1 Concept

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

The monetary policy of the National Bank aims at allowing the economy to make full use of its production capacity without jeopardising price stability in the medium term. 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 the National Bank does not take economic activity into account. Its policy helps to smooth cyclical fluctuations. If economic capacities are 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 capacities are overstretched, a potential-oriented monetary policy triggers interest rate rises. This dampens demand and acts against cyclical overheating. Moreover, the National Bank retains the option of reacting to unexpected developments – such as strong shifts in exchange rates or in the demand for money – in order to minimise damage to the real economy.

Monetary policy indicators

The National Bank uses indicators to determine whether a chosen monetary policy course is appropriate in view of the goal of price stability. In the event of a particularly close and stable connection between a specific indicator and the goal of price stability the indicator may be used as an intermediate monetary policy target. The monetary base, which comprises banknote circulation and the banks' sight deposits at the National Bank, fulfilled this condition for a long time. For this reason, the National Bank set a medium-term target path as a guideline for the monetary base. This indicated the direction in which the National Bank should change its supply of base money.

Distortion of the monetary base

In 1997 and 1998 it became clear that the monetary base is no longer a reliable monetary policy indicator. Its two components, banknote circulation and the banks' sight deposits, exhibited strong fluctuations that were not foreseeable. Overall, the monetary base rose much more steeply in both years than forecast by the National Bank, thus overstating the degree of expansion of monetary policy.

Increased reference to the money stock M_3 as a long-term indicator

In view of this uncertainty, the National Bank increasingly referred to the money stock M_3 as an additional monetary indicator. The money stock M_3 is the broadest monetary aggregate calculated by the National Bank. It comprises currency circulation, sight and other transaction deposits of the nonbank public plus savings deposits and time deposits at the banks. The development of M_3 is particularly relevant to the price level in the long term. As a rule, an excessive expansion of the money stock M_3 is followed, approximately three years later, by an acceleration in inflation.

Further indicators taken into account in the short term

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 influences threaten to set off a persistent inflationary or deflationary process, the National Bank has to take counter-measures. In laying down monetary policy, it therefore also takes into account the development of other factors, notably exchange rates and the business cycle, in addition to the monetary aggregates.

Fundamentals of monetary operations

The National Bank regulates the supply of money by concluding financial transactions with the commercial banks. In this way, it influences the amount of liquidity provided to the banking system and the 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, the National Bank triggers interest rate adjustments by market participants in conformity with its monetary policy intentions. In the course of time, interest rate adjustments influence banknote circulation and the monetary aggregates.

Implementation of monetary operations

The National Bank employs its monetary instruments for regulating the supply of sight deposits held with it. 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 Swiss Post – the volume of sight deposit balances is small. The National Bank therefore operates regularly in the call money market in order to guarantee an adequate supply of liquidity.

Precedence of open market policy

The National Bank controls the banks' sight deposit holdings with it by concluding transactions with the banks at market conditions. In order to maintain its freedom of action, it generally supplies the banking system with liquidity for only a limited period through open market operations with repos and swaps (by buying assets and at the same time selling them forward).

Repo as a new open market instrument

With the repo a flexible domestic instrument has been added to the range of monetary instruments. In a repo transaction (repurchase agreement), the cash taker sells his own or borrowed securities to the cash provider. At the same time, it is agreed that the cash taker will repurchase securities of the same type and quantity from the cash provider at a later date. Even though, in a repo transaction, ownership in the securities is transferred to the cash provider, from an economic point of view this is considered to be a secured loan. The counterparty risk and the market risk are reduced by the securities serving as collateral and by daily margin transfers in the case of changes in the price of these securities. In the course of 1998, repo transactions superseded foreign exchange swaps as the major monetary instrument. Swaps with federal money market debt register claims were completely replaced by repos within a short time. Maturities of repos are between one day and several months. The National Bank fixes the repo rate depending on the maturity of the executed transactions; the rate is in conformity with market conditions (cf. p. 28).

In addition to repo transactions, the National Bank also employs foreign exchange swaps for regulating the money market. Until mid-1998, the National Bank exclusively completed swaps against dollars. Since then, it has also regularly transacted swaps against D-marks. Maturities for swaps range from one to twelve months.

Foreign exchange swaps

For the short-term steering of liquidity, the National Bank also makes use of the possibility to place time deposits held with it by the Confederation at the banks. In this way, it can balance the shifts in liquidity between the banking system and the Confederation.

