Monetary policy of the Swiss National Bank

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 potential 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 inordinate 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.

1980–1999: targets for the monetary base

The National Bank needs indicators to determine whether a chosen monetary policy course is appropriate in view of the goal of price stability. Between 1980 and 1999, it used the seasonally-adjusted monetary base as monetary target and as an indicator. Until the end of 1989, it regularly set annual targets for the growth of the monetary base. At the end of 1990, it began fixing a medium-term growth target for this aggregate. By changing to a medium-term strategy, the National Bank took account of the fact that the development of the money supply influences the course of inflation mainly in the medium and long term. The medium-term strategy provided the National Bank with sufficient leeway, when planning its monetary policy, to take into consideration further indicators such as the economic situation and the exchange rate, which are relevant, in the short term, for the development of inflation.

Distortion of the monetary base

At the end of 1996, the indicator value of the monetary base increasingly began to lose its significance, with banknote circulation rising considerably faster than anticipated. This induced the National Bank to devote more attention to other indicators. It particularly set its sights on the economic situation, the exchange rate and the broadly defined money stock M_3, which comprises currency in circulation, sight and other transaction deposits of the nonbank public plus savings deposits and time deposits.

Adjustment of the monetary policy strategy

With the second five-year period for the medium-term money supply target nearing its end and given the continually distorted indicator value of the monetary base, the National Bank fundamentally reviewed its monetary policy concept. It decided to adjust this concept as from the beginning of 2000. The main emphasis is on three changes: first, the National Bank explicitly states what, from its vantage point, constitutes price stability in order to improve the transparency of its monetary policy in this respect. Second, it bases its monetary policy decisions on a medium-term inflation forecast, and, third, it sets an operational target range for the three-month Swiss franc interest rate. In future, the National Bank will no longer publish a growth target for a monetary aggregate. The money stock M_3, however, will continue to play a major role as a monetary policy indicator.

Definition of price stability

The National Bank considers price stability to be achieved with an annual inflation rate of less than 2% measured by the national consumer price index. This particularly also takes account of the fact that inflation cannot be measured with complete accuracy. Measuring problems may, for example, arise when the quality of goods and services changes. Such changes tend to overstate the actual inflation rate somewhat. For this reason, the money supply targets fixed by the National Bank in earlier years had already allowed room for a limited price increase.

Inevitable price fluctuations

The National Bank must reckon with price fluctuations in the short term that can only be influenced to a limited extent. As a rule, these derive from unexpected swings in oil and other import prices as well as from major exchange rate changes. As long as such price fluctuations do not lead to a sustained inflationary or deflationary development, the Swiss economy is able to cope with them. The National Bank will resolutely continue to counter any persistent inflationary or deflationary developments.

Inflation forecast

At year-end, the National Bank regularly publishes a forecast for the development of inflation in the three ensuing years. The period of three years takes account of the time required for the transmission of monetary stimuli. Forecasts over such a time horizon are difficult to make and fraught with considerable uncertainties. By publishing a forecast for the following three years, however, the National Bank emphasises the need to adopt a forward-looking stance and to react at an early stage to any threats to price stability.

Indicators of relevance to the inflation forecast

In the long term, price development depends to a decisive degree on the course of the monetary aggregates. Notably the money stock M_3 therefore remains a useful indicator. In the short term, by contrast, other indicators of the development of inflation are significant. Most important among them are general economic development and exchange rates. The National Bank will comment the development of major monetary policy indicators of relevance to the inflation forecast on a regular basis.

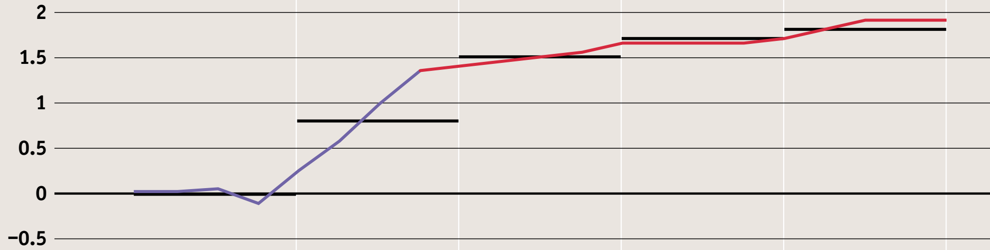
Adjustment of monetary policy based on the inflation forecast

If the inflation forecast deviates from price stability as defined by the National Bank, monetary policy has to be adjusted. Should inflation threaten to exceed the range deemed compatible with price stability, the National Bank will tighten the monetary reins. On the other hand, it is ready to relax the monetary reins if there is a danger of inflation falling below this range.

