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THE INDEPENDENCE OF THE SWISS NATIONAL BANK

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Is the independence of the Swiss National Bank so extensive that it stands outside the reach of our democratic system based on the separation of state powers, on checks and balances?

The topic of central bank independence is a matter of discussion beyond the borders of Switzerland. Around the world, a debate has started on the limits to power, in general, and the independence of central banks, in particular, and in some cases radical demands have been made.¹ Because many central banks found themselves obliged to resort to large-scale unconventional measures during the financial crisis, it is not surprising that the debate is raging now.

Central banks are indeed very special institutions. They hold the banknote-issuing monopoly and provide the domestic money market with liquidity. Consequently, they can never really be short of money. In Switzerland, the state has conferred the banknote-issuing monopoly on the SNB. This means that it always has the requisite means for meeting its obligations in Swiss francs. However, that does not stop it from making losses. As you know, the SNB had to report a large annual loss in 2010. This was due to exchange rate losses on the foreign currency holdings. These had increased substantially in the course of our foreign exchange market interventions, which we carried out in order to counter the deflationary threat identified by us.

The loss and the increased risk in our central bank balance sheet is a matter which we take very seriously. The annual loss has provoked critical remarks, in particular as regards our independence and our ostensibly far-reaching powers. It is understandable that people will question the extensive measures we had to take to manage the financial crisis. That is all part of life in a democratic society. I am therefore grateful for this opportunity to present to you, in the next few minutes, my thoughts on the essence, the boundaries and the pitfalls of our independence. I hope I will be able to clarify one or two misunderstandings in the process.

¹ For instance, a very well-known US congressman – possibly a future presidential candidate – has gone as far as calling for the Fed to be abolished. Cf. Paul, Ron (2009), *End the Fed*, New York: Hachette Book Group.

The reason why the SNB is independent is not because it happens to suit the members of the Governing Board, which is the body responsible for monetary policy. I can assure you that it would sometimes be easier if we could just accept instructions from a higher body. What actually happens is that we have to bear responsibility ourselves for the monetary policy decisions we take, and we take them – typically – under a veil of uncertainty.

The reason why we are independent is so that we can better fulfil our mandate. In other words, our independence is purely a means to a higher end. That end is defined in article 5 of the National Bank Act as pursuing a monetary policy serving the interests of the country as a whole and ensuring price stability, while taking due account of the development of the economy. Article 6 is the basis of our independence. Under this clause, we are explicitly prohibited from seeking or accepting instructions from Federal authorities. In other words, we are obliged to make our own decisions.

There are good reasons why Swiss legislators have established our independence so strongly. Theory and practical experience throughout the world are clear on this point. The more independent a central bank, the better it fulfils its mandate. It has much better chances of ensuring price stability and thereby making a contribution to sustained economic developments than a central bank that is not independent.² I am not planning to overwhelm you now by citing all the relevant literature.³ However, the most important reasons put forward by academic writers on the subject include differences in the legitimation, time horizon and incentives of politicians and central bankers. While politicians are legitimated through popular election, central bankers legitimate themselves by carrying out their legal mandate to the best of their ability. Political processes are often protracted, but once a decision has been taken, results should be rapidly visible. to be available as soon as possible. By contrast, central bankers are able to take decisions very

² These findings were taken into account when the European Monetary Union was founded. Under the Maastricht Treaty, a country planning to join the union must have an independent national central bank.

³ Cf., for instance, Ricardo, David (1824), *Plan for the Establishment of a National Bank*; Hayek, Friedrich A. von (1971), *Verfassung der Freiheit*, pp 440–41, Tübingen, Mohr Siebeck (4th edition 2005); Barro, Robert J. and Gordon, David B. (1983), A Positive Theory of Monetary Policy in a Natural Rate Model, *Journal of Political Economy*, 91 (August), pp 589–610; Cukierman, Alex, Webb, Steven B. and Neyapti, Bilin (1992), Measuring the Independence of Central Banks and Its Effect on Policy Outcomes, *World Bank Economic Review*, 6 pp 353–398; Alesina, Alberto und Summers, Lawrence H. (1993), Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence, *Journal of Money, Credit and Banking*, 25 (May), pp 151–162.

quickly, but the results of these decisions – whether good or bad – may not be evident until years later.

It is precisely because this lag is often so long that the credibility of central bankers is essential. If central bankers are credible, economic entities will trust them. As a result, monetary policy is more effective. For instance, if inflation rises due to increasing commodity prices, employees will not immediately ask for higher wages because they are confident that the increase in inflation is only temporary. Thus independence is a necessary prerequisite for a central bank, in order to develop the credibility it requires for carrying out monetary policy. Mind you, independence is a necessary – but not a sufficient – prerequisite for successful monetary policy.

