

# Perspectives on Monetary Policy in Switzerland<sup>a</sup>

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Along with a number of central banks, the SNB has adopted an up-to-date policy framework which has delivered price stability and moderate growth for nearly a decade. This auspicious period, however, has come to an abrupt end when the Great Crisis has spread around the developed world, hitting the Swiss banking system especially hard. Even though, Switzerland has withered the shock reasonable well. Part of the merit undoubtedly goes to monetary policy.

In my remarks, I focus on three issues that have figured out prominently during the conference: 1) Is the SNB really an inflation targeter? 2) What does the Swiss experience tell us about how to deal with asset prices? 3) Is the Swiss way of targeting the three-month LIBOR superior to what most other central banks do?

## Inflation Targeting or Not?

Many contributors to this conference have argued that, although it would not recognize it, the SNB actually operates as an inflation targeter. While some of us get pretty excited about this debate, it is fair to recognize that it is a fairly unimportant issue, maybe simply a question of doctrine or even just of vocabulary. Central banks that admit pursuing the inflation targeting strategy insist that they have adopted the flexible version of that strategy.<sup>1</sup> They target inflation in the medium run, but they choose how close they want to be to the target and, if they have deviated, how soon to get back to it, taking into account the output gap and possibly other factors. The SNB essentially follows the same strategy with one main difference: it does not announce an inflation target. Yet, it declares price stability as its main objective and it provides a definition of price stability (less than 2%).

Inflation targeting central banks usually specify a particular inflation rate that they want to achieve and a tolerance level. The SNB announces a range but no

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1 The reference is KING (1997).

particular position within the range. Thus an inflation targeting central bank implicitly commits to raise the interest rate if its inflation forecast exceeds the target, and conversely, while the SNB makes a seemingly less tight commitment. A flexible inflation targeter, however, makes no specific commitment and, in practice, mostly endeavors to keep the inflation rate within the tolerance range. In the end, therefore the only practical difference is in terms of communication and transparency.

As stated e.g. in WOODFORD (2007), the most widely accepted view is that transparency is highly desirable because it allows central banks to shape expectations of those variables (long-term interest rates, exchange rates, asset prices) that lie at the heart of the transmission mechanism. SVENSSON (1997), among many others, argue that inflation targeting provides more transparency than less precise strategies.

Why, then, does the SNB resist being labeled an inflation-targeter? A clue is given by the fact the new framework was adopted shortly after the creation of the ECB and that the strategy formulation is very similar, but not identical, to that of the ECB. A rationale for being similar is that the euro area is by far Switzerland's main trading partner, so that the euro-franc exchange rate is a very important variable for the SNB. Of course, fixing the exchange rate is not doable unless monetary policy independence is relinquished, but exchange rate stability is highly desirable. A nice situation, therefore, is one where the SNB and the ECB independently follow very similar policies because they face very similar conditions and react with very similar policies. Occasionally, the situation will differ and exchange rate movements will be the price to pay for monetary independence but, the rest of the time, the exchange will be stable. This is a very sensible approach. The main drawback is that the SNB will not accept being called an inflation targeter because the ECB strenuously refuses to be called an inflation targeter.

Another argument is that the SNB wants to maintain some flexibility. Inflation targeting, it is argued, imposes a straightjacket on the monetary policy strategy. A straightjacket may be welcome for central banks with limited credibility and experience but the highly reputed SNB can do without. The argument is powerful, of course, but not compelling. Inflation targeting advocates note that the strategy imposes a tight logical discipline on to policy makers. Not only can it help reduce mistakes but it is an excellent framework to organize discussions within policy-setting committees. The last point may not apply to the SNB given the small size of its Governing Board but the first one stands.

More importantly, maybe, inflation targeting is also a useful tool for central bank communication. It provides a natural framework to explain policy decisions.

It encourages transparency as it requires that policymakers reveal their forecasts of (at least) inflation and output at the relevant horizon. Transparency, in turn, is important as it helps shaping market expectation. It also matters for accountability. Yet, a curious aspect of the situation in Switzerland is that there is virtually no public debate of monetary policy. It seems as if both markets and the broader public – including the political authorities – completely trust the central bank for making the right decision.