New steering concept for the money market – target range for the three-month rate

The new monetary policy concept leads to adjustments in steering the money market. In implementing its monetary policy, the National Bank is oriented to the interest rate level in the money market rather than the amount of liquidity. As a reference interest rate it uses the three-month Libor (Libor: London Interbank Offered Rate), the economically most important money market rate for Swiss franc investments. It fixes a target range for the three-month Libor with a spread of one percentage point, which it publishes regularly. While the National Bank communicates its long-term monetary policy course with the inflation forecast, it announces its short-term intentions with the location of the target range. The National Bank as a rule checks the target range on a quarterly basis and gives reasons for any changes. Furthermore, the National Bank announces in what area within the target range it expects the three-month Libor to be.

Inflation forecast



Inflation

Forecast

Average annual inflation:
2000: 1.5%
2001: 1.7%
2002: 1.8%

Change in the national consumer price index in percent compared to the previous year's figure.

Discount rate no longer to be fixed

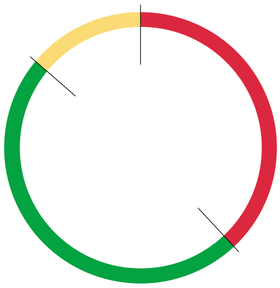
The innovations in the field of money market steering guarantee a high degree of transparency, and the National Bank has thus decided not to fix a discount rate from January 2000 onwards. Since 1993, it has not transacted any discount operations. The discount rate, however, still had a certain significance as a signalling device. In the new steering concept, this, too, has been lost, with the target range for Libor assuming this role. The rules governing the Lombard rate remain unchanged.

Steering technique

As a rule, the National Bank influences the Libor indirectly via short-term repo transactions. Any undesirable upturns in interest rates can be corrected by injecting more liquidity or, conversely, by draining liquidity, an upward movement of interest rates can be induced. The liquid funds of commercial banks in Swiss francs consists largely of sight deposits held with the National Bank. The banks' demand for sight deposits derives from statutory liquidity regulations; since intraday liquidity has been introduced (cf. below), demand for sight deposits stemming from cashless payment transactions has all but ceased. Holdings of sight deposits are small, measured by daily payments. Besides, the National Bank, by concluding open-market operations on a repo or foreign exchange swap basis (purchase of assets and simultaneous forward resale) generally provides the banking system with short-term liquidity only. In this environment, minor random influences can lead to strong fluctuations in the level of sight deposits and in call money rates. In order to even out these movements, the National Bank operates in the money market almost daily.

Repos as the major monetary policy instrument

Repo transactions are the National Bank's major monetary policy instrument. In a repo transaction, 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. Accordingly, the cash taker pays the cash provider interest for the term of the repo. 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. Maturities of repos are between one day and several months. The National Bank fixes the repo rates depending on market conditions and the maturity of the executed transactions. Fluctuations in repo rates, however, frequently have no connection with the monetary policy course, but rather, among other things, with the distribution of liquidity in the system.



Collateral from repo transactions
in percent

CHF bonds of domestic borrowers 38

CHF bonds of foreign borrowers 48

Euro bonds 14

Total: Sfr 28.1 billion.
End 1999

Repo rates and Libor

Repo rates cannot be directly compared with Libor. Libor tends to be higher for two reasons. On the one hand, it usually applies to maturities that are longer than those of repo transactions, on the other hand, it is based on unsecured credits between banks. It thus contains a credit risk premium, whereas repo rates are riskless interest rates since repos are backed by securities.

Foreign exchange swaps

Aside from repo transactions, the National Bank also employs foreign exchange swaps for regulating the money market. Until mid-1998, it exclusively completed swaps against dollars. Since then, it has also transacted swaps against D-marks and euros. As a rule, maturities for swaps range from one to six months.

