franc came under strong upward pressure due to its role as a safe haven currency.

We reacted to this dramatic deterioration in the economic situation by lowering the Libor target range in five steps by 225 basis points in total, between September and December 2008, to reach the envisaged level of 0.50%. Implementation of this strategy necessitated

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a major increase in the amount of liquidity in circulation on the interbank market. Due to the high level of credibility of our operation, we were able to lower the Libor even though risk premia remained high on foreign markets. The fall in the Libor allowed for a relaxation of monetary conditions in Switzerland and helped to alleviate the contraction in our economy.

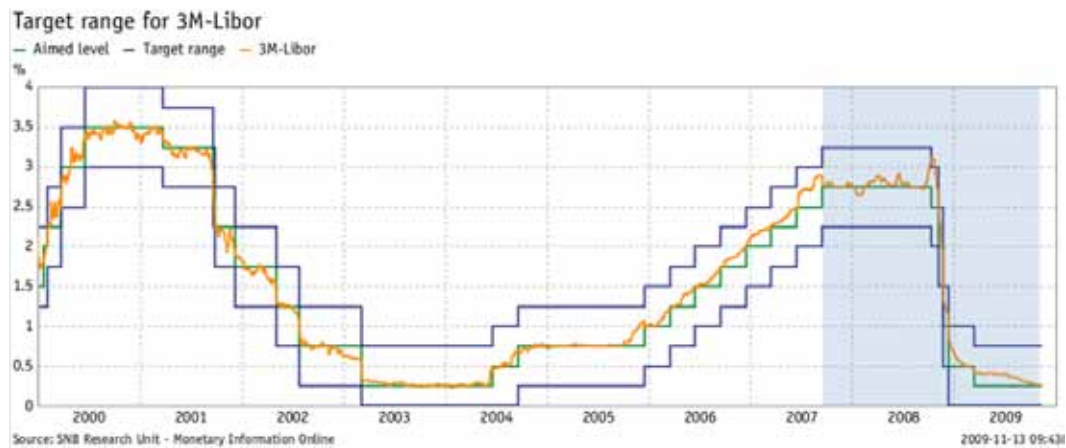


Chart 5. Libor target range; fourth stage in the implementation of monetary policy

In March 2009, we were faced with a situation in which the economic outlook was continuing to deteriorate. However, the Swiss franc was still gaining strength, which was offsetting our monetary relaxation efforts. Our inflation forecast even revealed a risk of a continued drop in prices over the next three years. Consequently, we decided to bring about a further relaxation in monetary conditions. The Libor target range was reduced once again and, at the same time, we decided to intervene on the currency market in order to prevent any further appreciation of the Swiss franc against the euro. This latter measure was absolutely out of the ordinary for us, but it was the only way to ensure that our policy would remain expansionary, as was required by the situation. In addition, in order to ensure the maximum impact on interest rates, we extended the maturity of our repo operations to one year, and introduced a programme for purchasing long-term debt instruments issued by private sector borrowers. These measures have been successful. They have allowed us to increase Swiss franc liquidity, reduce risk premia on the capital market and prevent excessive appreciation in the Swiss franc.

4. Assessment of the strategy

The mandate of the SNB is to conduct monetary policy in accordance with the interests of the country as a whole, and to ensure price stability while taking due account of economic developments.³ The SNB is also charged with contributing to financial system stability,⁴ within the limits imposed by the objective of price stability. The monetary policy strategy adopted at the end of 1999 has allowed the SNB to fulfil its objectives successfully to date. And this success is all the more remarkable when we consider that

³ Article 5, para 1, of the National Bank Act (NBA): 'The National Bank shall pursue a monetary policy serving the interests of the country as a whole. It shall ensure price stability. In so doing, it shall take due account of the development of the economy'.

⁴ Article 5, para 2, NBA.

the last decade has been marked by severe international turmoil and major monetary policy challenges, especially in the light of the current financial crisis.

