

# Monetary policy strategy

## Constitutional and legal mandate

Article 99 of the Federal Constitution entrusts the SNB, as an independent central bank, with the conduct of monetary policy in the interests of the country as a whole. The mandate is explained in detail in the National Bank Act (art. 5 para. 1 NBA), which requires the SNB to ensure price stability and, in so doing, to take due account of economic developments.

The SNB is thus charged with resolving in the best general interests any conflicts arising between the objective of price stability and business cycle considerations, giving priority to price stability. The requirement to act in the interests of the country as a whole also means that the National Bank must gear its policy to the needs of the entire Swiss economy rather than the interests of individual regions or industries.

## Significance of price stability

Price stability is an important condition for growth and prosperity. Inflation and deflation, by contrast, hamper economic development. They complicate decision-making by consumers and producers, lead to misallocations of labour and capital, result in income and asset redistributions, and put the economically weak at a disadvantage.

By seeking to keep prices stable, the National Bank creates an environment in which the economy can fully exploit its production potential. The aim of the SNB's monetary policy is to ensure price stability in the medium and long term. Short-term price fluctuations, however, cannot be counteracted by monetary policy.

## Appropriate monetary conditions

To secure price stability, the SNB must provide appropriate monetary conditions. If interest rates remain too low for a lengthy period, the supply of money and credit to the economy will be too high, triggering an inordinate demand for goods and services. There is also the risk of excesses on the asset markets. Although such excesses boost production initially, bottlenecks occur over time and production capacity is stretched, causing a rise in the level of prices. Conversely, if interest rates are too high for a lengthy period, the supply of money and credit to the economy will be reduced, leading to a shortage of aggregate demand. This will have a dampening effect on the prices of goods and services.

## Taking economic activity into account

The economy is subject to numerous domestic and foreign shocks. These cause fluctuations in the business cycle which generate pressures on prices that are more or less pronounced. Such fluctuations are inevitable. Although monetary policy is medium and long-term in nature, it can nevertheless help to limit these fluctuations. The SNB faces highly diverse situations.

The most common cause of inflationary or deflationary phases is when aggregate demand for goods and services does not move in line with the economy's production capacity. Such situations can arise, for example, as a result of unforeseen developments in the international economy, major fluctuations in exchange rates, serious government budget problems or inappropriate money supply levels in the past. Inflationary pressures increase in phases of economic overheating and decrease when production capacity is not fully utilised. Thus, the National Bank must gradually restore price stability by tightening monetary policy in the first case and easing it in the latter. Consequently, monetary policy that is geared to price stability has a smoothing effect on aggregate demand and thus encourages steady economic development.

The situation is more complex when prices rise owing to shocks that increase firms' costs and cause them to curb production. A continuous rise in the oil price is an example of such a shock. In these circumstances, monetary policy must, on the one hand, make sure that the higher production costs do not give rise to an inflationary spiral, while, on the other, ensuring that the companies affected by the shocks are not overburdened. An overhasty restoration of price stability might have adverse effects on the business cycle and employment.

## **Numerous uncertainties**

Even though the SNB considers economic developments when taking monetary policy decisions, it cannot be expected to fine-tune the economy. There are too many uncertainties with respect to the cause and duration of the shocks that impair economic performance, as well as with respect to the transmission mechanisms, the time lag that elapses before monetary policy measures impact on the business cycle and prices, and the extent of their impact.

## **Monetary policy strategy**

The monetary policy strategy in force at the National Bank since 2000 consists of the following three elements: a definition of price stability, a medium-term inflation forecast and – at operational level – a target range for a reference interest rate, the three-month Swiss franc Libor (London Interbank Offered Rate).

## **Definition of price stability**

The SNB equates price stability with a rise in the national consumer price index (CPI) of less than 2% per annum. In so doing, it takes into consideration the fact that not every price increase is necessarily inflationary, and that inflation cannot be measured accurately. Measurement problems arise, for example, when the quality of goods and services improves. Such changes are not fully taken into account in the CPI calculation; as a result, measured inflation tends to be slightly overstated.

