

Jean-Pierre Roth: Monetary independence and monetary stability - two sides of the same coin

Luncheon address by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, to the FEBRABAN Brazilian Federation of Banks, Sao Paulo, 18 November 2004.

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Ladies and Gentlemen

It's a real pleasure to be with you today. As you may know, our two countries have a long history of mutually beneficial relationships, going back as far as the 16th century. As very often in long-standing relationships, the first steps were quite difficult. In 1557, Protestant emigrants from Calvinist Geneva tried to found a "New Geneva" close to today's Rio de Janeiro. Unfortunately, their obedience to the Protestant church was not considered as an asset at the time, and they had to leave the country rather precipitately. But hard work is a Swiss characteristic, and business relations between Brazil and Switzerland developed intensively in the 19th and 20th centuries. In 1907, diplomatic representatives were sent to Berne and Rio.

As a matter of fact, the enormous potential of Brazil has been attracting Swiss firms from every sector of our economy. Nestlé and Jacobs-Suchard were among the first to cross the Atlantic in the 20s of the last century, but the chemical industry with Ciba, Geigy, Sandoz and Hoffmann La Roche rapidly followed in the 30s. After the Second World War, the machine-tool industry with Brown-Bovery, Schindler and Sulzer, to name only the most famous, joined the Swiss club, followed later on by Swiss banks. Today, more than 250 Swiss corporations are active in Brazil, which has become the top recipient of Swiss direct investment in Latin America and the fifth-largest worldwide.

Despite differences in the structure of our economies - or maybe precisely because of them - corporate Switzerland is very engaged in Brazil and has shared, for almost a century now, some of the fortunes and misfortunes affecting the Brazilian economy.

After a long period of pegged exchange rates, Brazil recently decided to float its currency, to follow a monetary policy primarily focused on price stability and to reform its public finances. This new economic program seems to bear fruit, as growth has clearly resumed. However, the road to price stability is not an easy one. Inflation, although extremely low in comparison to the four-digit period of the late 80s, is not yet subdued, and the state of government finances is still subject to legitimate worries.

The title of my speech is "Monetary independence and monetary stability: two sides of the same coin". I will start by looking at some of the features which have given Switzerland the reputation of a financially strong country. Among other elements, I will show that price stability has played a central role in this respect. But there can be no monetary stability without an independent central bank and an independent monetary policy course. Drawing on my experience at the Swiss National Bank, I will spend some time discussing what, in my view, are the most crucial characteristics of a successful monetary policy. I will conclude my speech by addressing the thorny question of the choice of a monetary policy regime. After all, is it worthwhile for a country in the vicinity of a large monetary zone - the euro zone or the dollar zone - to try to conduct an autonomous monetary policy?

Switzerland's tradition of financial stability

Many people outside Switzerland think that financial stability should be added to the list of Swiss specialties like chocolate, watches and banks. Indeed, the fact that Switzerland is the only country that has been able to keep unchanged its set of coins in circulation since the franc was created in 1850 speaks for itself. Even more spectacular is the position of the Swiss franc, which has retained its international purchasing power over time. The Swiss franc has been devalued only once, in 1936, during the Great Depression, following the devaluation of all major currencies.

Financial stability has contributed to shape Switzerland's business environment and, to a certain extent, explains some of the typical features of the Swiss economy. For example, with about 32% of GDP, the Swiss saving rate is among the highest in the world. Some of these savings are channelled abroad via our banking system, and their proceeds guarantee us a very strong balance of payments position. As a matter of fact, Switzerland's current account is almost endemically positive.

As the counterparties to large positive current accounts are, by definition, large negative positions in the capital account, Switzerland has become a net creditor to the rest of the world. Contrary to the popular belief that my country is the ultimate recipient of other countries' savings, Switzerland is in fact a traditional *net exporter* of capital. By and large, our current account surplus amounts to 13% of GDP.

Although portfolio investments remain the preferred channel for investing abroad, foreign direct investments have, in line with the process of globalization, increased steeply in the last ten to fifteen years. Today, thanks to its presence abroad, Switzerland employs almost 1.7 million people outside its borders. This amounts to 40% of its domestic labour force. National boundaries cannot delimit the Swiss economy anymore; it is better described as a kind of global network to which Brazil also belongs via the regional branches of ABB, Credit Suisse, Nestlé, Novartis, Roche, Schindler and UBS, to name only the most well-known firms.

