Philipp M Hildebrand: Monetary policy in a global context

Speech by Mr Philipp M Hildebrand, Member of the Governing Board of the Swiss National Bank, at the Swiss-American Chamber of Commerce, Zurich, 8 October 2003.

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It is a special privilege to be able to give my first formal address as a central banker before the distinguished audience of the Swiss-American chamber of commerce. I have always been very fond of the Swiss-American friendship. It has been an integral part of my family's life for several decades. More importantly, I am convinced it is an essential ingredient to the long-term vitality of the Swiss economy. Like any friendship, it has had to endure difficult moments. The vibrancy of your association is testimony to the fact that the cultural affinities and common interests between our two countries provide a reliable foundation for extensive and mutually beneficial economic relations.

Let us strive to make this foundation as solid as the public service record of the Geneva-born Albert Gallatin, whom Thomas Jefferson appointed as the fourth Secretary of the U.S. Treasury in 1801. To this day, Gallatin remains not only the longest serving Treasury Secretary in the history of the United States but the only Swiss-American to have occupied that most prestigious position in the then newly established capital in Washington D.C.

My focus today will be on the long period of global disinflation following Paul Volcker's paradigmatic shift of monetary policy in the United States. I will explore how the dramatic increase in international competition during the last twenty years has affected price levels. I will then return closer to home and attempt to illustrate how important segments of the Swiss economy have remained sheltered from international competition through a web of regulatory hurdles. I will make the case that freeing up these sectors would not only raise economic growth – something that is urgently needed in the effort to alleviate the growing stress on our social programs – but also render monetary policy more effective and provide it with more flexibility to focus not only on maintaining price stability but also on output stabilization. Finally, I will conclude with a brief economic and monetary policy outlook for the United States and Switzerland.

1. Great Inflation to Great Moderation

In the United States, the modern era of central banking began on October 6, 1979 when the Federal Reserve, under the leadership of its newly appointed Chairman Paul Volcker announced its adoption of monetary targets. Headline CPI inflation peaked at 15% at the beginning of 1980. Chairman Volcker slowed the growth of money dramatically. Interest rates rose sharply with the banks' prime interest rate exceeding 20%. The U.S. economy fell into a deep recession. Inflation began to recede steadily. Remarkably, despite the vigorous recovery that followed after 1983, inflation remained relatively subdued at 4%. It reached a temporary floor of 2.5% by mid-1992.

As we revisit this dramatic moment in monetary history, we need to remember that it occurred against the backdrop of nearly 15 years of disillusion regarding the ability of activist "Keynesian" economic policies to guarantee low inflation and full employment. From 1965 onwards, inflation had been on the rise and unemployment surged in the 70's, following the first oil shock. In the beginning of the 80's, it appeared that fiat money was inherently prone to cause periodic bouts of inflation and that there was little one could do about it. (see annex for graph 1)

Since 1979, the global monetary environment has evolved dramatically. Achieving and maintaining price stability has become the undisputed guiding principle of a vast majority of the world's central banks. Price stability ensures the signalling power of prices, thus bolstering the efficiency of the market mechanism. By preserving purchasing power, it facilitates long-term planning and induces long-term investments. Price stability also prevents social injustices from emerging between debtors, workers and retirees. Finally, price stability minimizes tax related distortions linked to the interaction of inflation and the tax code.[1]

[1] see Martin Feldstein (1983): "Inflation, tax rules, and capital formation", Chicago: University of Chicago Press.

The determined focus of monetary policy on price stability has contributed to anchoring the public's inflation expectations at low levels. The increasing scepticism of the 1960s and the 1970s about monetary policy's ability to fight inflation has given way to confidence that prudent, consistent and forward-looking monetary policy can contain the destructive forces of inflation.

