Monetary policy of the Swiss National Bank

1 Concept

Price stability and full use of production potential as goals of monetary policy

The National Bank has a mandate to conduct a monetary policy serving the overall interests of the country. Its monetary policy aims at maintaining price stability in the medium term and allowing the economy to make full use of its production potential. Stable prices are an important prerequisite for the smooth functioning of the economy. An excessive expansion of the supply of money would trigger an excessive demand for goods and services. Overall economic capacity would be stretched, causing prices to rise. An inadequate supply of money, by contrast, would hamper production; the economy would suffer losses of output and possibly a decline in the price level.

Taking into account cyclical fluctuations

Price stability as a goal does not imply that we do not take the state of economic activity into account. Our policy helps to smooth cyclical fluctuations. If economic capacity is not fully utilised, a monetary policy oriented to potential growth will lead to interest rate reductions. It thus serves to support demand and helps to remedy underutilisation. If, however, economic capacity is overstretched, a potential-oriented monetary policy triggers interest rate rises. This dampens demand and acts against cyclical overheating. Moreover, we retain the option of reacting to unexpected developments – such as strong shifts in exchange rates or in the demand for money – in order to keep any damage to the real economy as small as possible.

Distortion of the monetary base

In 1997 we encountered considerable difficulties in laying down and assessing our monetary policy. The monetary base, which comprises banknote circulation and the sight deposits of the commercial banks at the Swiss National Bank, expanded much more markedly than expected. We were therefore no longer able to rely on the medium-term target path which we had fixed for the monetary base. The monetary base had already exceeded this medium-term target path at the end of 1996, and the gap widened in 1997. Our monetary policy was, however, not nearly as expansionary as the development of the monetary base seemed to suggest (cf. pp. 31f.).

Increased reference to the broadly defined monetary aggregates, notably the money stock M_3

In view of these imponderables, we increasingly refer to the broadly defined monetary aggregates as additional indicators. These include the money stock M_1 (currency in circulation outside banks plus sight and other transaction deposits of the nonbank public), M_2 (money stock M_1 plus savings deposits) and M_3 (money stock M_2 plus time deposits). The aggregate M_3 is of primary importance to us since it is particularly relevant to the price level. As a rule, an excessive expansion of the money stock M_3 is followed, approximately three years later, by an acceleration in inflation. In contrast to numerous other industrial countries, where financial innovations and new payment techniques considerably diminish the indicator value of the monetary aggregates, a clear connection still exists in Switzerland between the development of the money stock and of prices. We therefore continue to aim at an expansion of the money stock in conformity with the growth of the production potential of an estimated 2% per annum and with price stability, defined as an annual rise of 1% in consumer prices.

Further indicators taken into account

The growth of the monetary aggregates sheds light mainly on the medium- and long-term price development. In the short term, the price level also reacts to other influences such as strong fluctuations of exchange rates and energy prices as well as the course of economic activity. Whenever such effects trigger a persistent inflationary or deflationary process, we have to take counter-measures. In laying down monetary policy, we therefore take into account the development of other factors, notably exchange rates and business cycle indicators, in addition to the monetary aggregates.

Fundamentals of monetary operations

We regulate the supply of money by influencing the amount of liquidity provided to the commercial banks, with a corresponding impact on money market rates. The commercial banks' liquidity consists largely of sight deposits held by them with the National Bank. By changing the supply of such sight deposits, we trigger interest rate adjustments by market participants in conformity with our monetary policy intentions. In the course of time, interest rate adjustments influence banknote circulation and the other monetary aggregates. Should any interest rate fluctuations not justified in a monetary policy context arise, we can exert a direct influence on the call money rate.

Implementation of monetary operations

Supply of and demand for bank liquidity are balanced in the call money market. We employ our monetary instruments for regulating the supply of sight deposits held at the National Bank. The banks' demand for such deposits is due to statutory liquidity requirements and to the need for operating funds for cashless payment transactions. Compared to daily liquidity movements within the banking system and between banks and nonbanks (including the Confederation and the postal service), the volume of sight deposit balances is small. We therefore operate regularly in the call money market in order to guarantee an adequate supply of liquidity.

Precedence of open market operations

We control the banks' sight deposit holdings with the National Bank by concluding transactions with the banks at market conditions. In order to maintain our freedom of action, we generally supply the banking system with liquidity for only a limited period through open market operations with swaps (by buying assets and at the same time selling them forward). We provide for basic liquidity requirements by means of foreign exchange swaps – Swiss francs against dollars with maturities ranging from 1–12 months – which, as a rule, are renewed after repayment. For supplying the market with liquidity in the short term, we usually transact swaps with debt register claims. We also make use of the opportunity to place short-term time deposits of the Confederation at banks. This enables us to adjust differences in liquidity between the banking system and the Confederation.