Onward placement of time deposits of the Confederation

Instruments for money market operations in Sfr billions

	1997		1998	
	Holding annual average	Turnover	Holding average[3]	Turnover[3]
Repo transactions[1]	–	–	9.7	313.8
Foreign exchange swaps with maturities				
up to 1 month	0.5	2.1	0.1	1.3
over 1 month to 3 months	6.0	15.1	3.4	10.3
over 3 months to 12 months	1.1	14.7	2.6	16.3
Total	7.6	31.9	6.1	27.9
Money market debt register claims[2]				
Swaps	0.9	78.9	0.4	43.7
Purchases and sales	0.6	2.8	0.1	0.4
Total	1.5	82.6	0.5	44.1
Federal Government funds				
New investments	4.8	77.8	12.1	128.4
Onward placements	4.3	79.3	5.1	74.9

1 since 20 April 1998

2 until 30 April 1998

3 Repo transactions: 20 April 1998 – 31 December 1998
Money market debt register claims: 1 January 1998 until 30 April 1998
Foreign exchange swaps, Federal Government funds: entire year

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. The National Bank keeps 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.

Advances against securities in an emergency

2 Implementation

Announcement of an unchanged monetary policy

At the end of 1997 the National Bank had announced that it would continue implementing a generous monetary policy. It expected short-term interest rates to fluctuate on a low level of less than 2%. The supply of money was to be adjusted to the increase in demand, with the National Bank expecting real economic growth at the rate of 2% and an inflation rate of 1%.

Consideration given to economic activity and the exchange rate

Despite the worsening international economic situation business activity in 1998 largely fulfilled the expectations of the National Bank. The growth of real gross domestic product corresponded closely to the anticipated rate, and the inflation rate was only marginally overestimated. In the course of the year, however, sentiment notably in the export sector deteriorated, and medium-term growth forecasts were adjusted downwards both in Switzerland and abroad. When the Swiss franc came under upward pressure in the foreign exchange markets, first in February and then in September and October, the National Bank reacted flexibly and provided ample liquidity to the market.

Strong fluctuations in sight deposits

The sight deposits held by the commercial banks at the National Bank rose markedly from the previous year's level. In the course of the year, moreover, they underwent considerable fluctuations. This reflected the sometimes marked expansion in liquidity with which the National Bank counteracted an excessive appreciation of the Swiss franc. The merger between Swiss Bank Corporation and Union Bank of Switzerland into UBS LTD and the creation of a repo market in Switzerland likewise influenced the banks' liquidity behaviour. Furthermore, the turbulences in the financial markets had an effect on the demand for sight deposits by inducing individual banks temporarily to substantially increase their liquid funds at the National Bank.

Expansion of the monetary base

The expansion of sight deposits caused the seasonally-adjusted monetary base to rise more markedly than expected. Between the fourth quarter of 1997 and the fourth quarter of 1998 it grew by 5.2%, thus exceeding the medium-term target path by 7.9%. Due to the shift in the demand for banknotes ascertained in the previous years and the switch by various banks of their liquid funds from postal cheque accounts to sight deposit accounts, the National Bank continues to assume that the gap between the monetary base and the medium-term target path overstates the degree of monetary expansion.

Weak growth of the money stock M_3

The money stock M_3, which the National Bank had increasingly used as an indicator in the past two years, showed only a slight rise in 1998. This reflected the continued slow growth of bank loans. In the fourth quarter, M_3 exceeded the previous year's level by 0.9%.

Monetary policy expected to remain unchanged in 1999

The National Bank expects real economic growth to amount to 1.5% in 1999. The utilisation of overall production capacities is likely to remain moderate and not to lead to increased inflationary pressure. The National Bank assumes the average annual inflation rate will be approximately 1%, half of which will be attributable to the rise in value-added tax effective from 1 January 1999. In these circumstances, there is currently no need to raise interest rates. Given the stable interest rates, the money stock M_3 should expand more markedly in 1999 than in 1998. The growth of M_3 will, however, remain within limits that are in conformity with price stability in the long term.

