Recent International Monetary Developments and the Swiss Economy

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As a result of rapid growth in international trade and capital flows, the interdependence among national economies has increased dramatically since World War II. Switzerland has not shunned the trend toward globalization of goods and capital markets. On the contrary, Switzerland is linked closely to the world economy through trade and capital flows. With exports accounting for roughly 40 percent of gross national product, the Swiss economy is highly sensitive to fluctuations in foreign demand for domestically produced goods and services. Furthermore, in view of Switzerland's role as a financial centre, foreign economic developments may impinge on the domestic economy through capital flows. The Swiss banking system and Swiss capital markets not only act as intermediaries between foreign lenders and borrowers, but they also serve as important avenues for the export of domestic capital. Due to a relatively high domestic savings ratio and negligible government budget deficits, domestically generated loanable funds are more than sufficient to finance investment by the domestic private sector. Excess funds are, therefore, placed abroad in the form of bank loans to foreigners, portfolio and private investments, as well as other assets. The importance of Swiss capital exports is highlighted by the fact that in 1985 total net income on Swiss foreign investments amounted to over 15 billion francs or roughly 2500 francs for every man, woman and child in Switzerland, a per capita figure probably not matched by any other country.

Switzerland has traditionally maintained a liberal system of international trade and capital flows. Save for restrictions on agricultural trade, tariff barriers and quotas have been dismantled to a large extent and controls on international capital flows – still important during the 1970s – have virtually disappeared. The gradual elimination of barriers to trade and capital flows reflects a firm belief that the free movement of goods and services across the national border is essential to sustaining Swiss economic growth and welfare.

While a liberal approach to international trade and capital flows is clearly beneficial to Swiss economic growth, the openness of the Swiss economy occasionally complicates Swiss monetary policy. In recent years, two problems have been of particular concern to the Swiss National Bank: the large swings in the dollar exchange rate and, to a lesser extent, the international debt situation.

As to the first problem, I should like to stress that the Swiss National Bank supports the existing floating exchange-rate system. We are not concerned about exchange-rate movements as such; some exchange-rate flexibility is required for the conduct of our monetary policy. The principal objective of Swiss monetary policy is to achieve and to maintain a stable price level. For the central bank of a small country like Switzerland, it is impossible to combat effectively inflation if there is an obligation to keep exchange rates fixed. So long as the major industrialized countries have not attained price stability, Switzerland must preserve the ability to shield itself from imported inflation by means of adjustments in the Swiss-franc exchange rate. From the standpoint of monetary policy, an ideal world would be one in which exchange rate movements reflect largely inflation differentials between various countries.

Needless to say, the experience of the past decade clearly indicates that purchasing power does not hold except in the very long run. In the short and medium run, that is over periods up to about two years, deviations in market exchange rates from their purchasing-power-parity levels

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have occurred rather frequently. Such deviations may impede or weaken the Swiss National Bank's anti-inflationary monetary policy. An excessive appreciation of the Swiss franc has both desirable and undesirable effects. On the one hand, it depresses the domestic prices of internationally traded goods and, thus, contributes to lowering the Swiss inflation rate. On the other hand, if domestic prices of internationally traded goods fall relative to production costs, the international competitive position of Swiss industry is impaired by the appreciation of the franc. As the turbulent events of 1978 clearly show, a drastic exchange-rate induced erosion in the competitive position of Swiss industry may well open up the prospect of a slump in economic activity, compelling the Swiss National Bank to abandon – at least temporarily – its fight against inflation.

More recently, the Swiss National Bank has had to cope with exactly the opposite problem in the form of a weak domestic currency, notably vis-à-vis the United States dollar. From 1983 to early 1985 the exchange rate of the U. S. dollar rose continuously relative to the Swiss franc and other major currencies. The strength of the dollar complicated the Swiss National Bank's task of lowering the inflation rate. While consumer price inflation declined quickly from a high of 7.5 percent in the autumn of 1981 to an average of 2.9 percent in 1983, it did not vary much from 1983 to the end of 1985, despite a fairly restrictive monetary policy stance. The rising dollar was an important reason for the exceedingly sluggish response of the inflation rate to monetary tightness. The renewed decline of the dollar since March 1985 has eased considerably the upward pressure on the Swiss price level emanating from the external side. In addition, the oil price decline has led to a further – albeit temporary – drop in the inflation rate.

In view of the massive currency swings, the question arises whether there are ways to achieve greater exchange-rate stability. Before I attempt to answer this question, I must stress a fundamental point: if necessary, monetary authorities are always able to stabilize or to fix exchange rates. The question that concerns the Swiss National Bank and other monetary authorities is not whether greater exchange-rate stability is feasible. What really concerns us is whether it is possible to achieve simultaneously stable exchange rates and a stable price level.