Global inflation figures suggest that such confidence is largely justified. In the industrialized world, inflation declined from 12% in 1980 to 1.4% in 2002.[2] In the developing world, the decline of inflation has been even more remarkable with yearly rates tumbling from an average of 31 percent in the early 1980s to currently under 6%.[3]

Along with a significant decline in inflation, volatility of economic growth has fallen everywhere. Both in the U.S. as well as in Germany, the volatility of real GDP, averaged over four quarters, was about 30 percent less during the 1984 to 2002 period than it was between 1960 and 1983.[4] The evidence therefore confirms that monetary policy efforts to achieve and maintain price stability promote stability in output and thereby help create economic conditions which are ultimately conducive to employment creation. (see annex for table 1)

2. New Challenges for Monetary Policy

Not unlike successful athletes, central bankers must never be complacent in victory. It would therefore be at best inappropriate and at worst irresponsible for the global central banking community to consider its job done. There will be no "End of Central Banking". For one thing, there is no guarantee that the elimination of inflation throughout much of the world economy is a permanent achievement. Moreover, with the achievement of what constitutes for all practical purposes price stability across many economies, a number of central banks discovered that with it came a new challenge: policy could no longer be directed exclusively to push inflation lower but had to pay at least as much attention to avoid inflation that could conceivably fall too low and thereby undermine the goal of price stability by initiating deflationary tendencies. As has traditionally been the case, vigilance will therefore continue to be the "Leitmotiv" for the world's central banks.

3. Global Competition and Disinflation

A number of factors have contributed to the striking disinflation since the 1970s.[5] Good monetary policy has undoubtedly made an important contribution of which many of today's leading central bankers have every reason to be proud of. In many cases, a precondition for good monetary policy was institutional independence. Politicians have therefore played an important role as well. They have empowered central banks and freed them from political interference. Fiscal policy probably also contributed somewhat to an improved global macroeconomic environment though the case is not entirely convincing.[6]

Finally - and this is the point I would like to emphasize today – the global disinflation of the last twenty years has been facilitated by dramatic structural changes in the global economy. These changes are best encapsulated by what is loosely referred to as globalization. By globalization I mean the

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[2] In the United States, consumer price inflation fell from an average of 7.1% between 1970 and 1979 to an average of 2.5% between 2000 and 2002. In Switzerland, consumer price inflation has declined from an average of 5% between 1970 and 1979 to an average of 1% between 2000 and 2003.

[3] Kenneth Rogoff (2003): "Globalization and Global Disinflation". Paper prepared for the Federal Reserve Bank of Kansas City Symposium "Monetary Policy and Uncertainty", Jackson Hole, August 28-30, 2003.

[4] Stock, James H. and Mark W. Watson (2003): "Has the Business Cycle Changed? Evidence and Explanations". Paper prepared for the Federal Reserve Bank of Kansas City Symposium "Monetary Policy and Uncertainty", Jackson Hole, August 28-30, 2003.

[5] For an excellent recent discussion with specific reference to the effects of globalization, see Kenneth Rogoff (2003).

[6] In the industrialized countries, public debt increased until 1995 when it reached 75% of GDP. This was followed by seven years of fiscal policy improvement, so that public debt decreased to 65% of GDP in 2002. More recently, fiscal balances are deteriorating once again, in some countries dramatically so. The case of emerging economies is slightly different. There government debt has been on the rise again since 1997.

increasing speed, quantity and geographical spread of technological, commercial and financial interaction throughout the world economy.[7]

These forces have sharply increased competition between economic agents throughout the global economy. Deregulation has followed as an inevitable consequence of competitive pressures. Particularly in the Anglo-Saxon countries, labour and product market reforms enhanced this structural shift towards a global competitive trading and financial system. This increased flexibility in factor and goods movements coupled with large scale technological innovations led to a boost in productivity which is the ultimate underlying force of potential trend growth.

Though the long-term effects of these structural adjustments on the real economy are complex, there is no doubt they have unleashed a powerful dampening effect on prices in many sectors of the economy. Most of you who are present here today are actively engaged in running companies in a global competitive environment. You need no sophisticated economic analysis to tell you that when exposed to fierce global competition, monopoly rents and pricing power decline and prices therefore come under downward pressure.

4. Switzerland: one Country – two Economies

As a small open economy, Switzerland is greatly affected by global cyclical let alone global structural developments. Unfortunately, over the last twenty years, our economy only partly subjected itself to the global market place. It has therefore developed along diverging paths.