Seasonally-adjusted monetary base

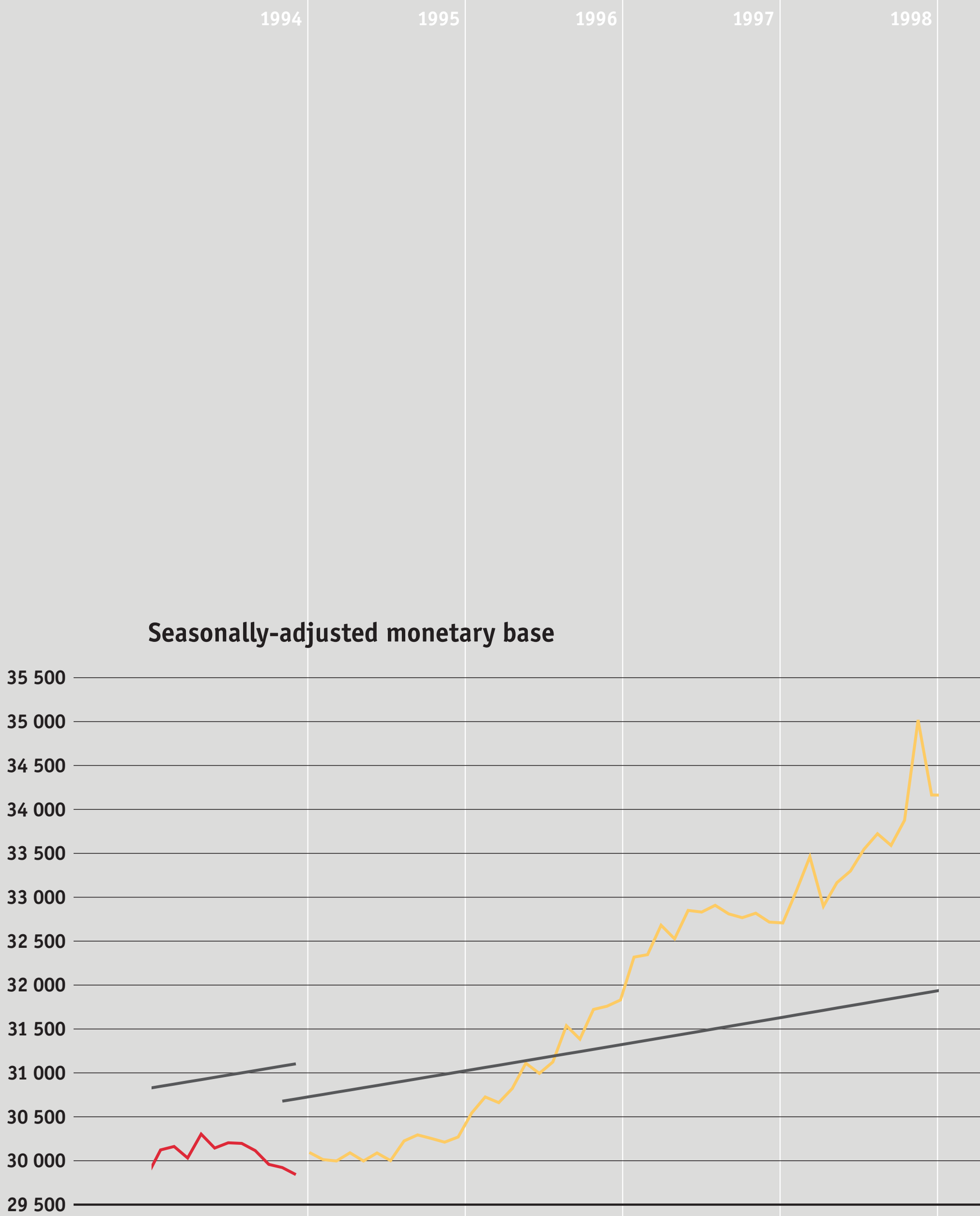
Monetary base until December 1994

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.