Price stability assured

The monetary policy strategy has an excellent record on price stability – average annual inflation based on the consumer price index barely exceeded 1% between 2000 and 2009. This average inflation figure lies around the middle of the range which we equate with price stability. Given that the lag between a monetary policy stimulus and the level of prices is two to three years, the experience with implementing the monetary policy strategy over a ten-year period offers a sufficiently long observation period for us to state that the strategy is capable of successfully fulfilling the principal mandate of the SNB: price stability. This success cannot be attributed to the strategy alone, since price stability has existed in Switzerland since 1994. The introduction of the strategy in 2000 was thus helped by very favourable circumstances, since the SNB's credibility was already well established and inflation expectations were firmly anchored.

A close examination of chart 6 reveals increasing inflation volatility from 2008 onwards. The range which we associate with price stability was exceeded – upwards in 2008 and downwards in 2009. CPI inflation exceeded 2% for a large part of 2008, and then breached the lower limit to turn negative at the beginning of 2009. At this point, it should be noted that a peculiarity of this episode was the unusually high volatility of oil prices, which surged from CHF 70 a barrel at the beginning of 2007 to over CHF 140 a barrel in 2008, before returning to their previous level in the second half of 2008. As chart 6 illustrates, CPI inflation excluding oil prices does not, at any time, move outside the range associated with price stability. Thus, the excessive inflation observed in 2008 and the deflation in 2009 can be attributed to these oil price fluctuations.

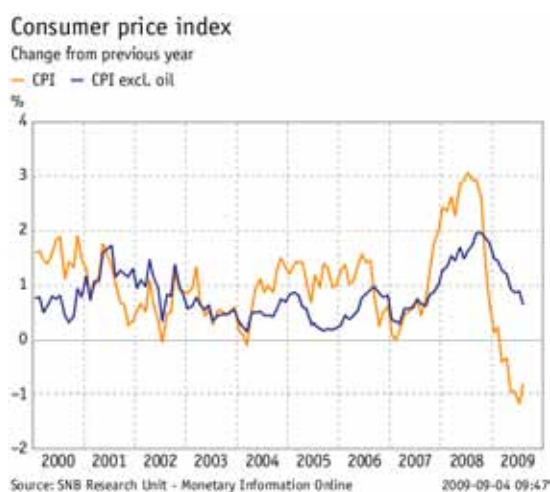


Chart 6. CPI inflation



Chart 7. Real GDP growth

The economic literature is unanimously of the opinion that the primary contribution of a central bank to economic growth lies in maintaining price stability. The choice of a medium-term price stability objective allows us to maintain price stability and react flexibly, by exploiting the room for manoeuvre at our disposal to support the economy in

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the event of external shocks. Chart 7 shows that GDP has not experienced a major contraction in the ten years of experience with the SNB's monetary policy strategy, apart from the current crisis, which has its own special characteristics. The SNB's monetary policy can thus be regarded as successful within the meaning of article 5, para 1 of the National Bank Act.