## **Purpose of inflation forecast**

The inflation forecast performs a dual function in the SNB's monetary policy strategy. While, on the one hand, it serves as the main indicator for the interest rate decision, on the other, it is also an important communication tool for the National Bank.

## **Quarterly publication of inflation forecast**

The SNB reviews its monetary policy on a regular basis to ensure that it is appropriate for the maintenance of price stability. With this in mind, it publishes a quarterly forecast on the development of inflation over the next three years. The period of three years corresponds more or less to the time required for the transmission of monetary policy stimuli to the economy. Forecasts over such a long horizon involve considerable uncertainties. However, by publishing a long-term forecast, the National Bank emphasises the need to adopt a forward-looking stance and to react at an early stage to any inflationary or deflationary threats.

The National Bank's inflation forecast is based on a scenario for global economic developments and on the assumption that the reference rate published at the same time as the forecast will remain constant over the entire three-year forecasting period. The forecast issued by the SNB thus maps the future development of prices based on a specific world economic scenario and an unchanged monetary policy in Switzerland. For this reason, it is not directly comparable with forecasts which incorporate expected monetary policy decisions.

## **Indicators upon which inflation forecast is based**

In the medium and long term, the price trend depends essentially on the supply of money. For this reason, the monetary aggregates and loans are important elements in a number of quantitative models used for forecasting inflation. As regards the path of inflation in the short term, indicators relating to economic developments, as well as exchange rates and commodities prices (crude oil), are generally of greater significance.

The SNB regularly issues statements on the development of the principal indicators factored into its inflation forecast. It provides details of the models it uses in a number of its publications.

## **Communicating through inflation forecast**

Since the inflation forecast published by the SNB takes the Governing Board's last interest rate decision into account, the probable course of future monetary policy can be deduced from the shape of the inflation curve. The inflation forecast is thus an important communication tool.

## **Review of monetary policy based on inflation forecast**

If the inflation forecast indicates a deviation from the range of price stability, an adjustment of monetary policy could prove necessary. Should inflation threaten to exceed 2% on a longer-term basis, the SNB would thus

consider tightening its monetary policy. Conversely, it would tend towards relaxation if there were a threat of deflation.

The SNB does not react mechanically to its inflation forecast. It also takes account of the general economic situation in its monetary policy decisions. If inflation temporarily exceeds the 2% ceiling as a result of one-off factors, such as a sudden surge in oil prices or strong exchange rate fluctuations, monetary policy does not necessarily need to be adjusted. The same applies to short-lived deflationary pressures.

### **Libor target range**

The National Bank implements its monetary policy by fixing a target range for the three-month Swiss franc Libor. The Libor is a reference interest rate in the interbank market for unsecured loans. It is a trimmed mean of the rates charged by 12 leading banks and is published daily by the British Bankers' Association. The National Bank publishes its target range regularly. As a rule, this range extends over 1 percentage point, and the SNB generally aims to keep the Libor in the middle of the range.

The SNB undertakes quarterly economic and monetary assessments at which it reviews its monetary policy. If circumstances so require, it will also adjust the Libor target range in between these quarterly assessments. It sets out the reasons for its decisions in press releases.

### **Monetary policy instruments**

Repo transactions (repo = repurchase agreement) are the main instrument used by the SNB to manage the money supply and the Libor. To increase liquidity and lower the Libor, the SNB buys securities from a commercial bank and credits the latter's sight deposit account with the countervalue. At the same time, the commercial bank undertakes to repurchase the securities at a later point in time. For the duration of the transaction, the commercial bank receives a secured Swiss franc loan, on which it pays interest (repo interest rate).

In addition to repos, the SNB can also make use of a number of supplementary monetary policy instruments for the purposes of managing the Libor, supplying the money market with liquidity and influencing risk premia on the money and capital markets. They include currency swaps, purchases of foreign exchange and purchases of Swiss franc bonds issued by domestic private sector borrowers. These instruments are generally only used in exceptional circumstances, for example if short-term interest rates are close to zero but there is a need for further monetary policy relaxation.

The National Bank regularly issues its own interest-bearing debt certificates. In this way, it can absorb large amounts of liquidity as necessary, thereby increasing its room for manoeuvre in liquidity management.