Onward placement of time deposits of the Confederation

For the short-term steering of liquidity, the National Bank also has the possibility to place time deposits held with it by the Confederation at the banks for account of the Confederation. In this way, it can balance the shifts in liquidity between the banking system and the Confederation. In 1999, however, this instrument was rarely used; the National Bank usually balanced such shifts in the context of its repo transactions with the banks.

Provision of intraday liquidity

At the beginning of October 1999, the National Bank began putting interest-free liquidity at the banks' disposal during the day. These liquid funds are offered in the form of repo transactions. If a bank fails to repay the liquidity on the same business day, it becomes liable to pay interest at a rate clearly in excess of the Lombard rate. In launching this instrument, the National Bank followed the example of other central banks that use intraday liquidity to facilitate the processing of payment transactions. The innovation does not adversely affect monetary policy. The liquidity provided during the day may not be used to meet statutory liquidity requirements. These are based on the figures at the end of a business day, i. e. they are calculated after repayment of the intraday liquidity.

Instruments for money market operations in Sfr billions

	1998 Holding Average[3]	1998 Turnover[3]	1999 Holding Average	1999 Turnover
Repo transactions [1]	9.7	313.8	16.9	722.9
Foreign exchange swaps	6.1	27.9	4.8	24.4
Money market debt register claims[2]				
Swaps	0.4	43.7		
Purchases and sales	0.1	0.4		
Total	0.5	44.1		
Federal Government funds[4]				
New investments	12.1	128.4	12.1	66.7
Onward placements	5.1	74.9	1.0	8.8
Swiss Post funds				
New investments			5.7	177.8
Onward placements			0.0	7.0

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

4 until end-1998: including Swiss Post investments

Advances against securities in an emergency

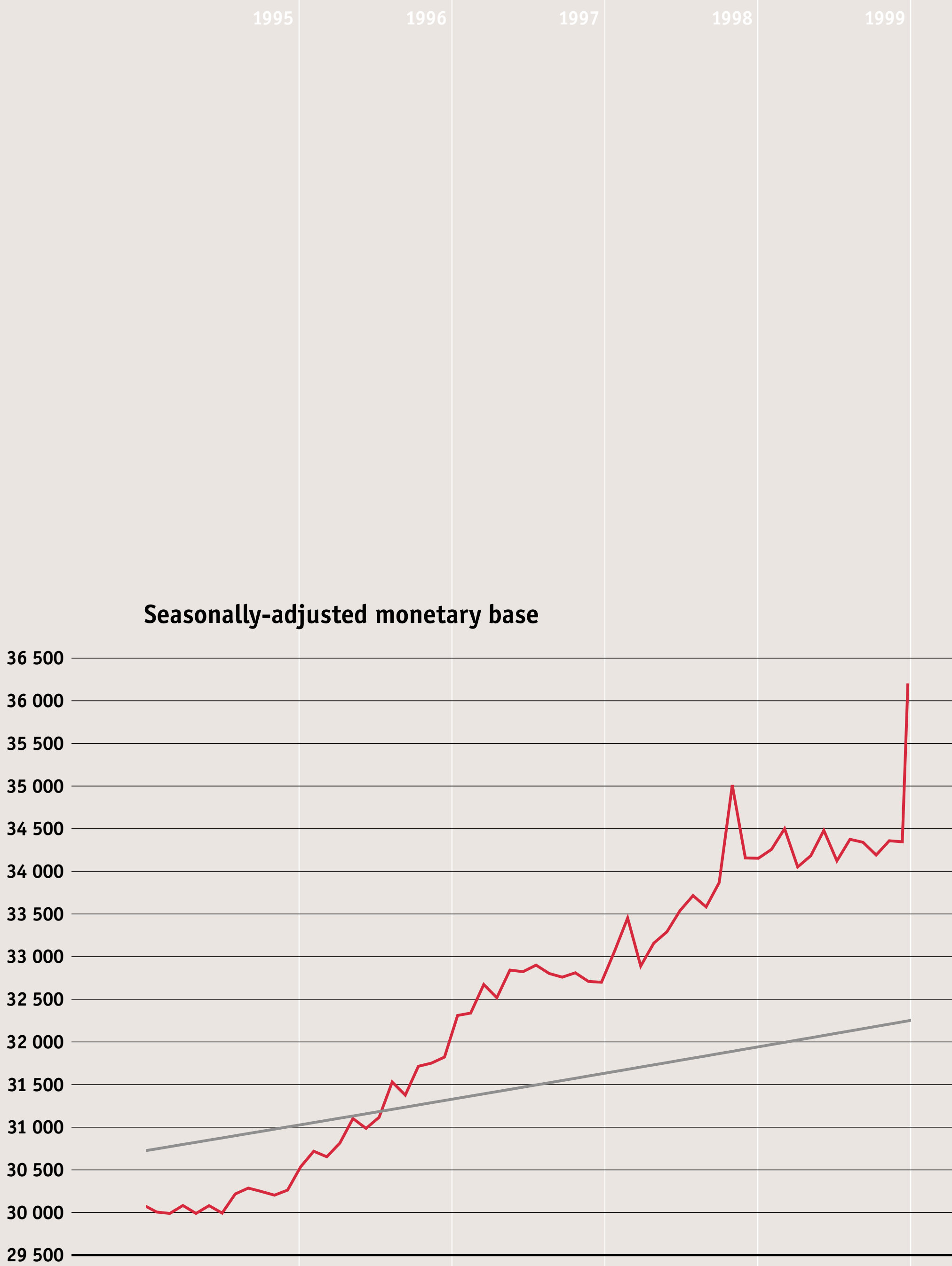
If a bank has urgent liquidity needs which it cannot meet in the money market, it may obtain an advance against securities (Lombard loan) from the National Bank. A Lombard loan, however, is limited to the amount of the collateral provided in the form of securities and granted only at the official Lombard rate. 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.