Our export sector has been fully exposed to the competitive forces of global economic and financial integration. Many of you represent this sector. To remain competitive in the global market place, you have had to innovate your production processes in a continuous attempt to increase your productivity. In light of Switzerland's large current account surplus (50 billion CHF or 12% of GDP in 2002), you have been additionally challenged by a real exchange rate which, over the last ten years, has on average appreciated by 0.6%.[8] For the most part, the Swiss export sector has risen to that challenge.

By contrast, the domestically oriented sectors of the Swiss economy have to a large extent remained sheltered from the competitive forces of an increasingly open global economy by an intricate web of regulatory measures which have prevented the product market from functioning according to market principles. Examples are numerous: The electricity market remains regionally monopolized. As a result, Swiss enterprises must bear higher electricity costs than their international competitors. In the telecommunication market, the achieved results in the deregulated part of the sector have not been matched on the still monopolized last mile. In the pharmaceutical and in the automotive sectors, parallel imports are still impeded by patent law or tacit collusion rendered possible by weak international cartel laws.

The detrimental effects of this economic bifurcation are clearly reflected in Switzerland's economic statistics. As one would suspect, prices in the domestic sector are being kept artificially high, thus undermining competitiveness. An analysis of longer-term price series demonstrates the diverging path of prices between the export- and the domestic-oriented sectors of the economy. The export price deflator rose much less than did the GDP deflator. (see annex for graph 2)

A similar picture emerges on the productivity side. While the export sector has continuously managed to achieve high productivity growth rates, productivity has lagged behind dramatically in the domestic sector of the economy. Since the domestic sector continues to represent the bulk of the Swiss economy (approximately 60% of GDP), the poor performance of the domestically oriented sectors undermines the growth potential of the Swiss economy.[9] In light of the rapidly deteriorating

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7 There are numerous useful definitions of globalization. Here I make reference to the one used by Ngaire Woods, ed. (2000): "The Political Economy of Globalization", New York: St. Martin's Press.

8 As a percentage of GDP, Switzerland's current account surplus is exceeded only by that of Singapore. Switzerland holds net foreign assets of about 135% of GDP which is unmatched in the world. The biggest part of the Swiss current account surplus is therefore derived from the interest earned on these assets (36 billion CHF vs. a surplus of 25 billion CHF from services and a 4.5 billion surplus from trade in 2002).

9 GDP growth in Switzerland is underestimated by the official statistics because these do not fully take into account the improvement of the terms of trade that are regularly realised by the tradable sector (see Ulrich Kohli (2002): "Veränderungen der Terms of Trade und reales BIP" (Terms-of-Trade Changes and Real GDP: Evidence from Switzerland (with English summary), Schweizerische Nationalbank Quartalsheft, June, pp. 54-63.

demographics and the pressure this will inevitably exert on our social services and programs, such a shortfall in growth can have debilitating longer-term consequences. (see annex for graph 3)

With the post-bubble collapse in the equity markets, a heated political debate has emerged in Switzerland as well as in many other countries about the sustainability of our retirement and social welfare programs. Ideas, concepts and frameworks are being discussed by politicians and frequently commented upon by the media. The fact that these difficult long-term problems which lie at the heart of our social contract are being openly debated is a welcome development. However, short of reneging on promises that are deeply embedded in our cultural and social fabric, the most meaningful way to address these problems in the decades to come is to invigorate our economic growth performance.

The challenge for our politicians is a formidable one. The political interests that defend the legislative hurdles which distort the domestic sector of our economy and thus undermine our growth potential are deeply entrenched. Never does this become more obvious than during a parliamentary electoral campaign. Admittedly, painful short-term adjustment problems might emerge once the reform process is initiated. Accelerating productivity growth rates can – in the short term – lead to a further reduction in employment as uncompetitive industries are compelled to restructure. In the longer-term, however, a rise in productivity is unquestionably beneficial. Ultimately, it will lead to higher growth rates. As the time bomb of demographics continues to tick, it will become increasingly obvious that this process is not a luxury our society can contemplate. It is a necessity!

