Thomas Jordan: Sound money – a fundamental pillar of our society

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the Ustertag, Uster, 23 November 2014.

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Introduction

It is a great honour for me to speak to you today from this lofty pulpit. Admittedly, as a central banker I cannot contribute a great deal to your spiritual well-being. I will therefore limit myself to my true area of competence and talk about money.

Let me begin by explaining why I am particularly delighted to be addressing you today, as your guest speaker. As you know, the Ustertag of 1830 was a major milestone on the long road towards the creation of the Swiss federal state. Just 18 years later, modern Switzerland was born. And only two years after that, the Swiss franc was introduced as the currency of the Confederation – although, in the initial stages, the federal state had to be content with coinage sovereignty alone. Not until 1907 did a central bank equipped with the exclusive right to issue banknotes begin operations. This was the Swiss National Bank (SNB). So you see, important developments were set in motion by the Ustertag, including changes that would affect our monetary system. Or, expressed in a different way, without the countryside uprising in the name of liberal ideas, 184 years ago, we might not have the SNB today.

In my presentation, I will, for once, devote less attention to current monetary policy. Instead, I will examine the Swiss monetary system from a more long-term perspective. My aim is to show you the significance of sound money, and why it is a major pillar of our society. In this context, I will also take a critical look at four proposals to reform the monetary system. My reason for doing this is that interventions of this kind in an existing monetary order can have grave consequences for our country and the entire population.

Talking of reform proposals: In the "Uster Memorial" document there is a demand which particularly appeals to me as a central banker, that, in the case of property charges such as tithes, it should be possible to transform them easily into mortgage claims whose interest level is appropriate. Appropriate interest rates or "appropriate monetary conditions", as it is expressed in central bankers' jargon – that is what modern monetary policy is all about. So you see that the demands made in Uster remain just as valid today. In the "Uster Memorial" document, an interest rate of 4% was considered to be appropriate;[1] well, as you know, Swiss interest rates have been considerably below this level for the past few years – so, in this respect, the SNB has fulfilled the requirements set out in Uster in 1830.

A short journey through monetary history

I would now like to take you on a short trip through Swiss monetary history. We will start our journey in the year 1830, and will make stop-offs at sixty-year intervals, i.e. in 1890 and 1950, before returning to the present day. Let us assume you wanted to buy a loaf of bread in the year of the Ustertag. What money would you have used to pay for it here in Uster?

My question may appear simple, but the answer is anything but easy. That is because the year 1830 falls within the long multiple coinage – or multiple currency – period. In other

[1] Carl Dändliker: *Der Ustertag und die politische Bewegung der Dreissiger Jahre im Canton Zürich (nebst Abdruck des "Uster-Memorials" als Beilage). Zur 50-jährigen Erinnerung*, Zurich 1881, p. 6 of enclosure.

words, the currencies being used in the canton of Zurich in 1830 included guilders, batzen, shillings, thalers, hellers and angsters, just to name a few.[2] Over 300 different kinds of coins were in circulation in Switzerland, with thousands of different embossed images.[3] That made conversion all the more time-consuming, and there were no electronic aids in those days. And although the exclusive right of coinage was really a cantonal prerogative, foreign gold and silver coins actually constituted the bulk of monetary circulation in terms of value. The cantons did not see any reason to mint money which was worth its face value. For everyday use they preferred to produce representative coins whose metal content was worth well below the nominal value. In this way, the cantons used their exclusive right of coinage as an easy source of funds.[4]

This resulted in an over-supply of lower-quality representative cantonal coins, which circulated freely between the cantons. Problems relating to the deterioration of coinage were a recurring theme in the legislative assembly. The hopeless confusion resulted in mix-ups, hampered trade and travel, and meant that capital remained idle.[5]

Sixty years later, however, in 1890, the Swiss multiple currency period was already past history. Nevertheless, Swiss monetary history had remained eventful. Since 1850, the Swiss franc had been defined in terms of silver, in line with the French franc, and after 1860, it was also defined in gold.[6] At the same time, foreign money was still in use, in the form of coins worth their face value.

