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Article

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Aussenwirtschaft

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Suggested Citation: Baltensperger, Ernst (2017) : The contribution of monetary institutions to stability: The Swiss case, Aussenwirtschaft, ISSN 0004-8216, Universität St.Gallen, Schweizerisches Institut für Aussenwirtschaft und Angewandte Wirtschaftsforschung (SIAW-HSG), St.Gallen, Vol. 68, Iss. 1, pp. 19-28

This Version is available at:

<https://hdl.handle.net/10419/231244>

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The contribution of monetary institutions to stability: The Swiss case

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This article studies Swiss monetary policy of the 19th and 20th century to understand the Swiss franc's strength and stability. The continued appreciation against other currencies over the course of a century went hand-in-hand with Switzerland's political and social consolidation as well as its increasing economic success. Political institutions arose from people's beliefs and convictions, granting them credibility. In Switzerland, these institutions have been a major force in creating an environment that has permitted the Swiss National Bank to successfully pursue its course of monetary stability.

JEL codes: E40, E50

Key words: monetary institutions, stability, Swiss franc, Switzerland

1 Introduction

I share with many others a deep conviction that institutions matter. They define the environment which constrains and influences individual behavior and social interaction and, in consequence, shapes political and economic outcomes in a society. This is true of institutions in general, and it is also true of economic institutions. Buchanan emphasized such a view in his Nobel prize lecture on “The Constitution of Economic Policy” (BUCHANAN, 1987) and has related this view to WICKSELL (1896).

However, we must also note that institutions, in order to be effective, must be credible and based on the conviction of those they are supposed to guide and bind. Their success or failure is as dependent on their firm embedding in society's convictions as it is on their technical specifications. Institutions do not fall from heaven and come into existence out of nowhere. They (must) arise from people's beliefs and convictions, if they are to be successful.

Institutions, in the sense in which the term is used here, include not only:

- formal bodies and organizations (public or private), such as parliaments, government agencies, judicial courts, central banks, supervisory and regulatory agencies, international organizations, trade and labor unions, and private enterprises;

but also (maybe even more fundamentally):

- all formal and informal rules constraining and influencing the behavior of individuals and authorities, including mechanisms for their enforcement (such as a nation's constitution and the code of law), rules defining the monetary order of a country (the "currency system"), rules defining the relationship between government authorities, central banks, and actors in the private sector, or rules defining central bank response to shocks and changes in the economic environment (policy "strategies" and rules, central bank reaction functions).

In a very broad sense, they include all fixed patterns of behavior and response to change shared by the members of a community, and thus characteristic of a community.

The organization of monetary institutions and their development over time, in particular, shape the structure of financial markets and affect the economic course of a country in important ways. Swiss monetary history of the 19th and 20th centuries provides an interesting case for their study. The performance, strength and stability of the Swiss franc over the unstable 20th century, notably, calls for an explanation.

Which institutional arrangements are characteristic of Swiss society and the Swiss economy and have contributed to this performance? The following come to mind.

The special, and in some respects unique, political constitution of the country

After 1848, Swiss politics at the federal level was dominated at first by the winners of the Sonderbundskrieg – the Liberals and the "Radicals". Over time, however, Switzerland found ways to overcome this limitation and develop a pronounced culture of power-sharing between all relevant groups of society – between Catholics and Protestants, between liberals and conservatives, between bourgeois and social democrats, between organized labor and employers, between the German-speaking majority and the French-, Italian- and Romansch-speaking minorities. According to LINDER (1994, xvi), "[t]his has led to social integration, peaceful conflict-resolution by negotiation, and national consensus amongst a once fragmented and heterogeneous population". Switzerland thus became a model of democracy of consensus and of political stability. Along with a strongly federalist structure, the institutions of direct democracy have played a significant role in this process by making political positions more easily contestable and encouraging incentives to compromise.

The direct democratic instruments of the referendum and the initiative were important elements in the development of Swiss-style liberal democratic

corporatism, as discussed by KATZENSTEIN (1985; 2003). Political decisions were threatened by referenda, and this led to an inclusion of organizations with the power to start a referendum in political decisions.