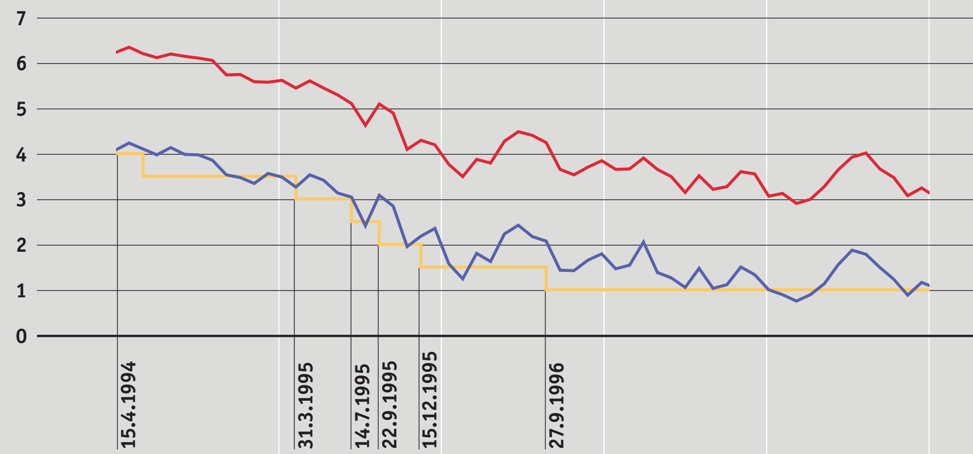
Discount and Lombard rates

Discount rate

Lombard rate

Call money rate

In percent.



Launch of the euro

The launch of the euro is of crucial importance for the Swiss economy. The new European currency was well received by the markets. In the first quarter of 1999, the exchange rate fluctuations of the Swiss franc against the euro remained within narrow limits. Should this change in future, the National Bank will be ready to combat any detrimental development with the monetary means at its disposal.

3 Reform of the monetary constitution

Conferential consultation procedure on the reform concept

The reform of the Swiss monetary constitution had been prepared by a group of experts consisting of representatives of the Confederation, the National Bank and academic circles (cf. 90th Annual Report, p. 36). In January 1998, the Federal Council held conferential consultations with the cantons, political parties, and employer and employee organisations on the draft of a new monetary article in the Federal Constitution. These discussions resulted in a basic general agreement on the reform concept submitted. However, opinions on the formulation of the central bank mandate and on the treatment of the monetary reserves no longer needed for monetary policy purposes partly diverged. Certain circles demanded that the National Bank should be held accountable for its policy as a counterbalance to its independence.

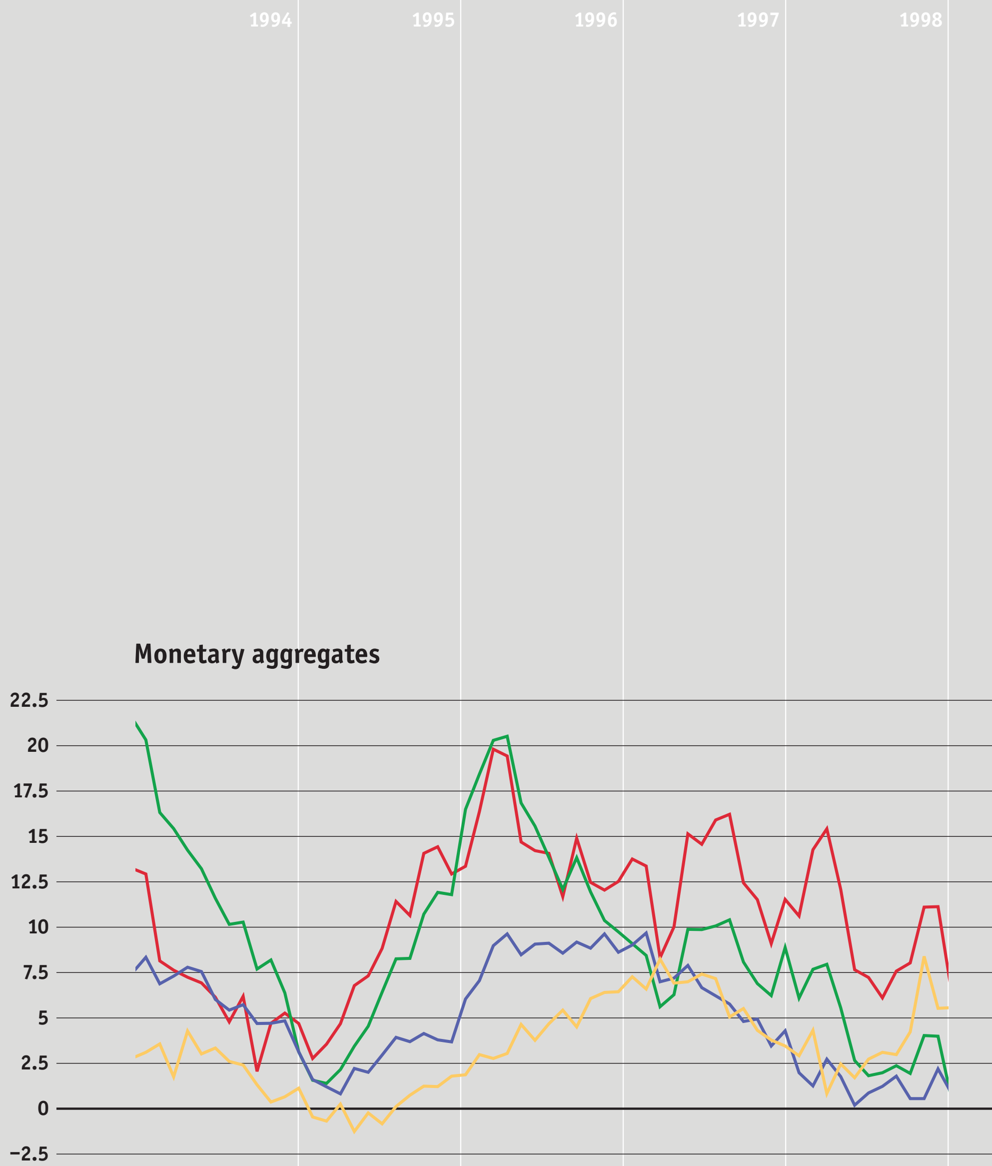
Message concerning the new monetary article