Unlike the situation in 1830, banknotes played an important role in payments transactions in 1890 (if not, perhaps for buying bread), partly because coins are unpractical for larger transactions. By now, the Federal Banknote Act of 1881 had come into effect. This legislation included provisions requiring the 29 issuing banks to hold at least 40% of their banknotes in circulation in the form of currency metal. In other words, banknotes were a kind of cash substitute and did not qualify as legal instruments of payment.[7] Since banks did not gear their banknote issue to fluctuations in demand, there were regular bottlenecks in supply on days when large numbers of bills had to be paid.

Our next leap in time takes us to the year 1950. By now, only Swiss coins and banknotes issued by the SNB were in circulation. The Confederation had transferred the exclusive right to issue banknotes to the SNB, which began business operations in 1907. Switzerland had been incorporated in the Bretton Woods fixed exchange rate system created in 1944, which was based on the US dollar as the lead currency – but ultimately on gold, since a fine ounce of gold was equivalent to precisely USD 35. However, for private individuals it had been impossible to exchange banknotes for gold at the SNB since 1936.

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2 Paul Meier: *Der Währungswirrwarr von der Helvetik bis zur Bundesverfassung*, dissertation, Berne 1951, p. 60.

3 The true scale of the multiple currency confusion only became apparent 20 years later in connection with centralisation of the coinage system at federal level. At this point, in 1851 and 1852, following the introduction of the Swiss franc, the old types of domestic coins were collected. A list of coins drawn up by the coinage commission featured 320 different coin types, although estimates came to as many as 867. If the different embossings are taken into account, there were as many as 6,000 or so. Cf. Meier, p. 72 et seq.

4 Cf. for example, Meier, pp. 29–30 and p. 124, and Ernst Baltensperger: *Der Schweizer Franken – Eine Erfolgsgeschichte. Die Währung der Schweiz im 19. und 20. Jahrhundert,* Zurich 2012, pp. 49–50.

5 Meier, pp. 124 et seq.

6 Following the revision of the Coinage Act of 1860, the value of one Swiss franc was equivalent to 4.5g of silver or 0.2903226g of gold. This was in line with its model, the French franc. Cf. Baltensperger, p. 83.

7 Moreover, in 1890, more coins were in circulation than banknotes, in terms of value. Coin circulation at the time is estimated at CHF 266 million, while banknotes to the value of CHF 172 million were in circulation. Cf. Heiner Ritzmann-Blickenstorfer (ed): *Historische Statistik der Schweiz*, Zurich 1996, p. 805.

Our final leap in time brings us to the present day. Nowadays we live with a purely paper currency. Since the collapse of the Bretton Woods system at the beginning of the 1970s, exchange rates have, in principle, been moving freely in relation to one another. During the 1960s, the monetary policy of the US central bank had been too expansionary. Since the currencies of many countries, including Switzerland, were tied to the US dollar, this had resulted in high rates of inflation. Not until flexible exchange rates were introduced could central banks manage monetary policy conditions in their own countries and thereby effectively combat inflation. The SNB belonged to a group of pioneering central banks in this respect, managing to greatly reduce inflation within a very few years. And if we return to our loaf of bread, it is still possible to pay for it with Swiss coins and banknotes, although nowadays cashless payment forms – debit and credit cards – are further options.

Two invariables of a sound monetary order

By taking you on this short journey in time, my idea was to illustrate the following points for you: The monetary order did and does not arise from natural causes; neither is or was it god-given. It is, rather, a – more or less – useful human invention. Some of the fundamental turning points were the result of an organic learning process. For instance, the centralisation of the right of coinage in the hands of the Confederation was a reaction to futile attempts to overcome the currency confusion through cantonal agreements, and was a response to the novel requirements of an economy that was developing rapidly. At other times, however, it was necessary to react to upheavals in the international arena with determination, and under time pressure. On example of this was the departure from fixed exchange rates at the beginning of the 1970s.