Apart from the institutional framework, “Swiss-style” democratic corporatism was fostered by the fact that Switzerland was a small state with a highly open economy. Despite its small size and lack of natural resources such as metals, coal or oil, Switzerland went through an early process of industrialization. This was only possible by relying on international trade and a relatively positive attitude towards free trade. The dependence on foreign economic and political developments created a perception of vulnerability of economic success – typical of small states according to KATZENSTEIN (1985) – which favored the emergence of a democratic corporatism relying on negotiated change rather than market forces alone. This characteristic may also help to explain the country’s long-lasting preference for the gold standard and fixed exchange rates, which were definitively abandoned only in the early 1970s, when controlling inflation was no longer possible under a fixed exchange rate regime (STRAUMANN, 2010, 276-307).

A firm commitment to economic and financial stability: The vital importance of political and financial stability for the rise of a currency

At its inception, the Swiss franc was not exactly predestined to become one of the most stable and successful currencies of the world. Created through the Federal Coinage Act of 1850, two years after the foundation of the modern federal state of Switzerland, the new Swiss franc was essentially a satellite currency of the French franc. This continued to be the case for the first 50 years of its life, until the establishment of the Swiss National Bank in 1905-07. During this period, the Swiss franc was far from the strong currency that we know today. Rather, it was distinctly “average”, with phases of weakness and strength relative to other currencies used at the time alternating with each other. In the decades before World War I, the Swiss franc tended towards weakness and was characterized by an interest rate malus with respect to the French franc, rather than the interest rate bonus we are familiar with today.

Since the outbreak of World War I, however, the value of the Swiss franc has increased hugely against all other currencies. In 1914, the US dollar was equivalent to 5.18 francs; currently, the dollar exchanges for slightly less than 1 Swiss franc. The relative loss of value was even much greater in the case of other currencies. In 1914, the pound sterling was worth just over 25 francs; today its value is about 1.25 francs. The relative loss of value is particularly pronounced in the case of the former partner currencies in the Latin Monetary Union – the French franc and,

even more extreme, the Italian lira (whose value in Swiss francs at the time of the introduction of the euro in 1999 had to be measured in terms of thousandths).¹ As far as the German mark – created after the German unification in the 1870s – is concerned, it had lost its value completely during the German hyperinflation of the early 1920s.

This nominal strength of the Swiss franc derives from two different sources: a “purchasing power parity (PPP) component” stemming from a relatively low trend inflation, created by the pronounced stability orientation of Swiss monetary policy; and a “real component” resulting from relative productivity differences and other real factors.²

The advance of the Swiss franc from a French franc satellite to an independent, strong currency of international importance went hand-in-hand with Switzerland’s political and social consolidation and its increasing economic success. The country’s firm determination to remain independent and to maintain financial and monetary stability – traits which have always been characteristic of Switzerland in comparison to other countries – played a key role in this respect. In a social and political environment characterized by instability, tension and strife, it is extremely difficult to establish and maintain a stable monetary order. The fact that Switzerland has been spared wartime turbulence for one and a half centuries, due to both political prudence and fortuitous circumstances, naturally has also helped in creating the stability and trust from which the Swiss franc benefits today.