On 27 May 1998, the Federal Council submitted a message concerning a new monetary article in the Federal Constitution to parliament. The proposed monetary article severs the legal link between the Swiss franc and gold. It replaces the central bank article and the coinage article in the Federal Constitution by a modern monetary order largely in conformity with European Community Law. The National Bank is given a clearly defined mandate: it is to conduct monetary policy serving the interests of the country as a whole, with the goal of price stability being given priority. The National Bank is to be independent in fulfilling its mandate. In addition to the principle of independence, the National Bank's obligation to be accountable to the federal authorities and the public for its monetary policy is also to be embodied in the Constitution. Finally, the proposed article in the Constitution obliges the National Bank to hold the necessary monetary reserves for fulfilling its mandate, a part of them in gold. Since the National Bank will have more monetary reserves at its disposal after the severance of the Swiss franc's link to gold than it needs for the conduct of monetary policy, approximately half of its gold holdings of 2,590 tonnes can be made available for other public purposes. It is the intention of the Federal Council that a part of the non-utilised reserves are to be used for financing the Swiss Foundation for Solidarity.

Consultation by committee

The Committee for Economic Activity and Taxes of the National Council dealt in detail with the proposed article in the Constitution in the summer and early autumn. It adopted, without any changes, the Federal Council's proposals for the embodiment, under constitutional law, of the Confederation's monetary sovereignty, for the regulation of the banknote and coinage prerogatives and for the formulation of the central bank's mandate, and specified the National Bank's accountability. Moreover, it decided in favour of a regulation requiring