Central bank independence in monetary policy is not a specifically Swiss achievement. In many countries it has helped to firmly establish inflation expectations in the long term. Consequently, monetary policy can react to shocks in the short-term, when necessary. However, with a view to certain characteristics of the Swiss economy, the independence of the SNB appears particularly valuable. Allow me to explain this briefly, using our experiences during the financial crisis as my example. When the extreme shock of the great financial crisis occurred in 2008–09, monetary policy was in a position to act rapidly. Our well-developed social security system also fulfilled its role as an automatic stabiliser. Discretionary fiscal policy, by contrast, played a relatively minor role. One reason for this is that we have a federal system with extensive decision-making powers in the hands of the people. Another is the extensive global integration and openness of the Swiss economy. This means that much of the impact of any fiscal programmes designed to stimulate the economy would have been felt abroad rather than in Switzerland. There are certainly positive sides to the fact that fiscal policy in Switzerland was not used actively, or to a large extent, for crisis management – as is evident if we think of the problems of sovereign debt currently afflicting other countries. Yet we should not forget that monetary policy had to bear the lion's share of the adjustment burden in its place.

As I mentioned before, article 6 of the National Bank Act constitutes the foundation stone of our independence. However, the principle that the SNB should be an independent central bank is actually established at the highest level of all, in article 99 of the Swiss

Constitution. This shows the importance attached to the independence of the SNB by the constitutional authorities, in other words, the Swiss sovereign power. Our independence comprises several dimensions – function, institution, finances and staff.⁴

I make a point of repeating the fact that we must fulfil our mandate without seeking or accepting instructions either from the Federal Council or from the Federal Assembly or any other body. The SNB is institutionally independent because it is a legal entity in its own right. It has the legal status of a special-statute joint-stock company. The financial dimension of independence comprises, on the one hand, the prohibition on state financing. Under article 11 of the National Bank Act, we are not permitted to grant the Confederation any loans. Neither are we allowed to acquire government bonds from new issues. These provisions are a strong defence against fiscal policy being bankrolled by the central bank. On the other hand, we can take risk onto our balance sheet should we regard this as absolutely necessary in order to fulfil our mandate. In this respect, the lesson learned from the crisis is that, in good times, we need to ensure that our balance sheet is as robust as possible, so that we can burden it in bad times. Finally, in terms of staff, our independence is expressed by the fact that the members of the SNB executive bodies – the Governing Board members and their deputies – are appointed by the Federal Council for a fixed and comparatively long term of six years.⁵

Ladies and Gentlemen, our independence is not unlimited, however. First, it is not absolute but related only to our mandate. It is not we ourselves but the Swiss legislators who charge us with maintaining price stability. Incidentally, that also applies to mandates other than the monetary policy core mandate, which I will not be talking about today.

The SNB has specified its monetary policy mandate and rendered it measurable. A situation of price stability prevails when the consumer price index (which is calculated by the Swiss Federal Office of Statistics, and not by us) shows an average annual rate of below 2%. Deflation is also regarded as a failure to attain the objective of price stability. Where we are independent is in our choice of the means by which we fulfil this mandate. Under article 9

⁴ Cf. also Message on the revision of the National Bank Act of 26 June 2002, FF 2002 6107 to 6109.

⁵ Together with the possibility of re-election, this helps to set the incentives for members of the Governing Board in a way that ensures that long-term fulfilment of the statutory mandate is also in their individual interest.

of the National Bank Act, we may use a great many instruments, as needed. This broad flexibility within our statutory legislation (which came into force in 2004) proved to be a huge advantage during the crisis, also by comparison with other central banks. For instance, we were quickly in a position to issue our own debt certificates and develop a large market for them. We do not use these SNB Bills because we need money. They are used to absorb excess liquidity in the money market.

Second, our independence is not unconditional. With the privilege and duty of independent action comes a particular responsibility. And whoever bears responsibility in our democratic constitutional state must be accountable for his or her actions, for the means chosen and the results achieved.⁶ Consequently, under article 7 of the National Bank Act, we maintain a regular exchange of information with the Federal Council, and the SNB and the Federal Council inform one another of decisions that will have a significant economic or monetary impact. This is important for us, because it ensures that we are familiar with the fiscal political framework within which we conduct our monetary policy. Nevertheless, each body retains full responsibility for its own area.⁷ Each year we submit an Accountability Report to the Federal Assembly, in which we outline how we have fulfilled our mandate. Also, on frequent occasions we are called upon to provide a full account of our actions to the relevant parliamentary commissions.

In addition, we provide the general public with regular information about our assessment of the economic situation and monetary policy – in press releases or half-yearly media conferences immediately after our quarterly monetary policy assessments, in speeches and in interviews. In this way we ensure transparency.