Seasonally-adjusted monetary base

Monetary base

Target path of 1%

In millions of Swiss francs.



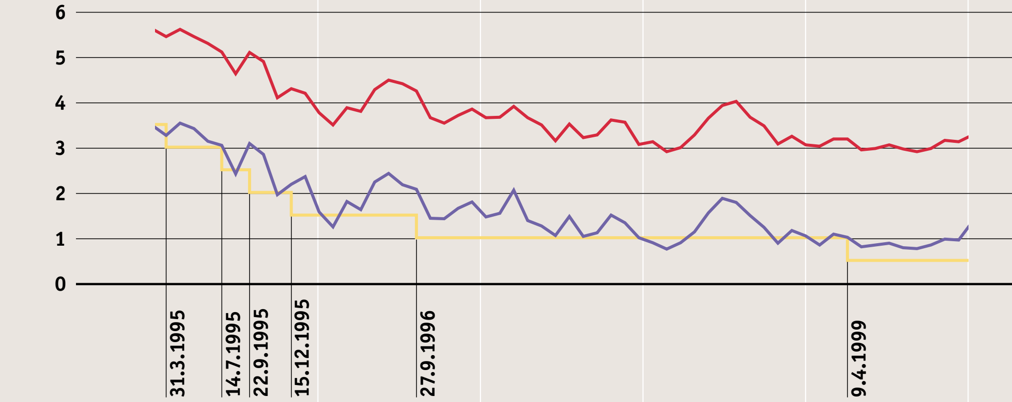
Discount and Lombard rates

Discount rate

Lombard rate

Call money rate

In percent.



2 Implementation

Announcement of an unchanged monetary policy

At the end of 1998, the National Bank had announced that it would continue implementing a basically generous monetary policy in 1999. In the wake of the problems in East Asia and the anticipated slowdown in growth in the United States it expected economic activity in Western Europe to weaken. For Switzerland, it forecast real economic growth of 1.5% and a rise in inflation to 1%. Furthermore, it indicated that with its planned monetary policy it also intended to take account of the uncertainties associated with the introduction of the euro.