5. Monetary Implications of Globalization

Let me now return to monetary policy. I have attempted to sketch out how after the “Great Inflation of the 1970s”, global financial and economic integration boosted competition, raised productivity growth rates and ultimately helped bring about an extraordinary reduction in global inflation and along with it a reduction in output volatility. As I have mentioned earlier, there is no doubt that good central banking itself has made an important contribution. But ultimately central banks have also benefited from the process. With inflation receding, many central banks have been able to focus increasingly on what typically constitutes a subordinate element of their legislative mandate: stabilization of output. In other words, a structural decline in the rate of inflation has increased the margins of manoeuvre for central banks. This does not alter the fact that central banks have no ability to fine-tune the real economy. Moreover, an important body of academic literature suggests that monetary policy has also become more effective as markets shed regulatory impediments.[10] Monetary policy is therefore not only one of the forces behind the dramatic decline of inflation since the early 1980s. Perhaps more importantly, it has been one of the main beneficiaries of the globalization process.

This insight has tremendous significance for Switzerland where, as I have attempted to show, much of the non-tradable sector of our economy remains tied up in a structural straight jacket. Eliminating this straight jacket or at least unbuttoning it would have wide-ranging positive effects on the Swiss economy. If our legislative authorities rise to that challenge, they are likely to replicate the competition-boosting effect that the forces of globalization have exerted on the external sector in the domestically oriented sectors of our economy. Higher productivity growth rates would ultimately lead to higher growth rates and thus reverse a worrying trend of declining relative growth dynamics in Switzerland in comparison with other OECD countries.[11]

Such productivity driven growth dynamics should lead to lower prices across a sizeable part of our economy. Obviously, this statement needs to be qualified. he Swiss economy will always remain vulnerable to developments abroad. A significant demand or supply shock to the global economy could reverse the beneficial impact on domestic prices of further domestic liberalization. For example, widespread protectionist measures rolling back the achievements of globalization or widespread geopolitical conflict and uncertainty would certainly threaten the broad achievements with regard to price stability. Nonetheless, breaking up the rigidities impeding competition in the domestically oriented sectors of our economy has every chance of rendering monetary policy not only more

[10] Alan Blinder (1998): “Central Banking in Theory and Practice”. Cambridge: MIT Press.

[11] For a detailed analysis see Aymo Brunetti (2003): „Hat die Schweiz ein langfristiges Wachstumsproblem?” Neue Zürcher Zeitung, 31.5./1.6.2003, p.29.

effective but also more flexible in its ability to focus its efforts beyond the primary mandate of maintaining price stability.

6. Economic and Monetary Policy Outlook

Let me now turn to a brief assessment of current economic conditions in the United States as well as here in Switzerland and conclude with a few comments regarding the outlook for Swiss monetary policy.

Recent U.S. economic data confirms that GDP growth has accelerated rapidly in the second half of 2003. Third quarter U.S. GDP growth will be close to 6%. For the fourth quarter, most market participants expect GDP growth to slow to a still robust 4%. This would imply a U.S. growth rate of approximately 3.5% for 2003. Substantial monetary and fiscal stimulus as well as strengthening financial conditions has supported the growth dynamic in the second half of 2003 in the United States.

Expectations of moderating growth going forward are linked to the fact that stimulus from fiscal policy is set to shrink. The contribution to consumer spending from this year's tax cuts is set to decline gradually during 2004. In addition, further substantial increases in the defence budget are unlikely in the coming year, thus dampening the relative contribution to GDP from defence spending during 2004.

The most worrying missing component of the U.S. recovery has been the absence of job creation which has led many market participants and media representatives to make reference to a "jobless recovery", or even a "jobloss recovery". With the September employment report which was released last week, we now have at least some evidence that labor markets in the U.S. are improving somewhat. Provided these numbers get confirmed in the months to come, it would add weight to the hypothesis that early at cyclical turning points, official payroll numbers underestimate the actual number of jobs created. At such times, the household survey statistics might be a more accurate gauge of labour market conditions.[12] At least for now, the latest employment data has strengthened market expectations of a sustained recovery.

