

# The Genesis and Performance of Swiss Monetary Targeting

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## Introduction

- Add Swiss perspective to the conference
- Monetarism strongly influenced Swiss monetary policy
- Karl Brunner – though not an official advisor to the Swiss National Bank (SNB) – made his mark on Swiss monetary policy through the central bank's research staff

## Adoption of a Money Stock Target

- Switch to a floating exchange rate in January 1973
- Governing Board slowly realized that it had gained full control of the money supply
- Adoption of annual money stock targets at the end of 1974
- Fighting inflation through strict control of the money supply required research
- Chair Fritz Leutwiler set up research department and press office – regular press conferences after 1974

## Setting the Targets and Managing the Money Supply

- 1975 to 1979: Annual targets for M1
- No target in 1980
- 1981 to 1990: Annual targets for monetary base
- Annual targets reduced gradually from 6 percent in 1975 to 2 percent in 1990
- 1991 to 1999: 5-year target lines for the monetary base
- From 2000 to today: Inflation objective of 0-2 percent and 3-year-ahead inflation forecasts

## Setting the Targets and Managing the Money Supply, continued

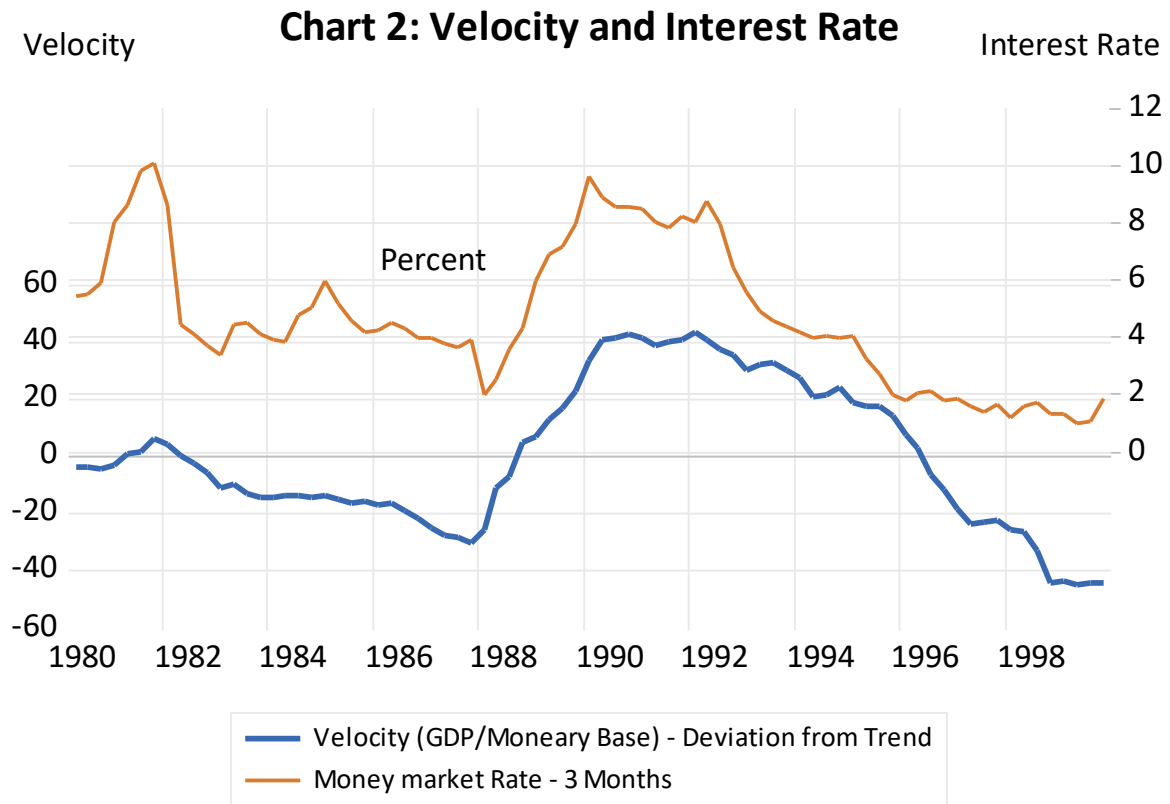
- In the longer run; increase in monetary base by 2-3 percent per year to accommodate potential growth in real GDP of 2 percent or less and to achieve an inflation objective of 0-1 percent
- From 1982 onwards annual targets set as follows:
- SNB determines activity-induced increase in demand for base money, expected for the following year; needs one-year-ahead forecasts of real GDP growth and inflation
- SNB decides to what extent it is willing to accommodate activity-induced increase in demand for base money