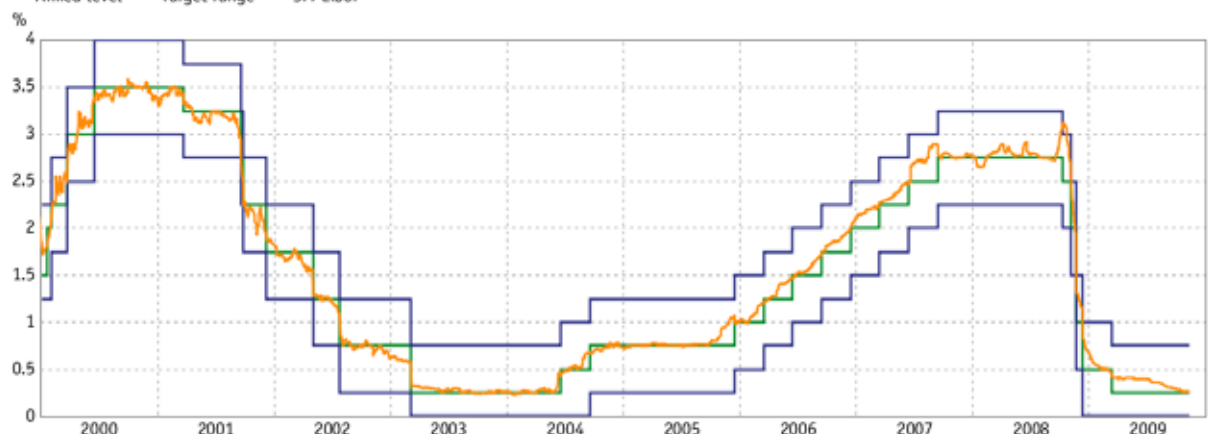
Two disparate elements of the SNB's strategy have also undoubtedly contributed to the success of its policy. On the one hand, the strong international competition – a result of increasing globalisation – and the huge advances in information technology have provided fertile ground for growth, while at the same time dampening inflationary pressures. On the other hand, since the establishment of the ECB, monetary policy in a large area of Europe has been firmly focused on maintaining price stability, and this has strengthened the continental monetary front and preventing the Swiss franc from being caught up in the same kind of turmoil as that experienced in the 1980s.

Libor well under control

The SNB's monetary policy strategy has also been successful in terms of its implementation. One of its idiosyncrasies is that the operational target – the three-month Swiss franc Libor – is determined, not by the SNB, but by interbank market forces. The advantage of this lies in the relevance of the operational target as an indicator of money market conditions, as well as of credit market conditions, since the Libor serves as a basis for setting a number of commercial lending rates. The drawback is that the SNB is only able to influence its operational target indirectly, through short-term repo operations with commercial banks.

Target range for 3M-Libor

— Aimed level — Target range — 3M-Libor



Source: SNB Research Unit - Monetary Information Online

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Chart 8. Target range, desired level and actual three-month Libor

To assess the operational aspects of our monetary policy strategy, we need to examine the SNB's ability to steer the Libor. As chart 8 shows, we have not experienced any major problems in this regard. The fact that our indirect steering, via adjustments to our repo rates, has been successful is largely due to the market's good understanding of our policy. Very short-term repo operations only influence the three-month Libor to the extent that the market correctly anticipates our policy. We have therefore taken great care to ensure

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that both our strategy and our policy are clear and credible, which allows us to appropriately shape market expectations and better control the Libor. If market expectations are in step with our policy, they help to move the Libor towards the target we have set. A well informed market can, so to speak, do the central bank's job for it.

Chart 8 shows that the three-month Libor has practically always stayed within our set range, and very close to the desired mid-level. Some concerns about losing control of the Libor emerged in October 2008, when the crisis took a turn for the worse. For two weeks, the Libor far exceeded the target range, due mainly to strong demand for Swiss franc liquidity from Eastern Europe, a market segment that we were unable to supply with our instruments. However, swap agreements concluded with the ECB and the Hungarian and Polish central banks made it possible for them to grant loans in Swiss francs in their home markets, and allowed us to regain control of the situation. This ability to control the Libor demonstrates how well the financial markets understand our monetary policy strategy, and is a clear mark of the success of our policy implementation.

Exchange rate questions better reflected

Given the highly open nature of the Swiss economy and the very close links between its financial market and those abroad, the Swiss franc exchange rate has always been something which the SNB has had to take into account in its monetary policy implementation, although without actually pursuing an exchange rate target. The experience of previous decades had shown that exchange rate movements can conflict with a policy of controlling monetary aggregates.