However, these are not the only developments which have the potential to revolutionise our monetary order. Another agent of change is technological progress, which has fundamentally altered the way we pay for goods and services over the course of time, and will continue to do so in future. Moreover, in our direct democracy, sovereign voters make decisions which may alter the institutional foundations of the monetary order. Examples of this are the gold initiative, which we will be voting on in a week, and the plain money initiative, for which signatures are still being collected. Given this situation, you will understand that I cannot make any predictions about what our monetary order will look like in 60 years' time.

In my introduction I stated that sound money is a central pillar of our society. What makes money – or a currency – sound? Money is sound when it fulfils its functions as a means of payment and store of value as smoothly and reliably as possible in people's everyday lives. A sound currency retains its value and everyone can be sure it will be generally accepted as a means of payment.

In Switzerland, the state has played an important role in the development of the monetary order since the foundation of the modern federal state. In this process, the first invariable has been very obvious – it is that efforts to ensure sound money in the interests of the population as a whole have always been a state responsibility.

At the present time, the SNB's most important task remains the requirement to ensure that our money remains sound, thereby safeguarding its value. In this context, retention of value refers to prices for the goods and services paid by an average consumer in our country. I am firmly convinced that price stability is, first, a fundamental basis for the growth of an economy, thereby contributing to prosperity. Second, it has an important social component and is part of the glue that holds our modern society together. Price stability protects the purchasing power of pensions and enables citizens with lower incomes to accumulate and maintain assets. Retention of value cannot be taken for granted. Over the course of history, our neighbour countries have often experienced the pain of a collapsed currency. Money that retains its value, backed by sound institutions, therefore makes an important contribution to social harmony and material prosperity in our country, particularly in today's world, with its major insecurities and imponderabilities.

However, sound institutions alone are not enough. Additional prerequisites for sound money are widespread fundamental trust by the general public in both our monetary order and the SNB, as well as understanding and support of our stability policy. It is only because these conditions were and are met in Switzerland – for which I am very grateful – that the SNB has been able, and is able, to fulfil its mandate. A second important invariable in our more recent monetary history is the fact that, in this country, this fundamental trust and the culture of stability are deeply rooted.

Making money even better? Alternatives to the present monetary order

Can we make our sound money even better? In order to answer this question, let us begin by recalling the basic framework of the current monetary order. As an independent central bank, the SNB is required to pursue a monetary policy in the interests of the country as a whole. It has a mandate to ensure price stability while taking due account of the development of the economy.

This mandate is the compass that guides all our actions. By guaranteeing price stability in word and deed over the years, the SNB, as an independent institution, has been able to build up its credibility. Credibility is the anchor needed so that the public at large has confidence in our paper currency. This confidence, in its turn, makes it possible for the SNB to react flexibly in the short-term to economic disruptions, because the public does not question its policies aimed at long-term stability.

In view of the major economic and social importance of the monetary order, as outlined previously, it is legitimate and necessary that this order be subjected to repeated review. In this sense, we welcome the general growth in interest in the monetary system, following the turmoil of the financial crisis, and the fact that discussion on reform ideas is more lively than in the past.

Nevertheless, we should also be aware that the monetary order is the result of a historic development. Since we are not starting from scratch, even well-meaning suggestions for improvement – ones that might in theory appear totally justified – may have grave unintended consequences in the real world. I will use four radical reform proposals to illustrate what I actually mean by this. The proposals in question are, first, private money instead of state money, second, a return to the gold standard, third, the introduction of plain money and, fourth, the adoption of foreign money.

Private money instead of state money

What would it be like if we could pay with varying currencies offered by private providers, instead of with state currencies? At first glance this idea seems quite appealing. After all, competition between different providers of goods and services is a major principle underlying our economic order. We owe much of our progress and, with it, our prosperity to this factor. Why should we make an exception when it comes to the currency, or to money?