## Setting the Targets and Managing the Money Supply, continued

- If in an inflationary environment the SNB does not fully accommodate the activity-induced increase in demand, interest rates must rise, curbing real growth and inflation
- Base-money demand and velocity related to interest rates
- Advantage of annual targets: only one-year ahead forecasts required
- Although the SNB was able to reduce inflation to low levels, its performance was less than stellar
- Inflation returned temporarily twice in the 1980s and 1990s

## Problems arising from annual targeting

- Excessive exchange rate movements
- Steady money growth not an optimum strategy

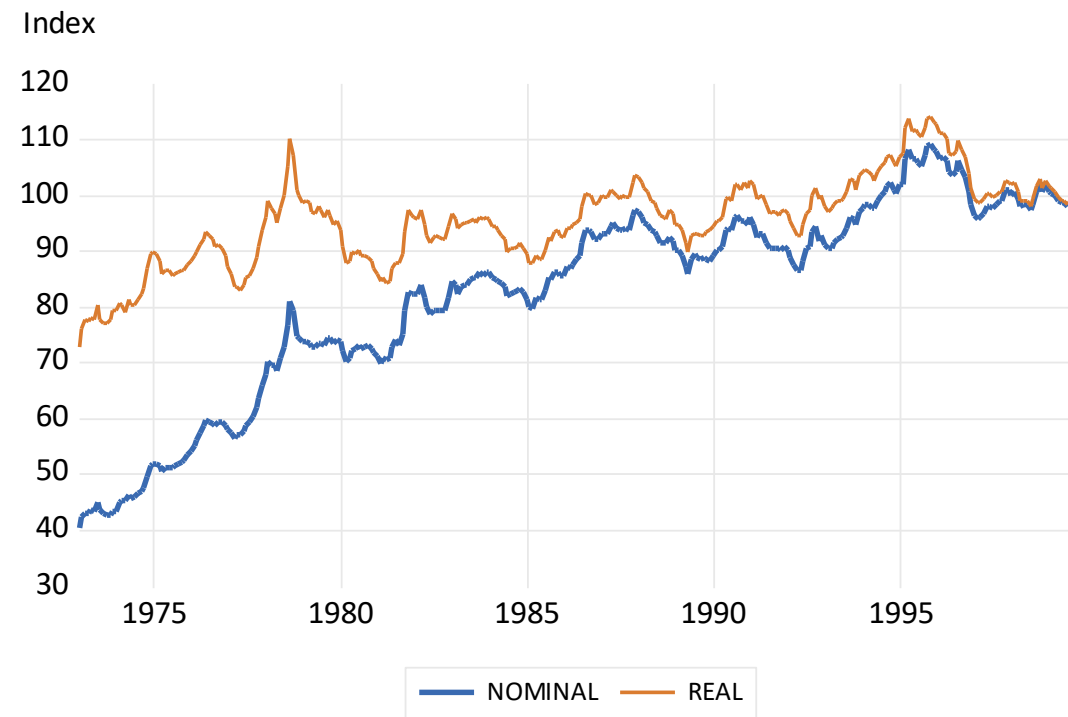




## Excessive Movements in the Exchange Rate

- Excessive appreciation of Swiss franc in 1979 threatened to wreak havoc with domestic export industries
- SNB set floor for Swiss franc price of Deutsche mark
- Interventions in foreign exchange market to defend floor led to large increase in monetary base
- No monetary target for 1980
- Tardy removal of monetary overhang contributed to renewed boost in inflation
- However, tardy SNB response not only problem

**Chart 3: Nominal and Real Effective Exchange Rate of Swiss Franc**



## Steady money growth not an optimum strategy

- With hindsight, targets for 1980 and 1981 too high
- Lower targets would have been incompatible with SNB's professed aim of reducing money growth gradually
- Fundamental problem of annual targeting: steady money growth did not act as a sufficiently strong brake to quell effects of cyclical and other shocks on inflation
- Medium-term targeting to solve problem
- New problem: three-year ahead forecasts required to determine deviations from medium-term target line

## Steady money growth not an optimum strategy, continued

- Multi-year strategy involved strong dose of inflation targeting
- In 1999 SNB abandoned monetary targeting in favor of an approach embracing an inflation objective of 0-2 percent and three-year ahead inflation forecasts
- Superiority of monetary targeting no longer obvious