Securities lending and repurchase agreements as a new open market instrument

When the revised National Bank Law (Art. 14, Section 2) entered into force on 1 November 1997, securities lending and repurchase agreements (repos) were explicitly admitted as an open market instrument. Such agreements imply the purchase or sale of securities combined with a simultaneous forward sale or repurchase. With the repo a flexible domestic instrument is added to the range of monetary policy instruments; moreover, this offers advantages in steering risks. In cooperation with the banks and the National Bank, the Swiss Securities Clearing Corporation (SEGA) has prepared the way for the establishment of a Swiss repo market.

Instruments for money market operations in Sfr billions

	1996 Holding annual average	1996 Turnover	1997 Holding annual average	1997 Turnover
Foreign exchange swaps with maturities				
up to 1 month	0.1	0.5	0.5	2.1
over 1 month to 3 months	5.0	10.2	6.0	15.1
over 3 months to 12 months	3.7	25.9	1.1	14.7
Total	8.8	36.6	7.6	31.9
Money market debt register claims				
Swaps	0.9	78.9	0.9	79.8
Purchases and sales	0.8	4.0	0.6	2.8
Total	1.7	82.9	1.5	82.6
Federal Government funds				
New investments	3.9	74.7	4.8	77.8
Onward placements	2.2	62.2	4.3	79.3

Advances against securities in an emergency

If a bank has urgent liquidity needs which it cannot meet in the money market, it may obtain an advance against securities (Lombard loan) from the National Bank. A Lombard loan, however, is limited to the amount of the collateral provided in the form of securities and granted only at the official Lombard rate. We keep this rate constantly at two percentage points above the call money rate to discourage banks from using the Lombard loan as a permanent source of refinancing.

2 Implementation

Announcement of a continued generous monetary policy

At the end of 1996 we had announced that we would continue implementing a generous monetary policy. This happened against the background of an unfavourable economic situation and the possible implications of European monetary integration. We also referred to the strong growth of the money stock and emphasised the associated risks for price stability in the medium term.

Abundant supply of money

In 1997, in addition to the development of the money stock aggregates, we paid special attention to the exchange rates and the course of economic activity. Until late summer we kept the supply of money abundant in an endeavour to prevent a rise in money market rates and thus to counteract an appreciation of the Swiss franc. When the signs of a clear economic revival increased the question arose whether our generous monetary policy was still appropriate.

We aimed at normalising the situation and therefore permitted the rise in money market rates that set in after the German Bundesbank had lifted the repo rate in October. We took care, however, that the money market rates remained below 2%. Given the higher valuation of the Swiss franc in the wake of the financial crisis in East Asia, we again relaxed monetary policy in November. Money market rates subsequently declined.

Surprisingly strong expansion of the monetary base

While economic growth and inflation largely conformed to our expectations in 1997, the monetary base expanded more markedly than anticipated. This was partly due to the decline in interest rates on savings accounts, which fell from an average of just over 2% at the beginning of the year to 1.6% in October, thereby stimulating the demand for banknotes. To this was added a massive increase in the circulation of one-thousand-franc notes for reasons largely unknown. Since the banks' sight deposit holdings at the National Bank also rose somewhat more strongly than initially envisaged, the seasonally-adjusted monetary base expanded by 3.1% between the fourth quarter of 1996 and the fourth quarter of 1997, exceeding its medium-term target path by 3.6%.

Overstated degree of monetary expansion

The shift in the demand for banknotes led us to assume that the rise in the monetary base overstated the degree of monetary expansion. Similar shifts in demand had already been observed in 1996. These were due mainly to the endeavours of some banks to switch their liquid funds from postal cheque accounts to sight deposit accounts at the National Bank. The shifts which occurred in 1996 and 1997 explain to a considerable extent the deviation of the monetary base from the medium-term target path.

Normalisation in growth of the broadly defined monetary aggregates

Due to the uncertainties with which the interpretation of the development of the monetary base in the past two years was fraught, we set our sights increasingly on the broadly defined monetary aggregates, notably on M_3. At the end of 1995, the growth of M_3 had clearly accelerated as a result of our generous monetary policy. The strong expansion of M_3 gradually gave way to normal conditions in the course of 1997. In the fourth quarter, M3 exceeded the previous year's level by 3.5%. This growth rate is in a range which is in conformity with price stability in the long run.