Absence of fiscal dominance and respect for central bank independence

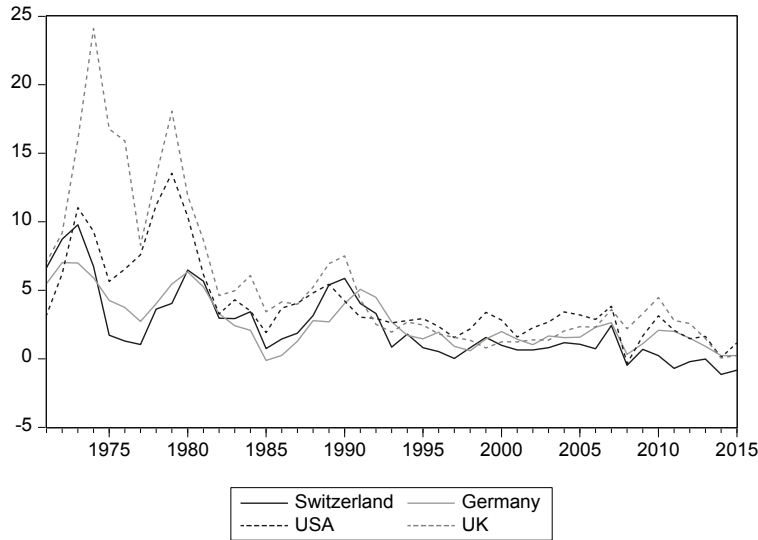
The period of exchange rate flexibility which began with the breakdown of the Bretton Woods system in 1973 is particularly instructive in this context. Swiss monetary policy and performance during this phase has been remarkably successful overall. The inflation record of the Swiss National Bank (SNB) across this entire period is outstanding among the major central banks. There have been extended periods in which inflation remained consistently low, such as between 1982 and 1988 (at a time when this was not the case in many other countries in the industrialized world) and then again from 1993 to the present (see Figure 1). At the same time, there is no sign that this has been at the expense of a sub-par performance in real economic activity and stability. With its policy, the SNB has successfully managed to establish an environment of confidence and credibility. Together with the stability of the political system, this has been a major force in

1 At the end of 1998, the French franc and the Italian lira were valued at 0.0024 and 0.00084 Swiss francs, respectively; see also KUGLER (2012).

2 See Chapter 11 of BALTENSPERGER and KUGLER (2017) for more on this.

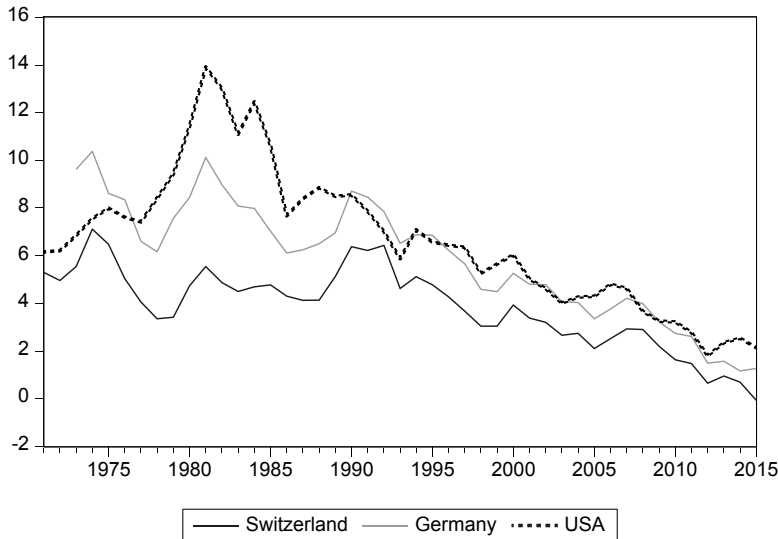
creating financial tranquility and levels of nominal and real interest rates which have consistently stayed below those in other currency areas (Figure 2).

Figure 1: Inflation 1971-2015 (yearly averages, in percent)



Source: BALTENSPPERGER and KUGLER (2017, 125).

Figure 2: Yields on government bonds (10 years), 1970-2015



Source: BALTENSPPERGER and KUGLER (2017, 126)

This (comparative) success of Swiss monetary policy and of the Swiss franc on the exchange market was strongly dependent on the fact that the Swiss population has supported a system of fiscal stability and moderation over a long period of time. Apart from a brief encounter with fiscal pressures on SNB policy during World War I, fiscal dominance of monetary policy has never been a serious concern during the last 100 years. Swiss voters have shown great respect for fiscal responsibility and soundness in economic policy in general. Taxation and government debt have stayed comparatively moderate, the latter even formally constrained through a constitutional ‘debt brake’ introduced at the federal level in 2001, after a brief flirtation with fiscal irresponsibility and overextension during the 1990s.

Reliance on rules, a focus on long-term developments, and a conscious decision for monetary autonomy and independence

The political institutions of direct democracy have been a major force in creating these conditions and, as a consequence, an environment that has permitted the SNB to successfully pursue its course of monetary stability. Monetary policy was characterized by a conscious decision for monetary autonomy and independence, moderation regarding short-term stabilization objectives, an emphasis on long-term rules and a willingness to “see through” temporary disturbances and shocks.