The fact that financial stability is a traditional facet of the Swiss economy is largely due to the socio-political characteristics of my country. Switzerland benefits from a stable political environment, an efficient legal system and a rather reasonable fiscal policy. Social security is well developed without being oversized, and relationships between labour unions and the employers' associations are rather smooth by international standards. Moreover, property rights are guaranteed.

As a result, one of the most salient features of the Swiss economy is the strength of its finance industry. Despite its very small size, Switzerland stands as the eighth largest securities market in the world. The total value of its quoted stocks and bonds amounts to four times its annual GDP, a world record. Swiss banks manage about one third of total offshore assets worldwide, and our insurance and re-insurance companies have reached global dimensions.

What are the keys to financial stability? For sure, financial stability is the result of many elements: the importance of domestic savings, the stability of the institutional framework, the strength of our banking system and - last but not least - the deeply rooted conviction of the general public that monetary stability is important and should be preserved.

Monetary stability: a well-accepted objective

Indeed, there can be no financial stability without monetary stability. History has taught us many times that policy instability almost invariably leads to financial chaos and, very often, to political unrest.

But the issue is not avoiding hyperinflation only. I suppose that everybody in this room would agree that hyperinflation must be eliminated by all means. Sooner or later, it leads to the total disorganization of a market economy. But even on a lower level, inflation interferes with growth and reduces welfare.

In Switzerland, too, some are of the opinion that "a little dose of inflation" is beneficial to growth and employment. I entirely disagree with this view. On the contrary, most empirical studies, as you know, show that there is a negative relationship between inflation and output in the long run. Inflation is a tax on financial assets; it distorts investment decisions and increases overall uncertainty.

In Switzerland, monetary stability has become part of the country's culture and has been the guideline of monetary policy for more than 30 years now. After the collapse of the Bretton Woods system in 1973, the Swiss National Bank made it clear that the overriding objective of its policy was to preserve long-term price stability. Convinced that inflation was a monetary phenomenon, it opted for a strategy aiming at a steady growth of the money stock in line with the potential growth rate of the economy.

At the time, the Swiss National bank was actually one of the first central banks to adopt a rule-based strategy. Between 1975 and 1999, we implemented a "pragmatic" policy, with monetary targets serving as benchmark and communication devices. Here I would like to emphasize the term "pragmatic", because it was never the goal of our policy to fulfil monetary targets *mechanically*. As a small economy with an international currency, we had to face severe exchange rate shocks or money demand instability. In such circumstances, pre-announced monetary targets could not be met. In these particular and difficult periods, however, we never gave up our objective of preserving price stability in the long term.

In the late 1990s, day-to-day implementation of monetary targeting turned increasingly difficult because of financial innovations. An update of our monetary strategy became necessary. In 2000, we decided to abandon our traditional monetary targeting in favour of a new monetary policy concept based on an inflation forecast.

Overall, despite difficult times, our policy has been a success. The annual average rate of inflation in Switzerland over the last 25 years amounts to 2.8%, one of the lowest in the world, and price stability has provided Switzerland with an important comparative advantage: the so-called Swiss interest rate bonus, which means that nominal and real interest rates are lower in Switzerland than in the rest of Europe.

Strategy towards monetary stability

Is there any secret about Switzerland's success in preserving price stability?

I do not think so. Switzerland, as a small and open economy that is deeply integrated in trade flows, has always felt that price stability was a necessary ingredient of competitiveness. In the almost 100-year history of the Swiss National Bank, fighting inflation has been a permanent objective, and there were only rare occasions of disagreement between the government and the Bank on monetary issues. Actually, central bank independence had been a tradition in Switzerland even before it became fashionable elsewhere. In my country, most politicians consider monetary stability as a kind of common good which should escape partisan disputes. The fact that our federal government plays only a limited role in economic policy also supports the view that monetary decisions should be left to technicians. It is only very recently that the explicit mandate of promoting price stability has been introduced in the Swiss National Bank Act.