Monetary policy expected to remain unchanged in 1998

No tightening of monetary policy is envisaged in 1998. The supply of money will be expanded as required to permit continued economic recovery without threatening price stability. Our assumption is that real gross domestic product will grow by approximately 2%, with the inflation rate amounting to around 1%. If growth and inflation are in keeping with our expectations, the demand for base money is likely to show a modest rise only and to move parallel to the target path. For the time being, therefore, there is no need to increase interest rates. If economic growth turned out to be distinctly slower than expected, interest rates would have to fall in order to prevent the money supply from expanding to a considerably lesser degree. Conversely, an unexpectedly strong economic recovery is likely to lead to a rise in interest rates.

Monetary base until December 1994

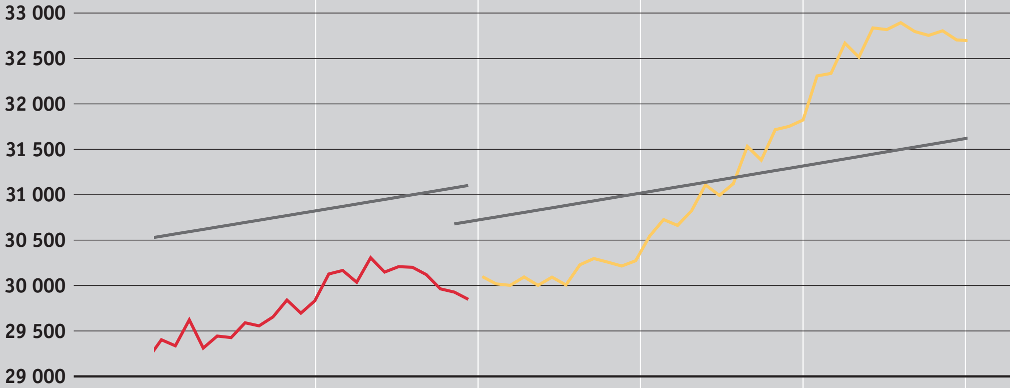
Monetary base as from January 1995

Target path of 1%

In millions of Swiss francs

From January 1995 onward, sight deposits held at the National Bank solely comprise the balances of domestic banks. Until end-1994 they included deposits of a few institutions not subject to the Federal Law on Banks and Savings Banks.

Seasonally-adjusted monetary base



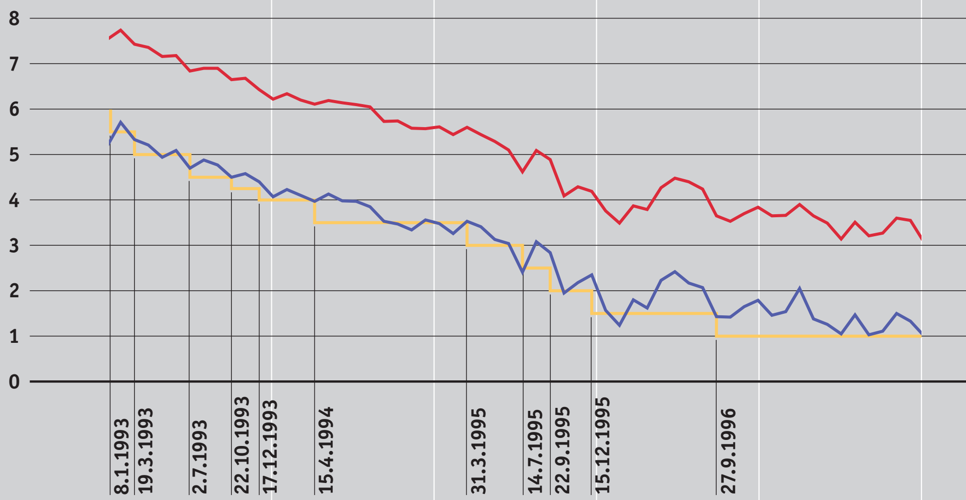
Discount rate

Lombard rate

Call money rate

In percent

Discount and Lombard rates



Beginning of the third stage of the Economic and Monetary Union – a factor of uncertainty

In spring 1998, the EU will decide on the beginning and the participants of the third stage of Economic and Monetary Union. It is conceivable that the transition to the third stage will trigger exchange rate fluctuations that are undesirable from the point of view of the economy as a whole. We would use the monetary means at our disposal to counter such fluctuations.