It must be acknowledged, however, that Swiss monetary policy since 1973 has not been free of occasional errors, and has turned out to be quite controversial in certain phases. In particular, there were surges of inflation in 1980-1981 and then again in 1988-1990. In both cases, this made subsequent phases of monetary tightening and consolidation necessary, with the usual resulting stabilization costs. In the early 1990s, especially, this – together with tardy structural reforms in areas of the real economy – contributed to economic recession and sluggish growth. In 1994, an exaggerated insistence of the SNB on monetary restriction prolonged economic weakness. Nevertheless, a firm embedding of its policy in a system of credible institutions allowed a quick return to monetary and economic stability from each of these phases.

Monetary, financial and economic stability are interdependent

Monetary, fiscal and political stability are mutually dependent. A sound monetary order can hardly arise and survive under unstable economic and political conditions. Disordered currencies, conversely, damage the efficiency of the economic system and, in the extreme, can lead to economic and political decay. Switzerland has been fortunate in this respect.

While the Swiss currency's stability has benefited from Switzerland's growing political and economic success, it is also true that the country's focus on monetary and financial stability has made an important contribution to political and economic consolidation; the two go hand-in-hand. Steady money and well-functioning, efficient financial structures are among the most important achievements of an economic and social system. A stable currency, in particular, is one of our most valuable public goods, comparable to an efficient system of law, of public security or of public finance and taxation. Without it, a liberal economic and social order cannot effectively develop.

Economic history is full of examples of how problematic currencies – or, indeed, failing currencies – can harm the efficiency of an economic system and, in extreme situations, lead to economic and political collapse. In the course of the 19th and 20th centuries, Switzerland succeeded – to some extent through slow and painful experience – in creating institutions and systems that have proved robust and resistant to this danger. An acute public awareness of the importance of monetary stability and reliability has been instrumental in this development.

Contrary to the widely expressed view, however, it is not true that the stability and success of the Swiss economy over the last 100 years is largely due to the international role of Swiss banking and finance, in particular Swiss banking secrecy. Analysis of the role of the Swiss financial system and its contribution to Swiss GDP shows that this perception is without foundation.³ Switzerland was already a high-income country by international comparison in the 19th century, when Swiss banks were still rather unimportant. Furthermore, the large importance of the financial sector in the Swiss economy is a quite recent phenomenon, starting effectively in the 1970s – long after the political, economic and monetary stability of the country was already firmly established. Beyond this, the rapid expansion of the financial sector over the last 40 years, which went along with a huge increase in bank leverage, while undoubtedly generating large returns, also created high risks for the country – risks which became evident in the financial crisis of 2008. There is no convincing evidence suggesting that Switzerland's monetary and economic success has been predominately created by its financial sector. A more justified conclusion, rather, is that the financial sector has profited from the exceptional political and economic stability of the country.

3 BALTENSPERGER and KUGLER (2017, ch. 12).

Institutions must fit

The political and economic institutions developed by Switzerland over the course of the last two centuries have worked well for the country, all in all. Whether they would equally fit other societies, if imposed on them, I do not know.

To repeat what I said at the beginning: the success or failure of institutions rests on their firm anchorage in society's convictions. Institutions do not fall from heaven; they must arise from people's beliefs and convictions in order to be effective. Imposed on a population which does not really believe in them, they are doomed to failure.

An example in case is the "no bailout" principle in Europe. While clearly proclaimed on paper, it has been disregarded again and again, as the political will to respect it is lacking in large parts of the EU community. Similarly, it would not be wise to artificially impose a common fiscal authority, or even a full fiscal union, on the Eurozone simply on the basis that only this can ensure its stability and future. It is true, of course, that a credible commitment to common fiscal rules would be extremely helpful, if successfully established. But it is very unlikely that this would be possible under present conditions. Attempts to fool yourself hardly ever work. The political will to transfer national sovereignty to the community level must be established first and must reflect peoples' true desires; only then can institutions built on this commitment be effective.

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