Nominal exchange rates (CHF per foreign currency)



Chart 9. Exchange rate movements

The strategy allows us to better reflect exchange rate movements, through two mechanisms. First, the Swiss franc exchange rate is taken into consideration when drawing up our inflation forecast. A strengthening of the franc leads to a fall in future inflation, and hence provides scope for interest rate cuts. Conversely, a depreciation heightens the risk of inflation and makes interest rate increases more likely. Exchange rate movements thus directly affect the assessment criteria on which our monetary policy decisions are based. Second, the existence of a target range for the Libor provides us with

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the freedom to react, where necessary, to tensions on the foreign exchange market. If the SNB had chosen a short-term reference rate (e.g. the repo rate) as its operational target, such flexibility would have been impossible, since any deviation would have been ascribed to a change in policy. Note, however, that this flexibility has not really been fully exploited since the strategy's inception, in the sense that we have never sought to try and steer the Libor towards the upper or lower bound of the target range. We have a certain aversion to fine-tuning. In the event of major disruption on the foreign exchange market, we prefer to move the range, rather than opting for a repositioning within the range. The advantage of a policy adjustment is, obviously, that the reasons can be easily explained, whereas a repositioning within the range is so subtle that its psychological impact on the markets is negligible.

Judicious choice of operational target

When the strategy was being drawn up at the end of the 1990s, the choice of operational target was a matter for considerable debate at the SNB. Should we opt for a reference rate, such as the one the SNB applies to the short-term credits it grants to banks in the form of repos, or should we choose a rate that reflects interbank market forces and is therefore outside our direct control? We decided on a market rate – the three-month Libor – since we wanted to be able to control the effect of our policy on overall demand as far as possible. We knew that, in doing so, we were departing from common central bank practice. Now, with the benefit of ten years' experience, we can say that this decision has certainly contributed to the high effectiveness of our policy over the past ten years, and turned out to be particularly judicious during the financial crisis which we have just faced. Indeed, by keeping the Libor under control, we actively neutralised the sudden deterioration in market conditions during the crisis – a deterioration which resulted in risk premia increasing across the board. By adjusting the range of liquidity available, in particular by cutting the repo rate in order to keep the Libor stable at a time when comparable rates were climbing on the dollar and euro markets, we were able to shield the Swiss credit market to a large degree from the impact of the general rise in credit spreads. Since the ECB's strategy is based on reference rates, the differential between the three-month Libors in Swiss francs and euros (as shown in chart 10) widened considerably in 2008, from 150 to 220 basis points. Our monetary policy strategy thus resulted in us being more accommodative than the ECB at the height of the crisis.

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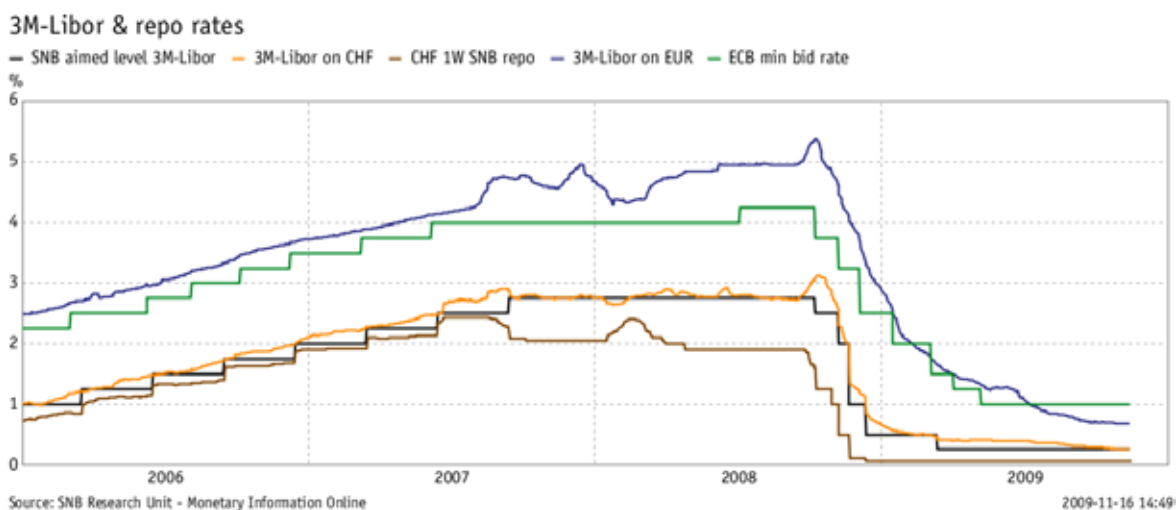