On the business spending side, we have also seen some encouraging signs of a pick up in spending on capital equipment though it would appear that, so far, much of this demand is for replacement purposes rather than expansion. However, business inventories in the United States have fallen to low levels. Rising inventories should therefore contribute to production increases in the months to come.

Without confirmation that a pick up in inventory spending and an expansion of the labour force complete the traditional pattern of a recovery cycle, market concerns about the sustainability of the U.S. expansion are bound to persist. Moreover, financial markets will continue to follow carefully the growing twin deficit in the U.S. and the potential risk it represents to global exchange rate stability. Finally, persistently high oil prices may add another element of caution with regard to the sustainability of the currently impressive growth dynamic in the United States.

On the monetary side, Federal Reserve officials have repeatedly pointed out that despite firm consumer growth and gradually firming spending, there remains much slack in the U.S. economy. As it stated in its release of September 16, the Federal Open Market Committee therefore believes that pricing power and increases in core consumer prices remain muted. Or, as Federal Reserve Governor Don Kohn stated a few days ago, "it will be a while before we can be sure that a self-sustaining expansion is underway of sufficient strength and persistence to put the economy back on a path toward full employment."[13]

Switzerland will undoubtedly benefit from the improved outlook in the United States. Unfortunately, apart from the lack of internal growth dynamic I discussed previously, Switzerland's growth prospective is further curtailed by economic developments in the rest of Europe where there is currently little evidence of a robust and sustainable upswing in economic activity. This is reflected in the fact that despite more favourable exchange rate conditions, Swiss exports during the second quarter declined again. While consumer spending had a stabilizing effect, investment also continued to decline.

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12 Ex post, this phenomenon can be observed empirically for the recessions of the 1990s.

13 Don Kohn (The Federal Reserve Board): "Productivity and Monetary Policy". September 24, 2003.

While the Swiss economy therefore remains weak, it is set to strengthen somewhat into the fourth quarter of 2003 and the first quarter of 2004. Improved corporate expectations, a pick up in residential construction and strengthened financial conditions suggest that the trough of this cycle was reached during the second quarter of 2003. Provided the growth momentum in the U.S. sustains itself, exports should rise gradually, followed by an increase in equipment investment. Given considerable margin of slack in resource utilization, an improvement in the labour market can only be expected in the course of 2004.

As we have indicated in our quarterly monetary policy assessment on September 18, the Swiss National Bank will continue to support the economy by conducting an accommodating monetary policy. Low interest rates – we continue to target our 3-month libor rate at 0.25% - are designed to keep Swiss franc investments unattractive. Despite a rapid expansion in our monetary aggregates which we monitor closely, price stability is currently not threatened.