Economic revival – smooth launch of the euro

Economic growth and inflation in 1999 came close to the expectations of the National Bank. Though business activity was still weak at the start of the year, this was soon followed by a marked recovery. The euro was launched without a hitch. In the first few months of the year, the National Bank strove to keep the Swiss franc exchange rate against the euro as stable as possible. In the second half of the year, however, the exchange rate still kept within a very narrow band. This was due not least to the fact that the economic situation was then similar in Switzerland and the countries of the euro area.

On average, slightly lower call money rates

The implementation of monetary policy was reflected by the course of call money rates. Their annual average was somewhat below the previous year's level. As from 9 April, the National Bank lowered the discount rate by 0.5 percentage point to 0.5%. This step went hand in hand with the lowering of interest rates by the ECB. Swiss money market rates fell in the wake of this interest rate reduction, only to rise again in the second half of September. Long-term money market rates were to some extent characterised by expectations of a liquidity bottleneck at the end of the year. The National Bank did not react to this increase in interest rates since the pickup in economic activity also tended to add to the danger of inflation. Nevertheless, it left the discount rate unchanged at 0.5%.

Declining sight deposits

The sight deposits held by the commercial banks at the National Bank declined substantially from the previous year's level. This fall is due, on the one hand, to the marked temporary expansion of sight deposits in October 1998, when the National Bank had provided the money market with additional liquidity in order to counteract an undesirable appreciation of the Swiss franc. On the other hand, it reflects the generally declining trend in the banks' demand for sight deposits. This was partly a consequence of the merger between Swiss Bank Corporation and Union Bank of Switzerland to form the UBS. Other factors that had the effect of reducing the demand for sight deposits are the introduction of intraday liquidity by the National Bank and the steady expansion of repo business which, in contrast to traditional interbank credits, does not require risk backing in the form of liquid funds.

No end-of-year problems

The year-end settlement proceeded smoothly despite the critical change of date. The National Bank had made it known at an early stage that it would fulfil any liquidity requirements in excess of the level that was usual at this time of year. It concluded several forward-forward repos and gave the banks an opportunity to temporarily raise their Lombard limits. It also increased its stocks of banknotes in order to be able to meet even a massive rise in the demand for banknotes.