Chart 10. Repo (reference) rate, CHF Libor and EUR Libor

Impact of unconventional measures appropriately taken into account and controlled

The crisis has shown that the maximum expansionary capacity, and thus the natural limits, of conventional monetary policy are reached when interest rates tend towards zero. In Switzerland, the marked worsening of economic conditions at the beginning of 2009 meant that further monetary stimulus was necessary in March, despite the fact that we had virtually used up our scope for cutting rates. We had to resort to unconventional measures in order to inject additional liquidity into the economy, in other words we had to engage in quantitative easing.

Our current strategy allows unconventional measures to be taken into account in an overall assessment of the impact of monetary policy decision-making at any given moment. Movements in the monetary aggregates, which are heavily influenced by unconventional liquidity injections, constitute an important variable in some of the models used for our inflation forecast. This means that the forecast shows us the probable effect of the measures taken, which in turn allows us to calibrate the dosage more precisely. This source of information is extremely useful when interest rate indicators are no longer able to play their role because they cannot fall below zero. The inflation forecast will therefore help us to pinpoint the appropriate moment to withdraw the unconventional measures. By guaranteeing a continuous time frame in which to observe the impact of monetary policy, our strategy has a major advantage over the management of monetary aggregates, where each demand or supply shock requires the cards to be reshuffled and a new operational target to be defined.

5. Conclusion

So, after a decade of implementing our monetary policy strategy, our conclusion is broadly positive, from both a policy and an operational perspective.

From a policy standpoint, price stability has been maintained without the economy experiencing any significant contraction, which is in line with the SNB's legal mandate.

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The economy has, however, experienced some major shocks: the advent of the euro, international turmoil and the financial crisis. The quarterly inflation forecast, drawn up using a broad range of indicators and models, has proved to be particularly useful. It has been an effective guide for our interest rate decisions. Moreover, when rates were close to zero, it enabled us to guide, at least to some extent, the impact on inflation of the unconventional measures we were obliged to take. The inflation forecast forces us to be rational, whatever policy path we may follow.

From an operational standpoint, our decision to steer the three-month Libor has been a daring gamble, but a successful one. Daring, because the three-month rate is not directly influenced by the SNB's lending operations but is largely driven by market forces, and hence by the way in which our policy is perceived. Successful, because by steering the movements in the three-month Libor we were able to influence lending conditions in Switzerland, which proved particularly useful during the financial crisis. Over the past ten years, it has always been possible to manage the Libor and position it where it could create the best conditions for the growth of our economy.

How has our strategy been able to survive for ten years, when its predecessor had to be constantly revised? Have we discovered the magic formula for monetary policy? Certainly not. If the strategy of the last ten years has been better able to weather the ravages of time, it is because it is above all a tool whose components evolve in the light of experience and advances in economics. The monetarist approach was a rigid framework, a more or less fixed vision of the link between monetary policy and prices, and as such found it hard to adapt to a constantly changing environment.

Having said that, the monetary policy strategy, good though it may be, is no substitute for the judgement of those in charge of decision-making. Its greatest quality is that it creates a rational assessment framework that provides a scientific analysis of the situation at any given moment, and the policy options available. It is an invaluable aid to the Governing Board in making its interest rate decisions, but it cannot dictate which course of action to follow.

In spite of all the advances in the science of economics, monetary policy remains an art...