When talking about monetary competition, I would like to begin by putting our banknote monopoly into perspective. Since freedom of contract prevails in our country, you are at liberty to agree a currency other than the Swiss franc with your business partner. You may purchase your loaf of bread using euros, US dollars, gold, WIR money or even one of the new virtual currencies such as bitcoins,[8] if the baker is willing to accept them. In other words, the Swiss franc already faces competition, not only against the currencies of other countries but also against alternative non-governmental currencies.

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[8] For further information, cf. '*Bericht des Bundesrates zu virtuellen Währungen*' (Federal Council report on virtual currencies, in German only) of 25 June 2014 (www.news.admin.ch/NSBSubscriber/message/attachments/35361.pdf).

However, the key issue is rather different. A modern economy with a well-developed financial market requires a statutory means of payment. The Swiss franc is the official unit of currency in our country; Confederation coins as well as SNB banknotes and sight deposits are Switzerland's statutory means of payment. Therefore these instruments must be accepted as payment in this country by every individual, without restriction, unless otherwise agreed. A statutory means of payment creates legal certainty and efficiency in everyday life. Consequently, the governmental Swiss franc is indispensable in Switzerland, even in a situation of competition with private currencies. Moreover, as long as a central bank fulfils its mandate diligently, I do not consider it likely that a private currency can pose any serious competition to a state currency.

Return to a gold standard

The second reform idea, the return to a gold standard, is directly linked to the financial crisis. In some circles there are fears of massive inflation in the short or long-term as a result of the unprecedented relaxation in monetary policy worldwide. The solution that is sometimes proposed is a return to a gold standard, in other words, pegging the currency to gold.

I intentionally spoke of "a" gold standard and not of "the" gold standard because this standard has taken various different forms over history. Under a pure gold standard, a Swiss franc is equivalent to a certain amount of gold, and therefore, vice versa, the gold price is fixed in terms of Swiss francs. The SNB would be obliged to purchase or sell gold at this price, without any restriction. In other words, there would be an obligation to redeem SNB banknotes in gold.

In my view, the are two main arguments against a return to the gold standard. The first argument relates to gold as an anchor of price stability. Our modern economy is diverse and complex. Why, then, should we confine it in a monetary corset that takes as its measure the scarcity of a precious metal that, for the overall system, is relatively unimportant? Price stability is not guaranteed by the gold standard. As we have most clearly seen in the past few years, there is no direct connection between the gold price and the general price level of goods and services.

The second argument is that the gold standard reduces the room for manoeuvre in monetary policy. The closer it comes to its pure form, the greater the reduction in the freedom of manoeuvre. Only those who believe that no monetary policy at all is required to react to economic shocks should plead the case of the gold standard. Yet this ability to react, in particular, is of great importance for our economy, which is heavily dependent on economic exchange with other countries. The current paper money system based on an independent central bank committed to long-term stability provides an alternative, which – overall – achieves far better results than a gold regime could.

Here, if you will allow me, I would like to return to the present day with a brief digression on the gold initiative I mentioned before. Although the advocates of the initiative do not wish to return to a gold standard, they do want to increase the role of gold within the currency reserves. They therefore demand that the SNB hold at least 20% of its assets in gold, that it sell no more gold and that it store all its gold in Switzerland. The initiative is both unnecessary and dangerous. It is unnecessary because, under the current monetary order, there is no link between price stability and the share of gold in the SNB balance sheet. Thus, the objective of price stability has been better achieved over the past few years than at times when the gold share was significantly higher. Moreover, compared to other countries, the SNB still holds high stocks of gold. It definitely values gold, as a part of its currency reserves, and has no plans to either purchase or sell gold. Finally, we are enormously vigilant in ensuring that our gold is stored safely in every respect, both in Switzerland and abroad.