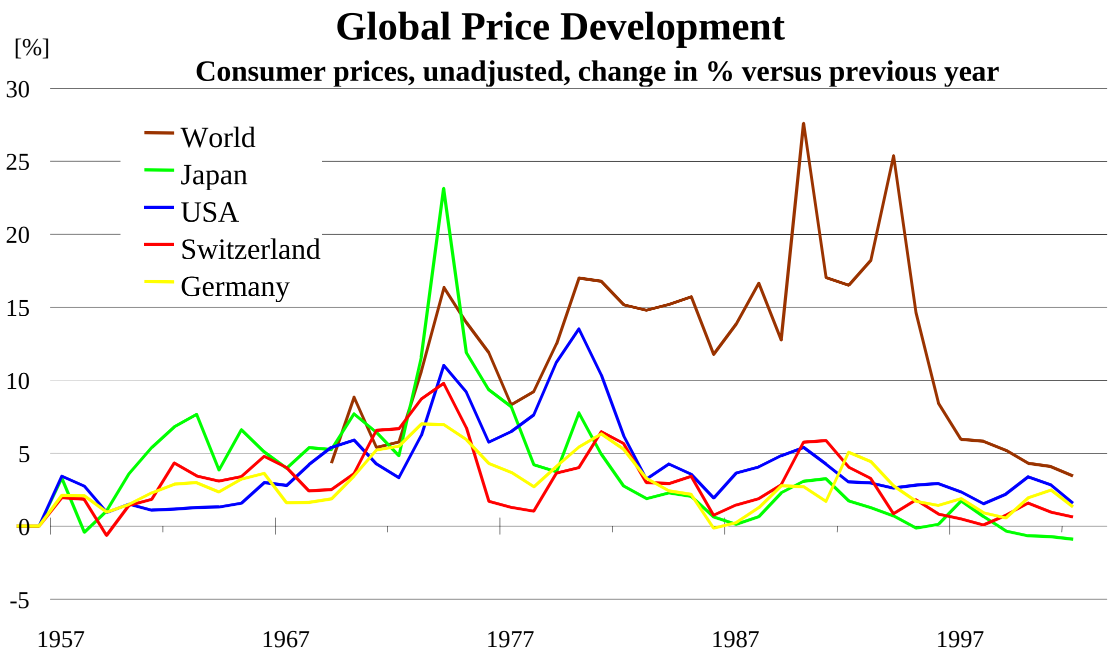
A rapid expansion of monetary aggregates does not automatically lead to higher inflation. In Switzerland, commentators often compare the current environment to the one in 1988, when money supply expansion rates were similar to what we observe today and inflation eventually rose to 6% by 1991. While understandable, the comparison is flawed. For one thing, current interest rates are significantly lower than they were at the time, thus reducing the opportunity cost of holding money to virtually zero. More importantly, the monetary expansion between 1986 and 1988 occurred against the backdrop of an unemployment rate of around 1%. A careful examination of the data of that period reveals that the margins of slack in resource utilization were rapidly declining at the time. Moreover, credit expanded dramatically during the late 1980s, thus providing a direct channel for the excess liquidity to find its way into excess demand.

The current economic environment is a different one. Still adjusting from a historically unique speculative financial bubble, we currently observe an unemployment rate of close to 4% which markets expect to rise further in the months to come. In addition, virtually any measure of slack in resource utilization suggests that our current output gap is somewhere between 1.5% and 3%, thus indicating that it would take at least a year of significant above-trend growth before a balance would be reached between aggregate demand and potential supply.

In conclusion, let me repeat what we have said after our last quarterly monetary policy assessment. In light of the underlying weakness of economic conditions in Switzerland, the risks pertaining to the sustainability of the welcome upswing in the United States and the benign global and domestic inflation outlook, we conduct our monetary policy with the aim of preventing a premature shift to a more restrictive monetary policy stance which could endanger the fragile upswing underway in Switzerland. Given the openness of our economy, exchange rate developments greatly affect monetary conditions in Switzerland. It therefore follows that our commitment to an expansionary monetary policy includes a firm commitment to fight against an unwelcome tightening of monetary conditions in the event of a marked appreciation of the Swiss franc.

ANNEX

Graph 1



Source: Datastream.