But central bank independence requires more than just an appropriate legal framework. What are the necessary elements? I see three of them.

First of all, to avoid any ambiguity as to what the ultimate goal of policy really is, price stability must be clearly defined. In other words, at some point, a nominal anchor has to be set. This can be an inflation target approved by the government, or a definition of price stability adopted by the central bank. A clear definition of the central bank's goal underpins expectations and allows an objective assessment of the implemented policy. It also protects the central bank from counterproductive bargaining concerning the appropriate direction of its policy.

Secondly, monetary policy must be *forward-looking*. Because monetary actions affect prices only after long lags, the central bank's policy must be pre-emptive. This implies that in certain circumstances, policy decisions taken in order to guarantee price stability in the long run may be difficult to communicate, or even unpopular. It is thus of key importance that the goal and the strategy of the monetary authorities are well understood by the market and the public.

This leads me to two of the most important aspects of modern central banking: accountability and transparency. For sure, central banks have to be independent in order to fulfil their job of maintaining price stability in the long run. But in a democratic society, each institution must be held accountable for the consequences of its policy decisions. The central bank is no exception. I am deeply convinced that its independence might be in danger if the general public perceived monetary policy as not in line with the central bank's mandate. To guarantee their independence in the long run, central banks must therefore invest a lot of energy in communicating and explaining their decisions. Although this might appear constraining, it is in their own interest if the general public has a proper understanding of the monetary action.

I also believe that transparency is not only necessary for the accountability of a central bank's action, but that it also has its own merits: transparency reduces any uncertainty surrounding monetary policy and the future course of interest rates; it makes private planning easier and enhances overall efficiency. Transparency reinforces both the central bank's independence and the market's support for monetary policy.

Is there any chance to survive outside monetary policy blocks?

I would like to conclude these remarks by addressing the more fundamental question of the feasibility, or even desirability, of pursuing an independent monetary policy in the vicinity of a large monetary zone. Is it realistic to assume that the SNB, for example, can follow a monetary policy that differs from the one set by the ECB?

Wouldn't it be preferable to have a fixed exchange rate between the Swiss franc and the euro? And with Switzerland now being fully surrounded by euroland, is there any danger the euro replacing the Swiss franc?

Those are, of course, the questions we had to answer when the euro was launched in 1999.

Our experience so far has shown that the much feared euroization of Switzerland has not taken place. To date, the Swiss franc has kept its attractiveness. It has been stable enough to be relied on as a valuable medium of exchange and store of value. Euros are accepted in Switzerland as a means of payment, like dollars or pounds sterling, but there is no sign of the franc being crowded out.

A more important question, however, is the desirability of an independent monetary course for a small country located in the midst of the euro zone. Isn't an autonomous policy a myth in a world where capital markets are so well integrated? Wouldn't a country be better off by importing the monetary stability of its large neighbour?

Unfortunately, the painful case of Argentina shows that fixing the exchange rate does not solve all the problems. When country-specific shocks are large and persistent, the absence of a national policy can be extremely costly.

But let me again take the example of Switzerland. Shocks to the Swiss economy are not perfectly correlated with shocks to the euro area, and our business cycle is more influenced by developments in the investment goods market and in the financial market than the rest of Europe. Therefore, it seems rather intuitive that a "Swiss-made" monetary policy would potentially fit Switzerland's needs better than a "one-size-fits-all" European policy.

The latest recession is a case in point. The investment spree of the late nineties created a massive worldwide capital overhang. The collapse in asset prices, in 2001, and the ensuing worldwide recession had a particularly strong impact on Switzerland, whose exporters are specialized in the production of capital goods and where the production of financial services represents about 13% of GDP. Because ensuring price stability means avoiding deflation as well as inflation, the SNB had to cut interest rates much more aggressively than the ECB from March 2001 to April 2003.

The case of Switzerland is not unique in this respect. Canada, Australia, New Zealand, Norway, Sweden and the UK, for instance, also let their currencies float and pursue successful national monetary policies. They all follow a clear strategy of preserving long-term price stability, and they all have an independent central bank pursuing an independent policy.

So we can definitely say that monetary independence and monetary stability are two sides of the same coin.