3 Partial revision of the National Bank Law

Message of the Federal Council

On 17 March 1997, the Federal Council submitted a message concerning the partial revision of the National Bank Law (NBL) to Parliament. The amendment to the law is based on the recommendations which a joint working group of the Federal Department of Finance and the National Bank formulated in December 1996 (cf. 89th Annual Report, pp. 41f.). It was designed as an immediate measure with the aim of granting the National Bank – on the present constitutional basis (Art. 39 Federal Constitution) – greater flexibility in investing its currency reserves more profitably by benefiting from innovations in the financial markets.

Changes in the scope of operations of the National Bank

This necessitated a number of changes in the scope of operations of the National Bank (Art. 14 NBL). Thus the statutory maximum maturity of twelve months for easily marketable debt certificates of foreign governments, international organisations and foreign banks was abolished in order to permit the National Bank to considerably extend the average maturity of foreign exchange reserves. Securities lending and repurchase agreements were explicitly included in the scope of operations of the National Bank. The National Bank was empowered to conclude derivatives transactions for the purpose of steering the market risks relating to foreign exchange reserves. It was furthermore authorised to actively administer its gold holdings by engaging in gold lending operations. Finally, the National Bank was exempted from direct federal tax (Art. 12 NBL).

Changed coverage for banknote circulation

The legal provisions specifying the constitutional coverage for banknotes by gold and short-term assets (Art. 39, para 7 Federal Constitution) were adapted to the changed conditions. The maximum maturity of foreign currency assets which may serve as cover for banknote circulation was brought in line with the maximum maturity applying to domestic assets and fixed at two years (Art. 19, para 1 NBL). As in gold lending the National Bank would run the risk of no longer complying with the coverage rules during the lending period, the gold coverage for banknote circulation was lowered from 40 percent to 25 percent (Art. 19, para 2 NBL).

Effective on 1 November 1997

The bill for the partial revision of the National Bank Law was passed by the National Council on 12 June 1997 and by the Council of States on 20 June 1997. The amendments to the Law became effective on 1 November 1997, after the deadline for the referendum had expired. The new legal basis for the administration of foreign exchange reserves should enable the National Bank to achieve considerably higher earnings in future.