Monetary aggregates

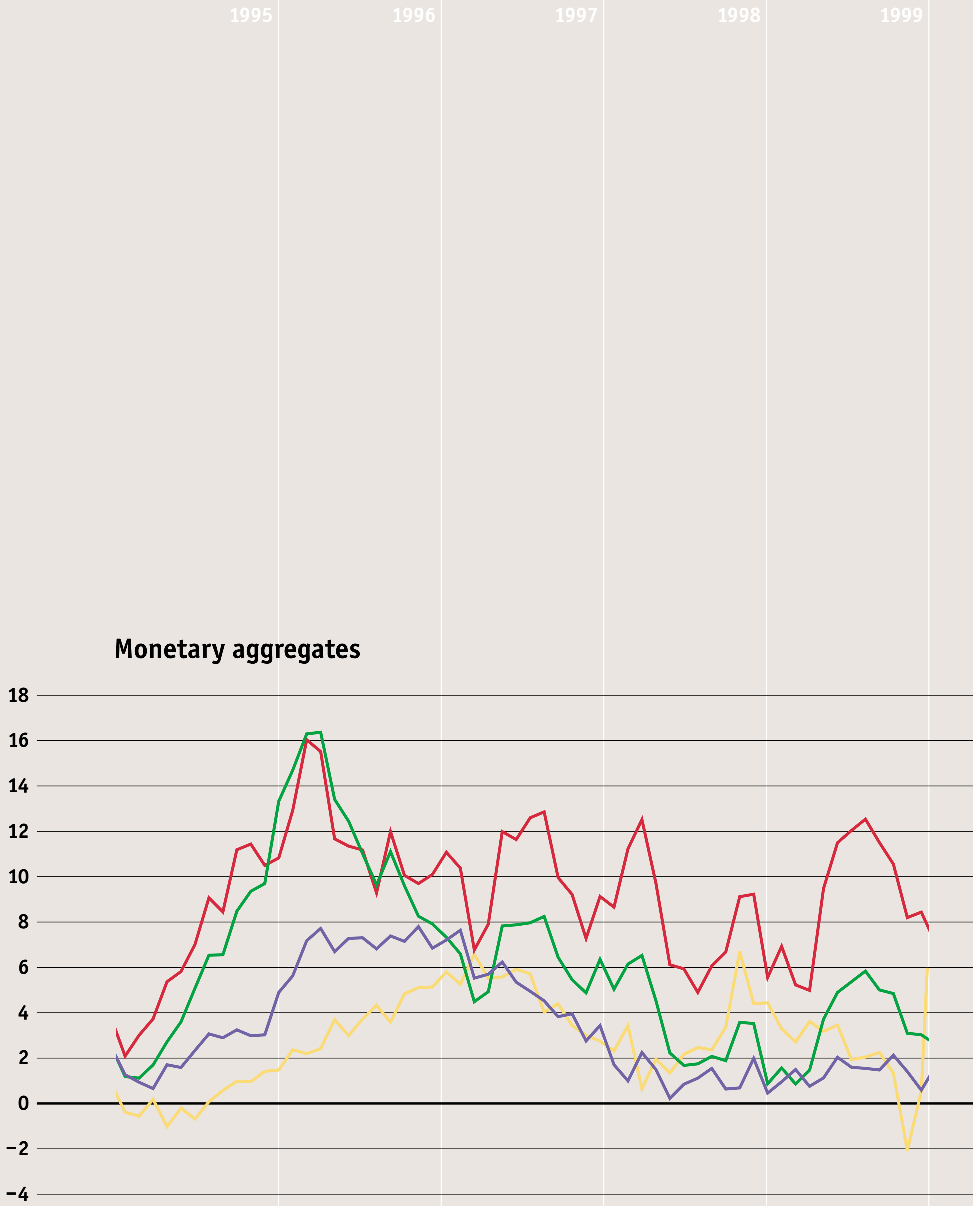
Monetary base

M_1

M_2

M_3

Percentage change from previous year's level.

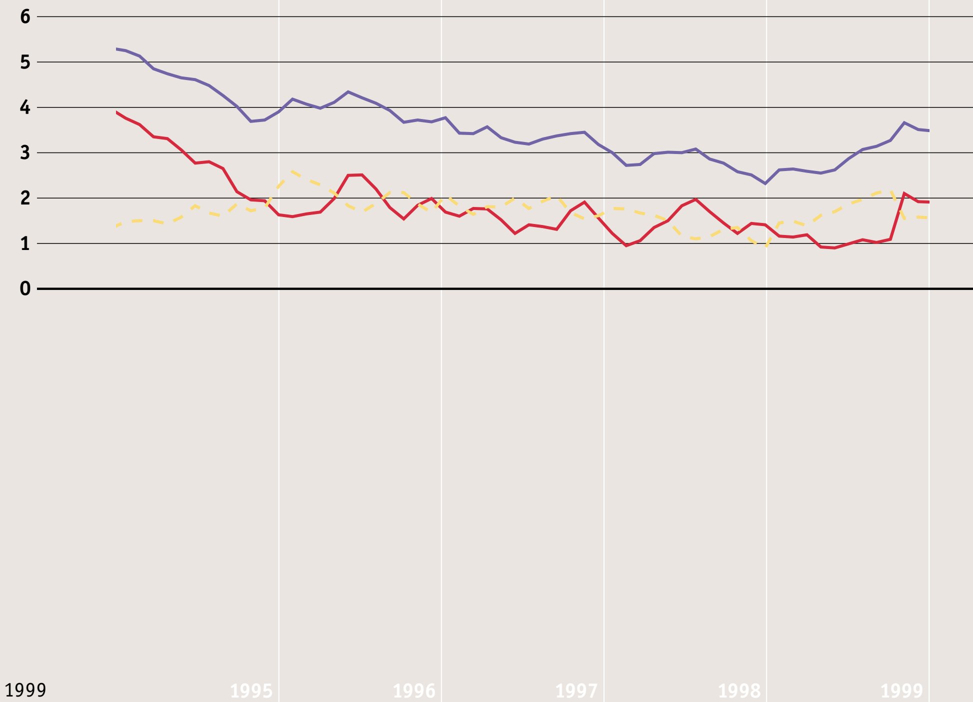


Money and capital market rates

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

Yield on federal bonds, percent per annum

Differential in percentage points



Stagnating monetary base

The seasonally-adjusted monetary base barely changed at all in the course of 1999, only to rise markedly at the end of the year. In the fourth quarter, it surpassed the corresponding year-earlier level by an average of 1.5%, exceeding the medium-term target range laid down at the end of 1994 by 8.4%. Based on the shifts in the demand for banknotes observed over a number of years and the banks' changed liquidity behaviour, the National Bank assumes that the gap between the monetary base and the medium-term target path again overstated the degree of monetary expansion in 1999.