⁶ Other societies espouse comparable principles, “It cannot be acceptable in a democratic society that a group of unelected individuals are vested with important responsibilities without being open to full scrutiny and accountability.” Cf. speech given by Alan Greenspan on 5 December 1996 on “The Challenge of Central Banking in a Democratic Society,” Washington D.C. Also, “Democratic principles demand that, as an agent of the government, a central bank must be accountable in the pursuit of its mandated goals, responsive to the public and its elected representatives and transparent in its policies.” Cf. speech given by Ben Bernanke on 26 May 2010, on “Central Bank Independence, Transparency and Accountability,” Tokyo.

⁷ This is also laid down in the Message on the revision of the National Bank Act with regard to art. 7 para. 1 NBA (6191), “The SNB’s decision-making autonomy must be retained because its accountability would otherwise inevitably come into conflict with its authority to act independently of instructions (under art. 6).” Consequently, the SNB bears “sole responsibility for the mandates described in art. 5” while the Federal Council, in turn, “is solely responsible for the economic decisions that fall within its area of responsibility.”

Through our legal status as a joint-stock company, we also have duties towards our shareholders which we fulfil each year, at the General Meeting, within the framework set out by the National Bank Act. The cantons – our majority shareholders – are well represented in our supervisory body for operating matters, the Bank Council.

As you see, the special characteristics of the Swiss system are taken into account. Federalism is mirrored in the composition of the Bank Council and in the distribution of our shareholdings and – not least – in the distribution of profit.

The Swiss constitution and the National Bank Act provide for the SNB's profit to be paid to the Confederation and the cantons. Two-thirds accrue to the cantons and one-third to the Confederation. However, a distribution can only be carried out if the balance sheet and the SNB's result allow for this to be done. The robustness of our balance sheet, in other words, setting aside provisions for currency reserves, takes first priority over a distribution. This can be derived directly from the legislation. The appreciation of the Swiss franc against most other currencies weakened our balance sheet last year. In addition, very volatile results may be expected in the next few years because of the current size of the balance sheet and the uncertain situation in the capital markets. Consequently, the possibility that distributions to the Confederation and the cantons will have to be suspended in certain years cannot be excluded. Fiscal interests must take a back seat when it comes to ensuring our long-term monetary policy freedom of action and independence.

The Governing Board is also genuinely Swiss. The executive body consists of three members with equal rights who jointly carry out the tasks defined in article 46 of the National Bank Act and bear joint responsibility for them. First and foremost, the law describes these tasks as conceptual and operational monetary policy decisions. The Chairman does not have any special powers. Consequently, responsibility is shared.

Transparency and accountability are crucial, particularly in times of crisis, when the information needs of the general public and financial markets, as well as other authorities, are increasing exponentially. We have responded to this need. For instance, information on central bank balance sheet items and SNB Bills has been stepped up, and our news conferences can now be watched on our website. During the course of the crisis, in

particular, at the time of the measures to strengthen the Swiss financial system in October 2008, the number of appearances of Governing Board members before parliamentary commissions increased significantly.⁸ I would like to hazard a guess that the SNB has never been as transparent as it is today. In this respect, it also stands up well to international comparison.

However, central bank independence has its pitfalls. A latent threat to such independence can, in principle, always be said to exist. This threat is particularly great in times of crisis. Consequently it was right and important, during the recent crisis, for central banks around the world to work closely with governments. However, the risk now is that false expectations have been raised amongst politicians. Central banks need to remain firm and concentrate on their monetary policy mandate. While it was necessary to be close to other government authorities at a time of emergency, now that the crisis has been confined, a little more distance is in order.

As I outlined at the beginning, the SNB has also taken exceptional measures in order to fulfil its mandate. In doing so, it has shown that it is prepared to make use of the independence it has been granted. What is essential here is that we are always guided solely by our mandate when making our decisions. At the same time, we are continually analysing developments and constantly drawing conclusions with a view to our future actions. Based on this, the SNB will continue to use the instruments we judge best suited and necessary for fulfilling our mandate in the interests of the country as a whole, to the best of our ability. The SNB must be able to continue exercising its independence without this being fundamentally questioned.

Ladies and gentlemen, I have shown you that the SNB's independence is limited to fulfilling the mandate with which it has been entrusted by the politicians, and that it is accountable for this mandate. The SNB is not powerful. With the precision of a Swiss watchmaker, it has been embedded in our democratic institutions, our constitutional state and the society of our nation.⁹ We are aware that a high level of responsibility is attached to our mandate-

⁸ In 2010, members of the Governing Board appeared 13 times before parliamentary commissions.

⁹ One of my predecessors described the SNB as, "to some extent", "the fourth power in the land", while adding the comforting comment that "this additional element within the – generally speaking – highly developed

related independence. That is why we use the independence we have been granted with prudence.

balance of powers in Switzerland, has functioned well" (Lusser, *Geldpolitik* 1996). Cf. Lusser, Markus (1996), *Geldpolitik*, p. 100, Zurich: Verlag Neue Zürcher Zeitung.