1993 1994 1995 1996 1997

Monetary aggregates

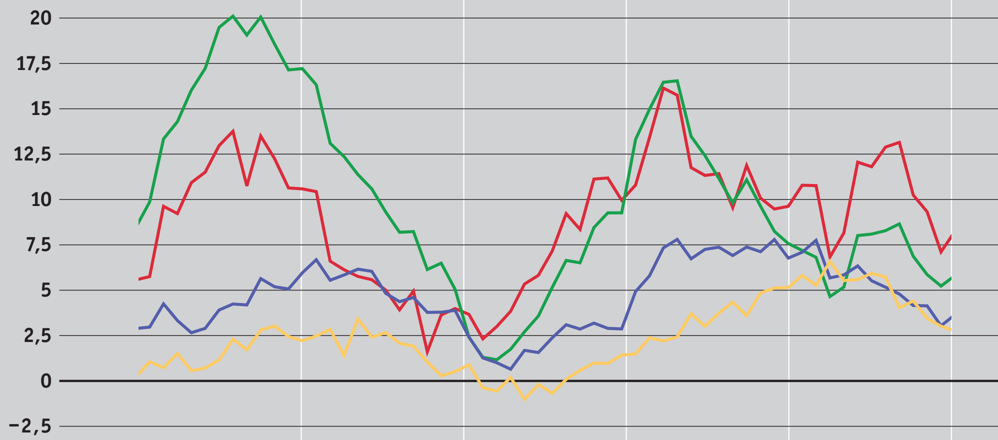
Monetary base

M1

M2

M3

Percentage change from previous year's level

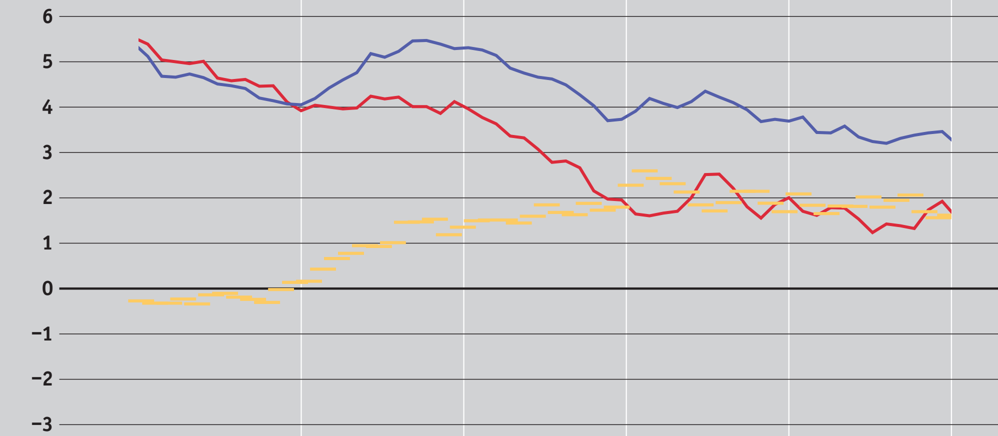


Money and capital market rates

Euromarket rate on three-month Swiss franc deposits, percent per annum

Yield on federal bonds, percent per annum

Differential in percentage points



1993 1994 1995 1996 1997

4 Reform of the monetary constitution

Mandate to a group of experts

Originally, the revision of the monetary constitution had been planned within the context of the overall reform of the Federal Constitution (cf. 89th Annual Report, p. 36). Two parliamentary initiatives, however, induced the Federal Council to expedite the reform of the coinage clause and the central bank clause (Arts. 38 and 39 Federal Constitution). By order of 18 April 1997, the head of the Federal Department of Finance set up a group of experts for the "Reform of the monetary order". The group of experts was commissioned to draft a message for a new monetary constitution and to study the statutory problems arising from the severance of the link between the Swiss franc and gold, giving due consideration to the company law regulations applying to the National Bank as well as to its organisational structure.

Report and draft of an article "Money and currency" in the Constitution

The group of experts fulfilled the first part of its mandate by drawing up a report which was presented to the public on 24 October 1997. The draft of a new article on "Money and currency" in the Constitution severs the legal link between the Swiss franc and gold, a tie that in actual practice has long since lost its relevance. The group of experts further suggested that the central bank's mandate, which has been defined in rather broad terms, should be specified in the Constitution by obligating the National Bank to orient its policy to the primary goal of price stability. As far as is possible without jeopardising this goal, the National Bank is to support the general economic policy of the government. The group of experts pointed out that the primary goal of price stability makes it binding upon the National Bank to combat inflation as well as to prevent deflation. It therefore holds the view that the priority of price stability does not constitute a downgrading of growth and employment targets under constitutional law. The clear obligation imposed on the central bank to maintain the purchasing power of money and the embodiment of the National Bank's independence in the Constitution are meant as an appropriate equivalent following the abolition of the gold standard. The group of experts took into account the general experience that central banks subject to direct state influence are usually less successful in preventing the inflationary financing of government deficits by means of the note press than central banks that are independent in the exercise of their mandate.

Release of gold reserves

In compliance with its mandate, the group of experts also investigated what level of monetary reserves was required for conducting monetary policy if the gold reserves, which have hitherto been immobilised, are to become normal and marketable central bank assets. It came to the conclusion that the required amount of monetary reserves depends principally on the size of the economy and the degree of a country's international involvement. A comparison of the National Bank's current monetary reserves with those of central banks in other countries similar to Switzerland in structure and size showed that the unhedged foreign exchange reserves held by the National Bank seem adequate in relation to gross domestic product. In order to make an effective contribution to the stability of the Swiss financial centre, the group of experts considered international reserves of at least Sfr 10 billion, over and above the unhedged foreign exchange reserves, to be necessary. Based on a cautious valuation, this would be equivalent to approximately 1,200 tonnes of gold. The group of experts proposed that the National Bank release 1,400 tonnes of fine gold from its stocks in order to make this national wealth available for other public purposes. This recommendation was made in an endeavour to avoid conflicts of interest between the National Bank as monetary authority, on the one hand, and as asset manager of the nation, on the other hand.

Comments of the Department of Finance and the National Bank

In his comments of 24 October 1997, the head of the Federal Department of Finance acknowledged the experts' report as a comprehensive assessment of monetary key questions. In agreement with the Governing Board of the National Bank, he announced a shift of emphasis in two points: The Department of Finance was planning to submit a proposal to the Federal Council for a broader definition of the central bank's mandate to include other economic policy goals in addition to the primary goal of price stability. With respect to a separation of surplus gold reserves, it intends, in principle, to follow the original concept which initially only provides for the possibility of releasing gold to the countervalue of Sfr 7 billion for financing a Swiss Foundation for Solidarity. The Department of Finance also announced that it would submit a message for a new monetary article to the Federal Council with all due speed.