## Dealing with Asset Prices

Switzerland already had an encounter with housing and asset price bubbles in the early 1990s. Deep losses, including in the banking sector, were followed by five years of average zero growth. As in other countries, the lesson was largely learned and asset prices have moved with great moderation during the Great Moderation years. Yet, this time, the asset price problem appeared under a new guise. The overvalued assets appeared in the books of one of the two large banks, not on the books of the non-financial sector.

The Swiss lesson, here, is that central banks cannot just ignore asset prices, but that they have to also be concerned with the quality of bank assets. In a country whose two large banks hold assets that amount to six times the GDP (before the crisis), relatively small losses can be devastating for the whole economy. The lender-of-last-resort function is not an option left to the discretion to policymakers, it is an obligation. From there follow a whole range of implications that the SNB has drawn ahead of most other central banks. The new requirements suggested last December by the Basel Committee on Bank Supervision have been imposed on Swiss banks by end 2009.

Yet, the too-big-to-fail problem remains. Imposing higher capital requirements and capping leverage is bound to reduce the occurrence of failures, but bank crises remain a possibility. Having seen that they are effectively protected from failure, the two large banks have limited incentives to avoid the high returns that come with large risk-taking. The question is whether a small country can host huge world-player banks.

## The LIBOR miracle

During the crisis all developed country central banks have been led to gradually lengthen the maturity of their lending to commercial banks. The move was intended to stabilize their funding. Eventually, most central banks went all the way to offer one-year maturities, and so did the SNB. But the SNB enjoyed a favorable starting position since its normal practice is to stabilize the three-month LIBOR.

This fortuitous advantage is often seen as a vindication of the SNB's practice. In many ways it is, but those who believe that there is no free lunch want to understand better how it operates. The table below reports the volatility of interest rates for Switzerland a few other countries, controlling for changing monetary policy targets. Unsurprisingly, LIBOR volatility is lowest in Switzerland, far below volatility in the Euro Area or the United States. Much the same is found for the volatility of the OIS rate. In all case, however, volatility is similar or even lower in the case of Sweden, whose central bank operates the traditional overnight interest rate target.

This evidence casts doubts on the LIBOR miracle assumption. Lower LIBOR volatility is only to be expected when the central bank shapes its market activity with the explicit aim of stabilizing the LIBOR. The LIBOR may also be stable because the risk premium is stabilized. The ratio of the volatility of OIS rates to the volatility of Libor rates is a measure of perceived risk. On that measure, Switzerland comes last and Sweden first. This observation suggests that, indeed, there is no free lunch. By stabilizing the LIBOR, the SNB compensates for risk fluctuations by moving the risk-free rate. As a result, the quasi risk-free OIS rate is unusually volatile.

Is it good practice to stabilize LIBOR at the cost of destabilizing expectations on future short term rates? It all depends on which is the more important for the economy as a whole. JORDAN, RANALDO and SÖDERLIND (2009) argue that the LIBOR dominates the overnight rate because it less sensitive to prone to short-term reversible shocks. They also note that it cannot be manipulated by individual market participants. An additional argument is that three-month maturities are more convenient for financial intermediaries that carry out maturity transformation.

These are weighty arguments, but they open up a question. If three-month is better than overnight, would not six-month or one-year be even better? The issue of the optimum maturity for the monetary policy instrument does not seem to have been addressed in the literature. The successful experience of the SNB suggests that this issue deserves systematic analysis, both theoretical and empirical.

Table 1: Interest Rate Volatility (1 August 2007 to 14 September 2008)

	Euro Area	Sweden	Switzerland	United Kingdom	United States
OIS Swap 3M Vola.	0.08	0.07	0.12	0.09	0.17
Libor 3M Vola.	0.18	0.11	0.06	0.21	0.18
Spread Vola.	0.18	0.08	0.14	0.19	0.23
Vola. OIS Swap / Vola. Libor.	0.47	0.67	1.90	0.42	0.96
future Libor 3M (3M ahead) Vola.	0.23	0.19	0.10	0.20	0.22

Source: DELL'ERBA et al. (2009).

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