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GDP data revisions and forward-looking monetary policy in Switzerland

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Abstract

This paper analyzes forward-looking rules for Swiss monetary policy in a small structural VAR model consisting of four variables taking into account data revisions for GDP. First, the paper develops an analytical method to analyze the effect of data-revision errors in GDP on the ex-ante or conditional inflation-output-growth volatility trade-off and applies it to Swiss data. Second, the effects of different targets in a forward-looking monetary policy on ex-post or unconditional volatility of inflation and output growth is explored with a simulation exercise. In general, the results suggest that focusing monetary policy on GDP growth instead of inflation may lead to an inefficient policy with both increased medium-term inflation and GDP growth volatility in the presence of GDP data revisions.

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1. Introduction

After 25 years of monetary targeting, the Swiss National Bank (SNB) adopted a new monetary policy framework at the end of 1999. Severe shocks to the demand for central bank money, especially for large bank notes and for reserves held by commercial banks at the SNB, rendered it impossible to use the medium-term target path for the seasonally adjusted monetary base as a guideline for monetary decisions. Thus, the SNB decided to abandon monetary targeting. The new framework consists of three elements. The first element is an explicit definition of price stability. The SNB regards price stability as achieved if CPI inflation is below 2 percent. The second element consists of the use of an inflation forecast as the main indicator to guide monetary policy decisions. The third element is a target range for three-month Swiss franc Libor as an operational target to implement monetary policy. As in the old concept, maintaining price stability over the medium term remains the main objective of monetary policy also in the new framework.

In the new framework, the inflation forecast serves as the main indicator for guiding policy decisions. Although there is no mechanical reaction to the inflation forecast and the inflation forecast is not treated as an intermediate target, the discussion at the board about monetary policy is focused on the inflation forecast. The forecast used in the decision-making process is a consensus forecast that is derived from a series of models and indicators. The SNB recently started to publish studies regarding these models. [Jordan and Peytrignet \(2001\)](#) delivered an introduction to the inflation forecast of the SNB and the models used to derive it. [Stalder \(2001\)](#) presented the large traditional structural macro model of the SNB and [Jordan, Kugler, Lenz, and Savioz \(2002\)](#) provided an overview of the different VAR approaches used at the SNB.

For the purpose of analyzing forward-looking policies, a small structural VAR consisting of four variables was developed by [Kugler and Jordan \(2004\)](#) and [Kugler and Rich \(2002\)](#). This research is extended by [Kugler, Jordan, Lenz, and Savioz \(2005\)](#), who developed an analytical method to analyze the ex-ante or conditional medium-term inflation-output-growth volatility trade-off for a forward-looking policy aiming at a convex combination of a medium-term inflation and an output-growth target in a SVAR model. This paper extends this framework in two respects. First, it considers the effects of data-revision errors in GDP on the ex-ante or conditional medium-term inflation-output-growth volatility trade-off. Second, the effects of different targets in a forward-looking monetary policy on ex-post or unconditional volatility of inflation and output growth are explored by a simulation exercise.

The foregoing outline of the paper indicates that it is related to a growing literature on the effects of uncertainty about potential output and the output gap on the performance of monetary policy rules. [Orphanides \(2000, 2001\)](#) was one of the first, who considered this question using real time data for the U.S. output gap. He concluded that data-revision errors in the output gap were of crucial importance for excessively expansionary U.S. monetary policy in the sixties and seventies and that neglecting such data-revision errors leads in general to policies that are too activist. However, [Svensson and Woodford \(2000\)](#) argue that this result is mainly caused by the fact that in Orphanides' framework the central bank behaves as if there were no data-revision errors and that the problem disappears when the

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