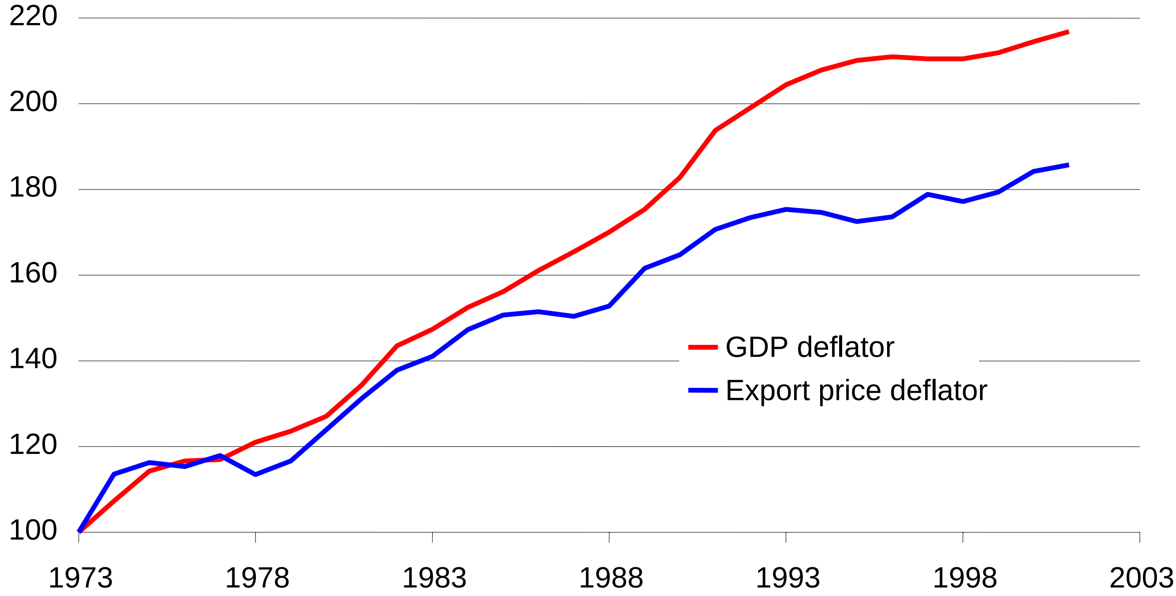
Table 1

Standard Deviation of Four-Quarter Growth or Real GDP per Capita

	1960-1983	1984-2002
USA	2.7	1.7
Germany	2.5	1.5
Japan	3.7	2.2
United Kingdom	2.4	1.7
Source : Stock and Watson, 2003		

Graph 2

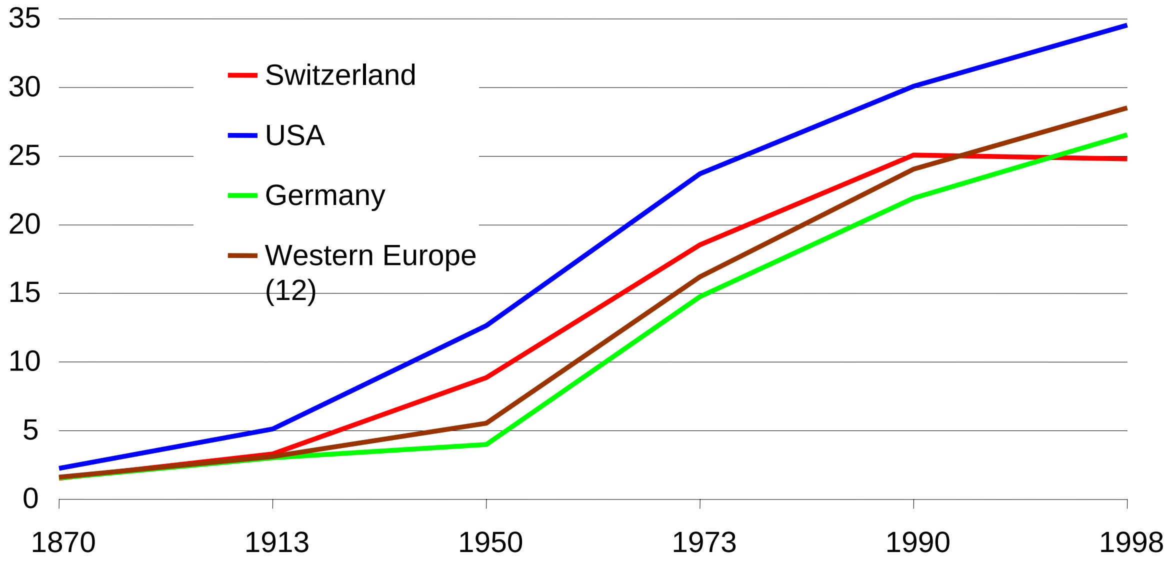
Swiss Price Deflators



Graph 3

Labor Productivity 1870 - 1998

GDP per hour worked (in 1990 international USD per hour)



Source: A. Maddison (2001): "The World Economy - A Millenial Perspective". Paris: OECD.