Monetary aggregates



Monetary base

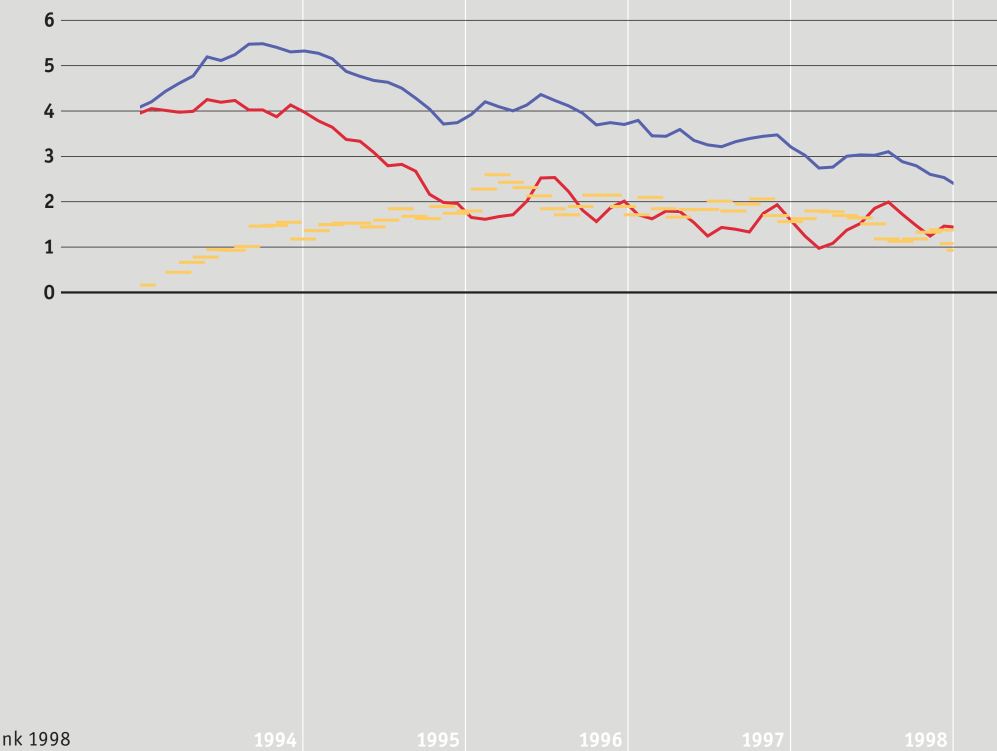
M1

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

the National Bank to hold the necessary monetary reserves for exercising its mandate and to remit two-thirds of its net profit to the cantons and one-third to the Confederation. Conversely, the committee regarded a release by the National Bank of monetary reserves not required for the conduct of monetary policy only admissible if an explicit constitutional basis is created for deviating from the profit distribution rule laid down under constitutional law. Accordingly, it added a relevant paragraph to the constitutional article proposed by the Federal Council.

Consultation in the National Council

The National Council was the first chamber of parliament to deal with the new monetary article in the Constitution in its December session. It fully approved the version submitted by the Committee for Economic Activity and Taxes.

Relation to renewal of the Federal Constitution

In the December session the National Council and Council of States also settled the last remaining divergences in the project of renewal of the Federal Constitution (comprehensive revision). The renewed Federal Constitution now contains a monetary article (Art. 99) which severs the Swiss franc's link to gold and embodies the National Bank's independence in the Constitution (cf. 89th Annual Report, p. 36). The newly introduced article in the Constitution differs from the separate reform of the monetary order in that the National Bank's mandate is defined as in the past, i.e. that no orientation of monetary policy to the primary goal of price stability and no accountability by the National Bank have been envisaged. Moreover, the newly introduced monetary article contains no reservation to deviate from the current profit distribution regulation. The National Bank holds the view that the renewed Constitution therefore does not offer a sufficient basis for releasing monetary reserves no longer required by the central bank and making them available for other public purposes (cf. p. 56).

4 Draft of a Federal law on currency and payment instruments

First step towards the implementation of the new monetary order

The group of experts for the "Reform of the monetary order" set up in April 1997 had been commissioned by the head of the Federal Department of Finance, after drafting a new monetary constitution, to study any statutory problems in the context of the reform of the Swiss monetary order (cf. 90th Annual Report, p. 36). In 1998, the group of experts drafted the provisions of federal legislation which were to replace the regulations on the Swiss currency's link with gold. The group of experts proposed that this should take the form of a new Federal law on currency and payment instruments.

Opening of the consultation procedure on the draft law

The draft law provides a definition of the Swiss currency unit and describes the instruments serving as legal tender. It fully replaces the current Coinage Act and takes over the regulations concerning banknotes from the National Bank Law. This regulatory approach will in due course permit the National Bank Law to be concentrated on National Bank functions other than the distribution of currency, on its monetary policy instruments and on organisational provisions. It has become necessary to introduce a new law as – on a constitutional level – "money and currency" will no longer be divided into a coinage article and a central bank article. The current approach to federal legislation – Coinage Act in fulfilment of Art. 38 of the Federal Constitution, National Bank Law in fulfilment of Art. 39 of the Federal Constitution – has become outdated. Instead it seems reasonable to incorporate all the characteristics of currency and legally accepted money that are of public relevance in business transactions in a single federal law. The Federal Council opened the consultation procedure for this draft at the end of October 1998.

Sight deposits at the Swiss National Bank as new legal tender

The draft law is divided into six sections. Aside from Swiss coins and banknotes, it now also designates sight deposits at the Swiss National Bank as legal tender. Payment instruments serving as legal tender must be accepted in satisfaction of a debt. While banknotes must be accepted in payment by everyone to an unlimited extent, the obligation to accept sight deposits as payment is restricted to holders of a sight deposit account at the National Bank. As in the past, the coins in circulation issued by the Confederation must be accepted in amounts of up to 100 pieces; the obligation to accept coins serving as an investment vehicle or commemorative coins at nominal value, however, will in future apply to the National Bank and the public cash counters of the Confederation only. The criminal norms for the protection of the coin and banknote issuing privilege are likewise embodied in the draft.