The initiative is dangerous because it would weaken the SNB. The connection between a minimum share and a ban on selling which it embraces would very greatly restrict our monetary policy room for manoeuvre, since the SNB only retains its full capacity to act when it is in a position to adjust its balance sheet to monetary policy requirements – in other words, if the SNB can expand or shrink it – without any restrictions. The value of this flexibility in reality has been impressively demonstrated in the past few years by two measures which allowed us to avert substantial damage from our country. First, the SNB supported the country's biggest bank by establishing a stabilisation fund, thereby stabilising the Swiss financial system. Second, it combated the massive overvaluation of the Swiss franc by introducing a minimum exchange rate of CHF 1.20 to the euro. With the minimum share of gold and the selling ban demanded by the initiative, enforcement of measures like these would have been very much more difficult. Consequently, the initiative would make it considerably harder for us to intervene with determination in a crisis situation and fulfil our stability mandate. For this reason, the gold initiative could result in worse money instead of better money, totally in contradiction to the intentions of the originators.

Introduction of plain money

A popular initiative is also behind the third reform idea – the introduction of plain money. Nowadays, the SNB and the commercial banks together provide the economy with money. Through credit creation, the banks are in a position to create book money, only a small part of which they are required to cover with SNB sight deposits. In everyday life, this book money – for instance deposits in salary accounts – is generally accepted in the same way that cash is accepted. A plain money system would mean that banks had to cover 100% of their book money with SNB sight deposits.

The people behind the initiative believe that this would simplify monetary policy because a plain money system would allow the SNB to manage the money supply with utmost precision. Moreover, plain money is thought to increase the stability of the financial system because deposits are secured by SNB sight deposits. In addition, profits from money creation would accrue fully to the SNB and no longer, in part, to the banks.

Although the idea of plain money may be interesting in certain respects, I am sceptical as to whether acceptance of the initiative would result in better money. My reticence is born not only of considerable doubts as to the anticipated benefits of plain money, but far more because the introduction of plain money would constitute an enormous experiment for which we lack any experience or comparative figures from the past. Never in monetary history has a country introduced plain money based on central bank money. Assumptions which appear plausible could therefore prove to be incorrect.

Foreign money instead of our own money

The final proposal is considerably less challenging in theoretical terms, but is highly explosive politically. Is there any reason why Switzerland should maintain an independent currency for its relatively small territory and conduct its own monetary policy? Since Switzerland has close economic ties with other currency areas, and the central banks in question also pursue stability policies, the idea of importing monetary policy from abroad would not be so far-fetched at first glance. After all, there are examples such as Denmark and Hong Kong which voluntarily and unilaterally peg their money to foreign currencies, even though they still mint their own coins and print their own banknotes. They hand over their monetary policy de facto to a foreign central bank and have often had quite good experiences with this approach.

However, as soon as we look at the situation a little more carefully, surrendering monetary policy autonomy appears considerably less favourable from a Swiss point of view. First, our country has had good experience with its independent monetary policy, and this differentiates us from countries where the adoption of foreign monetary policy has brought a real gain in terms of stability. Second, structural and economic differences continue between the currency areas, irrespective of all the interrelationships, and these are decisive for the effectiveness and apportionment of monetary policy. Equally, the preferences of the general public as to how the central bank should react to given challenges vary from one country to another. This also speaks in favour of a national monetary policy and against delegation. Consequently, in my opinion, the use of foreign money would not result in better money in our country, in the current situation.

At this stage, you might object that, through the minimum exchange rate against the euro, the SNB has already, in point of fact, adopted foreign money and handed over its monetary policy to a foreign central bank. Such a view of affairs would be incorrect. The minimum exchange rate is a measure which we adopted in order to fulfil our mandate in the interests of the country as a whole. The world economy is currently in an extremely difficult situation and the minimum exchange rate allows us to maintain appropriate monetary conditions and secure our long-term capacity to act. The minimum exchange rate is therefore an expression of our national policy sovereignty and the SNB's lived independence, not a sign that we have given up our autonomy.

