The SNB's New Monetary Policy Framework Ten Years On: Panel Discussion

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There is little doubt, as the papers at this conference document, that the new monetary policy framework of the Swiss National Bank has served the Swiss economy well. Rather than bask in the congratulatory mood befitting the tenth anniversary of a successful venture, I will raise some questions first about past successes, second about some issues in need of further research, and third about the future.

1. The Past 10 Years

The new monetary policy framework (NMPF) seems to have served the Swiss economy very well indeed, but a number of questions of interpretation remain. The first is whether an alternative framework could have performed as well or better. Of course the question is an unfair one since it is always possible with the benefit of hindsight to think of some, even if only marginal, improvement in the conduct of monetary policy. However and for the sake of argument, consider the following issue: could the previous MPF, with its emphasis on the targeting of monetary aggregates, have done as well? After all, the performance of the Swiss economy under the previous regime, except for part of the nineties, was not particularly bad in international comparison even if targets were missed more often than met and the targeted aggregates were changed several times. This suggests that Swiss success in terms of inflation control from the mid-eighties to the inception of the NMFP (and perhaps during the latter period) probably rests in good part with a long history of price stability, however achieved. That said, we all suspect that the new regime is better adapted to the conditions of the last ten years if only because the performance of the Swiss economy in terms of price stability and, more recently in terms of growth and resiliency to the crisis, seems to have been among the best of its peers.

That, however, does not provide an answer to a second and related question: Was that favorable outcome due to luck, to changes in economic structure, or to a wise monetary policy framework and decisions? That issue has been raised a

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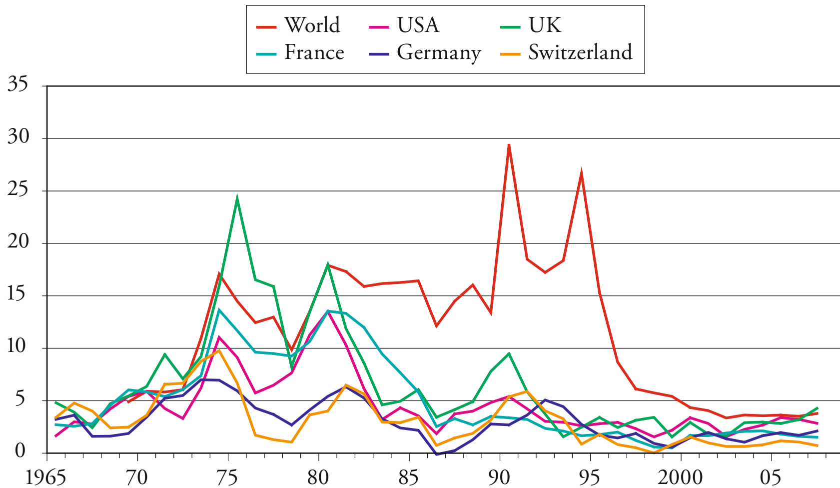
number of times in relation to "the great moderation" mostly, but not only, with respect to the United States. Federal Reserve officials would probably answer 70% skill, 15% structural change and 15% luck. A skeptic would take a more agnostic stance and assign 1/3 probability to each of these "causes" (on the assumption that they are exhaustive). After this conference and for the case of Switzerland, I would opt for something like 50% skill, 10% change in economic structure, and 40% luck.

By luck I mean a benign environment for monetary policy in the sense, first, that there were no violent shocks until the end of the period that followed the NMFP's introduction, though not all the papers presented at this conference would concur: while Genberg and Gerlach, for instance, would, Jordan, Peytrignet and Rossi speak of several supply shocks hitting the Swiss economy and of the success of the new framework "in spite of an economic climate characterized by dramatic international turbulence and major monetary policy challenges" –though they do recognize that the overall improvement in the Swiss economy during the period may have been facilitated by "worldwide improvements in growth and inflation (The Great Moderation)". Second, the period was benign in that there was (or seemed to be) no severe conflict between pursuing the objectives of price stability and low output variability with a single instrument, namely, interest rate policy. This is of course partly a by-product of the Great Moderation with its fall in the variability of output growth and inflation as well as a marked decline in inflation, starting in the mid-eighties for the United States and the low-inflation countries of Europe including Switzerland and Germany, a little later for other countries in Europe and at the beginning of this century for many developing and emerging market economies. Figure 1 illustrates for inflation. In many ways, the great moderation was a golden age for monetary policy of the inflation targeting variety.

It is only with the (foreseeable) end of the great moderation around late 2007 that monetary policy would be truly challenged in the simultaneous pursuit of the three objectives of price stability, the maintenance of low unemployment and financial stability. Those three objectives become incompatible in the face of a conjunction of severe supply shocks, asset bubbles and a systemically fragile financial system.