Swiss experience clearly suggests that the fires of inflation can be extinguished only if the central bank is able and willing to control tightly the growth in the domestic money stock. The statistics speak for themselves: Since the transition to floating, an increase in money growth has invariably been followed by an acceleration of inflation, with the inflation rate lagging behind money growth by up to three years. Conversely, a drop in money growth sooner or later has led to a decline in the inflation rate.

Because of the close link between prices and money, it is absolutely essential that the Swiss National Bank retain close control over the money stock if the war against inflation is to be won. In Switzerland, a commitment to fix – or even to stabilize – the exchange rate of the Swiss franc is incompatible with the Swiss National Bank's desire to keep a tight rein on the money stock. As ordinary mortals, we do not possess superhuman powers: either we control the money stock or we keep exchange-rate fluctuations within bounds, but we cannot do both.

Considering the impossibility of simultaneous money-stock and exchange-rate management, the Swiss National Bank has opted for a system of monetary control based on growth targets for the monetary base. These targets are set with a view to achieving price stability in the medium run. Of course, we know only too well that we cannot afford to ignore the exchange rate entirely. For this reason, our approach to monetary-base targeting has been pragmatic. Should exchange-rate developments get out of hand, we are prepared to deviate from or to give up temporarily our money-stock target. However, the exchange-rate misalignment must be serious if the Swiss National Bank is to adopt such a course of action. A good case in point is the sharp appreciation of the Swiss franc in 1978, which led the Swiss National Bank temporarily to substitute an exchange rate target for its money-stock target.

Contrary to the exchange-rate developments in 1978, the recent strength of the dollar has not

prompted the Swiss National Bank to modify its policy of controlling money growth. Over the period 1983 to 1985, actual money growth averaged 2.8 percent and was close to the target of 3 percent. Although we did not like the inflationary consequences of the high dollar, we refused to tighten significantly our monetary policy in order to lower the Swiss franc exchange rate of the dollar to more acceptable levels. We felt that a policy of trying to correct the overly high dollar/Swiss franc exchange rate was undesirable for two reasons.

First, a tightening of monetary policy would have caused an appreciation of the Swiss franc against all foreign currencies, not just the U. S. dollar. While we considered the dollar/Swiss franc exchange rate to be seriously misaligned, we were quite happy with the external value of the Swiss franc vis-à-vis the Deutsche mark and the other EMS-currencies. We might have been more willing to contemplate a tightening of monetary policy if the trouble had been a general weakness of the Swiss franc rather than a pure dollar problem.

Second, while in the long run, a drop in the domestic money stock *ceteris paribus* will bring about a proportionate rise in the external value of the Swiss franc, the short- and medium-run response in the exchange rate to a shift in monetary policy is quite unpredictable. In the face of these forecasting problems, we could not rule out the possibility that a drastic contraction in the money stock would have been required to bring about the desired movement in the exchange rate. Such a policy shift would have been undesirable from the standpoint of domestic stability as it might have thrown the Swiss economy into a recession.

The dilemma posed by the strong dollar clearly shows that the central bank of a small country may not always be able to keep everybody pleased. Since domestic policies, by themselves, have frequently not been effective in enhancing exchange-rate stability, a growing number of central bankers, government officials and academics has proposed closer co-operation among national governments and monetary authorities as a means of moderating the wide currency swings. In their view, the variability of exchange rates is due largely to disparities or conflicts between national economic policies, which may be overcome by multilateral co-operation. The example of the Deutsche mark/Swiss franc exchange rate is occasionally mentioned as a case in point: due to the similarities of Swiss and German economic policies, notably monetary policies, that exchange rate has displayed a remarkable degree of stability in recent years.

The Swiss National Bank has always been in favour of strengthening international co-operation among national monetary authorities. We would also be prepared to accept a system of international surveillance of national economic policies, as has been suggested by the Group of Ten and other international bodies. However, though we support closer international co-operation, we do not believe that any kind of co-operation is better than none, nor are we overly optimistic about the results of international surveillance. A greater willingness to co-operate internationally is one thing. Quite another problem is to know how national economic policies should be altered in order to achieve more stable exchange rates. Let me illustrate this problem by speculating on the kind of international co-operation that might have prevented the sharp rise in the dollar from 1983 to 1985. The appreciation of the dollar has frequently been attributed to U. S. budget deficits that – until very recently – were increasing at a rapid pace. Mounting budget deficits purportedly drove up real interest rates in the United States and caused foreign demand for U. S. assets to rise. If this explanation of dollar strength had in fact been correct, policy makers should have directed their attention at the U. S. budget in order to rectify the exchange-rate misalignment. A system of surveillance could have served as an additional incentive for the United States to take appropriate corrective measures.