The power of monetary policy

Despite the criticism of these four proposals, I attach importance to making two things clear. First, it is absolutely possible and, as history has shown, even probable, that over the course of time the situation could change in such a way that the assessment of specific points might change. However, whatever these changes might be, the aim of the monetary order should remain unchanged – to ensure sound money in the interests of the public at large. Second, the reform proposals I have discussed are fundamental questions which, ultimately, cannot be decided on by a representative of the SNB but by voting citizens. In our democracy, they are the ones who have the final word, either indirectly through their representatives in the Federal Parliament or directly at the ballot box – for instance next Sunday – and that is how it should be.

And this brings me to another point which is very dear to my heart. Although the SNB is independent, its power remains limited. Through the Federal Constitution and the National Bank Act it is firmly bound into our democracy and our constitutional state. Numerous control mechanisms guarantee this, and of these, I would like to make particular mention of the fact that, every year, the SNB must render account to the Federal Assembly as to how it has fulfilled its statutory tasks. This accountability report is published, so that the general public is also informed about the SNB's activities. We do not do this merely because we are obliged to, but also because we are convinced that rendering account is important. We attach great importance to increasing the understanding of the general public in monetary policy matters, since we are aware that basic trust in the monetary order and its institutions will only be justified and lasting if we communicate in a candid and comprehensible manner. Otherwise, the valuable culture of stability which characterises our country would probably suffer.

Despite the restrictions, central banks enjoy wide-ranging powers. Those who are in charge of monetary policy have strong tools at their disposal. Their responsibility is always heavy, due to the fact that their actions or failure to act impact on the entire population. In normal times, however, the impact of these strong tools is rather less acute, and the effects of monetary policy – both intended and non-intended – are usually easy to foresee. At the moment, this is more difficult because we are obliged to use unusual instruments. Consequently, at times like this the SNB bears a particularly high level of responsibility. We are therefore subjecting the impact of the measures we have taken so far to repeated and very fundamental review, and are approaching this task with a completely open mind.

Conclusion

I would like to conclude my presentation to you as follows. The SNB is fighting for price stability with total conviction and great commitment, while at the same time keeping the development of the economy in view. Within the context set by our monetary order, the SNB does its utmost, through its monetary policy, to ensure that our money retains its value, thereby remaining a sound pillar of our society. This is the SNB's most important contribution to ensuring the long-term attractiveness and competitiveness of the Swiss location, as well as the social cohesion of our population.

By their nature, central banks tend to be conservative institutions. Yet in recent years, the central banks, including the SNB, have become quite creative and innovative when faced with difficult circumstances. However, two points need to be noted in this respect. On the one hand, central banks must never lose sight of their mandates. There should never be any doubt about their unflinching adherence to their stability mandates. On the other, it is important to recognise that monetary policy cannot be used to solve all economic problems. Otherwise we run the danger that, in the long term, monetary policy will no longer achieve its intended effects, and our money will deteriorate.

As far as the Swiss monetary order is concerned, I am confident that the SNB is in a position to fulfil its mandate in the interests of the country – now and in the future –because of the backing it enjoys among the general public. My optimism is also founded in the history of the Swiss currency, which began moving in a positive direction after the memorable Ustertag of 1830. Admittedly, the efforts to achieve sound money in our country were not immediately crowned with success and it was a gradual process. However, our monetary order and institutions have enjoyed broad acceptance and a high level of basic trust for over 100 years now. This has made it possible, while adhering to the basic foundations of the monetary order, to carry out essential adjustments on repeated occasions, while at the same time allowing transient fashion trends to pass and forgoing experiments with uncertain outcomes. It appears to me a particular strength of our country and an important part of the Swiss recipe for success that we are able to review new developments impartially and prudently, adapt them to our own situation if we consider them good, and link them organically to tested and tried systems wherever possible.