Weak growth of the money stock M_3

The money stock M_3, considered by the National Bank to be the most important monetary aggregate in the past few years, showed only a slight rise in 1999. In the fourth quarter, M_3 exceeded the corresponding previous year's level by 0.7%.

Slight tightening of monetary policy in 2000

At its news conference of 10 December 1999, the National Bank announced that it would be tightening monetary policy slightly in 2000, after already having allowed money market rates to move up in autumn. It made known its intention to keep the three-month Swiss franc money market rate within a target range of 1.25–2.25% for the time being and the three-month rate, which, at the beginning of December had still been in the lower part of the target range, in principle in the middle part of the range at first. In 2000, the National Bank expects real economic growth of 1.8% and an average annual inflation rate of 1.5%.

Inflation forecast for 2000–2002

With the slight tightening of monetary policy, the National Bank wants to ensure that inflation remains below 2% in the following three years. According to the medium-term inflation forecast published by it for the first time, inflation is likely to increase somewhat to 1.8% by 2002. That is the upper range of what the National Bank regards as price stability. The slight rise in inflation mirrors the anticipated economic upswing, which – so experience has shown – normally goes hand in hand with certain upward price trends. These result from the higher utilisation of production capacities and the improved situation in the labour market. Given the favourable outlook for the international economy, raw material prices are also likely to increase; however, intense competition and falling prices in telecommunications and in the agricultural sector will continue to have a dampening effect. Nor does the development of the monetary aggregates, which in turn is responsible for the long-term development of inflation, point to any inflation threats. Until the end of 1999, the money stock M_3 only showed a moderate increase. No notable inflationary stimuli are therefore likely to emanate from the expansionary monetary policy pursued by the National Bank until autumn 1999. The National Bank will closely observe the chief indicators and review the analyses on which the inflation forecast rests on a quarterly basis. The results of its monetary policy assessment will be published in the Quarterly Report.

3 Reform of the monetary constitution

Federal parliament deals with the new monetary article

On 17 March 1999, the Council of States dealt with the Federal Council's bill for a new monetary article in the Federal Constitution (message of the Federal Council of 27 May 1998: cf. 91st Annual Report, pp. 36 f.). Like the National Council, it adhered largely to the concept of the Federal Council. It adopted the priority of price stability in the central bank's mandate, the National Bank's independence in fulfilling its mandate, and the principle of accountability as new elements of the constitutional norm. Like the big chamber before it, the Council of States opted for an explicit constitutional basis to enable the gold reserves no longer needed for monetary policy purposes to be separated from the National Bank's holdings and be put to other public uses. While the National Council had added a further section to the monetary article for this purpose, the Council of States decided to introduce a respective transitional provision into the Federal Constitution.

Separate reform of the monetary constitution fails

In its June session, the National Council adopted the Council of States' version concerning the reform of the monetary constitution in the conciliation procedure. In the final vote of 18 June 1999, the Council of States passed the new monetary article with a clear majority, whereas the National Council rejected it by a narrow margin. In the National Council, two sets of votes had a cumulative effect: those cast by the opponents of a National Bank mandate focusing on price stability and those cast by the opponents of establishing a constitutional basis which would have allowed the use of the National Bank's excess gold reserves to endow the planned Swiss Foundation for Solidarity. The new monetary article in the Federal Constitution was thus doomed to fail; from the perspective of the National Bank this is to be regretted.