While it is likely that a cut in the U. S. budget deficit would have relieved somewhat the upward pressure on the dollar, I seriously doubt that the exchange-rate misalignment could have been corrected by fiscal measures alone. Numerous empirical studies suggest that the relatively high real U. S. interest rates and the strong U. S. dollar were only partly explained by

the budget deficit. Another possible cause of the rise in the dollar is the remarkable success of the Federal Reserve System in lowering the U. S. inflation rate. The confidence instilled by U. S. monetary policy may have induced investors to alter the composition of their portfolios in favour of dollar assets. If U. S. monetary policy had been an additional factor accounting for the strength of the dollar, it is hard to see how international co-operation could have ameliorated the exchange-rate situation. After all, it would clearly have been unreasonable to ask the Federal Reserve System to relax substantially its monetary policy or foreign central banks to tighten up in order to bring down the dollar. This would have jeopardized the fight against inflation in the United States and possibly caused a recession in other countries. The fact of the matter is that a major shift in monetary policy is frequently followed by considerable exchange rate variability, a cost that must be borne if inflation is to be brought under control. Thus, there are no easy means of curbing exchange-rate variability: in my opinion, the best result a system of international surveillance could achieve is to convince the various participants that stable prices are an absolutely essential precondition for stable exchange rates.

As for the debt problem, the other international monetary development the Swiss National Bank has been concerned with in recent years, I can be mercifully brief in discussing it.

We all know about the staggering sums involved (more than a 1000 billion dollars), the mind-boggling difficulties debtor countries are in to find the 100 odd billion they need yearly to service the interest payments, the sometimes drastic adjustment measures taken in some Latin American countries and the new problems recently added to an already bleak overall picture by crumbling oil prices. Since 1982, the debt strategy has taken the classical approach: balance of payments adjustment, strengthened export performance and curtailed imports, monetary and fiscal restraints including realistic interest rates and exchange rate policies. Even if this orthodox adjustment strategy has been found wanting in more than one respect, I am still convinced that there is no alternative.

Similarly, on the creditor side, even if only slow progress is being made, the general strategy put forward last October by U.S. Treasury Secretary Baker is the only way I know to get out of the difficult situation Western banks have put themselves in.

As far as Switzerland and the Swiss banks are concerned, despite the relative importance of our financial centre there is very little we can do to change the basics of the debt problem. We simply have to be flexible enough to adapt ourselves to this shifting environment and contribute as much as we can to the international effort to find an orderly way out of these dangerous currents.

Thanks to the carefulness of our bankers, the Swiss banks' exposures in indebted countries are proportionally much lower than in many other G-10 banking systems. For example, at the end of 1985, the Swiss banks' outstanding claims against the fifteen countries listed in the Baker initiative amounted to about 7.4 billion dollars, i. e. 2.5% only of the total external banking debt of these countries. However, two thirds of these amounts were concentrated in three major Latin American countries; the Swiss banks have thus not been able to escape the need for strengthening their capital position.

At the request of the Federal Banking Commission, all Swiss banks have by now provisioned to the tune of twenty percent their outstanding stock of loans vis-à-vis these «problem countries». Moreover, this unusually high level of provisioning (at least by international standards) was reached within a very short time span. The tax-relief scheme made possible by our government sped up this process now fully completed. This strengthening of our banks' capital position has of course put them in a much more comfortable position than many others to consider resuming their lending to indebted countries. Clearly, our banks have been very constructive at this difficult juncture; they have played their part in reinforcing the current debt strategy and they will, no doubt, make their contribution when the Baker initiative is implemented.

The Swiss National Bank has always been very sympathetic not only to the Baker initiative but

also to the many efforts of the Swiss banks to take part in that exercise in international financial cooperation. However, if, like any other central bank, we are ready to bring assistance to banks faced with temporary liquidity problems, we are in the business of saving banks, not bankers. The Swiss National Bank thus has no intention of bailing out, either today or tomorrow, a bank that has run into a solvency problem. It is my opinion that our banks are in full agreement with this principle. This probably explains why, in the international debt problem, they rightly insist so much on debtor countries regaining some sort of credit-worthiness before offering them new money. The solidity of their capital adequacy is the best contribution our banks can make to their own profitability, to the solidity of the international financial system and, of course, to an early resumption of net transfers to indebted countries.

Exchange-rate fluctuations and, to a lesser extent, the current debt crises are two of the main problems that today complicate Swiss monetary policy. But, of course, they only form a small part of the challenge faced by a small economy like Switzerland, wide open to the strong winds of international competition. And I would even venture to argue that the excellent performance displayed by the Swiss economy since the war is largely the result of the quasi-permanent adjustment process brought about by the outside world on our economic structures. This fact, plus our firm belief that free movements of goods and services best serve the world economy at large, will certainly contribute in the future, as they have in the past, to Switzerland's growth and welfare.