These considerations leave us with two questions about the past ten years. First, is there really a "Sonderfall Schweiz?" The answer could be yes, insofar as the inflation performance of Switzerland was better than that of its peers over the period, and no, insofar as the improvement in performance was general during the period of the great moderation (which, incidentally, was a great moderation mainly in comparison with what might be termed the great "immoderation" of

Figure 1: CPI Inflation in Percent



Source: IFS

the period extending from the late sixties to the mid-eighties). Second, one may well ask whether the NMPF is but a fair weather policy framework. True, Switzerland has performed rather well during the last two or three stormy years in international comparison. A robust economic and financial structure, a rapid injection of liquidity into the economy, and of capital into UBS, as well as a favorable starting situation, especially with respect to the fiscal position and to government debt, may, however, provide most of the explanation. That said, the flexibility of the policy framework did allow for an appropriate and rapid response to the crisis and the framework itself appears to have been a stabilizing rather than destabilizing factor. Whether it will be adequate in the future is a question to be taken up further below. But first, two factual issues for further research are taken up below.

2. Two Issues for Research

One justification for choosing a three-year horizon for the SNB's inflation forecast and for showing the forecast path of inflation over the period rests with the notion that Swiss monetary policy measures impact on the price level and

inflation with long (up to three years) and variable lags. Such long and variable lags are conventional wisdom in Switzerland and seem to derive from estimates that date back to the 1980s, in particular to the belief that the burst of inflation around 1981 found its origin in the floor put under the Deutsche Mark in 1978 and in the subsequent expansion of the monetary base and money supply; and the belief that the inflationary acceleration of the late eighties and early nineties occurred as a consequence of the monetary expansion that followed the stock market crash of 1987. Whatever the merits of this view, one would expect that these lags should be sensitive to the change in monetary policy framework and the switch from monetary aggregates to the rate of interest as the instruments of choice of that policy. An in-depth investigation of these lags and their determinants would seem worthwhile if only to build better confidence estimates around inflation forecasts and to assess the impact of alternative policy instruments such as various measure of "quantitative easing."

A second issue which would deserve further research is how the NMPF has changed the weight of foreign vs. Swiss factors (including monetary policy) in the evolution of the Swiss economy. In a study dating back to 1985, Hans Genberg and I found that foreign influences were the dominant factor in the Swiss business cycles under either fixed or flexible exchange rates. The main difference between the two regimes, as theory would lead us to expect, was in the scope that flexible rates afford to monetary policy for the control of inflation.[1] Revisiting these findings would help assess the contribution of monetary policy to the stabilization of Swiss output over the past decade.

3. The Next Ten Years

The SNB will have to meet several challenges to serve the country as well in the next ten years as it has in the past ten. In the first place, it will need to maintain its independence and to concentrate on its main mandate, the preservation of price stability. To that end it must avoid central banker schizophrenia, that is, avoid being torn between achieving multiple goals with only one main instrument, its interest rate policy under the NMPF. In turn, this means that the policy framework should be adjusted to insure that there are as many instruments of economic policy available as there are targets of policy, in line with the Meade-

1 See HANS GENBERG and ALEXANDER SWOBODA (1985), *External Influences on the Swiss Economy under Fixed and Flexible Exchange Rates: 1964–1981*, Grüsch: Verlag Rüegger, 182 p.

Tinbergen principle. Concretely, that means that fiscal policy should play its role in employment stabilization; the latter is also a legitimate concern of monetary policy but only to the extent that it does not jeopardize price stability in the medium run. It also implies that financial stability should be pursued mainly with the help of specific macro-prudential instruments rather than through interest-rate policy (that does not mean that interest rates should not be used to lean against asset bubbles). Such instruments include capital and leverage ratios and the lead that the SNB together with the FINMA is taking in this respect is to be welcomed. There is one caveat, however: such ratios have to be made countercyclical lest they be destabilizing rather than stabilizing: there must be incentives for buffers to be built up in good times and reduced in bad, at the financial system as well as individual firm level.

More immediately, the NMPF has been abandoned in the past year and a half as the policy rate essentially hit the zero bound. In a sense, so-called quantitative easing constitutes a reversion to monetary aggregate targeting. As is the case for other central banks, the challenge for the SNB over the next months will be to exit from Q.E. and other "unconventional" measures such as the purchase of bonds issued by Swiss private borrowers. The most important exit, however, will be from the moral hazard –in particular the too big to fail syndrome that has been injected into the financial and economic system over the years. This is the overarching structural challenge for economic policy for the global as well as Swiss financial system.

If these challenges are met, the monetary policy framework that was introduced ten years ago should, used with flexibility and adjusted sensibly to changing circumstances, also serve the country well over the next ten years.