New Federal Constitution is adopted and enters into force

In the ballot of 18 April 1999, the Swiss people and the cantons approved the comprehensive revision of the Federal Constitution. The new Federal Constitution, which was put into force by the federal parliament as from 1 January 2000, also contains a renewed monetary article (art. 99 of the new Federal Constitution [nFC]). This article replaces the former coinage article (art. 38 FC) and the central bank article (art. 39 FC) of the Constitution. The renewed monetary article severs the Swiss franc's constitutional link to gold. It embodies the National Bank's independence in the Constitution, as also the obligation to set aside adequate currency reserves from its earnings, part of them in gold. Both elements are designed to help maintain public confidence in monetary stability. As previously, the central bank mandate consists in the obligation of the National Bank to conduct a monetary policy in the interests of the country as a whole. The provision according to which the National Bank must deliver at least two-thirds of its net profit to the cantons was also left unchanged. Art. 99 nFC lacks a reservation with respect to this profit distribution rule permitting surplus currency reserves to be put to other public uses.

Intentions of the Federal Council concerning the future procedure

The Federal Council has decided against a renewed reform of the monetary constitution. At the same time, it envisages formulating the central bank's mandate in more detail within the context of the planned revision of the National Bank Law, as well as introducing a formal accountability of the National Bank in this Law. Furthermore, the government intends to submit a proposal to the federal parliament to create a special constitutional basis both for separating surplus gold reserves from the National Bank's holdings and putting them to other public uses. The Federal Council intends to open a consultation procedure on this subject in the first half of 2000.

4 Federal law on currency and payment instruments

Message of the Federal Council

On 26 May 1999, the Federal Council passed its message concerning a Federal law on currency and payment instruments (cf. 91st Annual Report, p. 38). With this law, the severance of the Swiss franc's link to gold – which was adopted on the constitutional level as part of the comprehensive revision of the Federal Constitution – is implemented. The Federal law on currency and payment instruments definitively abolishes the National Bank's obligation to redeem banknotes in gold, which had already been suspended for decades; it removes the minimum gold coverage of the banknotes in circulation and the gold parity of the Swiss franc. The law contains regulations on all the characteristic features of currency and money (legal tender) relevant for the public. In addition to coins and banknotes, Swiss franc denominated sight deposits at the Swiss National Bank are now also deemed to be legal tender. The institutions that process payment transactions (commercial banks and several of their jointly operated organisations, Swiss Post and large security transport companies) are entitled to open a sight deposit account with the National Bank. The Coinage Act currently in force will be integrated in the new federal law; all regulations governing banknotes will be transferred from the National Bank Law into the Federal law on currency and payment instruments.

Deliberation in parliament

The National Council dealt with the Federal law on currency and payment instruments on 5 October 1999, leaving the draft of the bill largely unchanged. It merely rejected an innovation in the field of coinage proposed by the Federal Council, i.e. to replace the present authorisation requirement for the manufacture of coin-like objects by a penal provision. The Council of States, in its December session, in turn followed the motions submitted by the Federal Council, while at the same time also including the option of privatising the Swiss Federal Mint in the law. During the conciliation procedure, the National Council adopted the version of the Council of States in full. On 22 December 1999, the Federal law on currency and payment instruments was approved by a large majority in the final vote in both the National Council and the Council of States. If no referendum is launched, the law is expected to take effect at the beginning of May 2000.

5 Agreement concerning gold sales

Agreement between European central banks concerning gold sales

Once the Federal law on currency and payment instruments enters into force, the National Bank will be in a position to revalue its 2,590 tonnes of gold holdings and to carry out gold transactions. The National Bank already previously announced its intention to begin as soon as possible with the sale of 1,300 tonnes of gold no longer required for monetary policy purposes. In this context, the agreement on future sales of monetary gold concluded between 15 European central banks, including the National Bank, in Washington on 26 September 1999 is significant.

Contents and significance

In the agreement, the participating central banks have undertaken to sell a total amount of no more than 2,000 tonnes of gold within the framework of a coordinated programme in the next five years, i. e. approximately 400 tonnes annually. They furthermore agreed not to expand their gold leasing and gold forward transactions during this time. Other industrial countries declared unilaterally that they would abstain from any gold sales during the period in question. This covers some 85 % of the official gold reserves of central banks, governments and international organisations. The 1,300 tonnes of gold which the National Bank intends to sell are included in the total quota of 2,000 tonnes.