

1 Concept

Stable prices are an important prerequisite for the smooth functioning of the economy, and they enhance prosperity. The National Bank's monetary policy aims at maintaining price stability in the medium term. It thus creates a favourable environment allowing the economy to make full use of its production potential. In order to ensure price stability, the National Bank must provide adequate monetary conditions. If the interest rate level is too low, the supply of money to the economy is excessive, thus triggering an inordinate demand for goods and services. Although this will boost production initially, production bottlenecks will occur in the course of time and overall economic capacities will be stretched. As a result, only prices will rise, and the production situation will deteriorate once again. By contrast, if the interest rate level is too high, this will tighten the supply of money and, consequently, lead to a demand shortage. Prices for goods and services will come under pressure, hampering economic development.

Significance of price stability

The National Bank needs indicators to determine whether its monetary policy course is appropriate in view of the goal of price stability. Until the end of the 1990s, the development of the monetary aggregates was of prime importance. Today, the National Bank bases its decisions on a broad range of real and monetary indicators. The monetary policy concept in force since the beginning of 2000 consists of three elements. First, the National Bank states what, from its vantage point, constitutes price stability. Second, it bases its monetary policy decisions on a medium-term inflation forecast. Third, it sets an operational target range for a reference interest rate selected by it, the three-month Libor rate (London Interbank Offered Rate). The National Bank does not publish a growth target for a monetary aggregate. However, the monetary aggregates continue to play an important role as monetary policy indicators, since they provide important information on the long-term trend of inflation.

Monetary policy concept

The National Bank equates price stability with a rise in the national consumer price index of less than 2% per annum. With this definition, the National Bank also takes into account that inflation cannot be measured with complete accuracy. Measuring problems may, for example, arise when the quality of goods and services improves. Such changes tend to slightly overstate the actual inflation rate.

Definition of price stability

In mid-year and at year-end, the National Bank publishes a forecast for the development of inflation in the three ensuing years. The period of three years corresponds to the time required for the transmission of monetary impulses. Forecasts over such a time horizon are, however, fraught with considerable uncertainties. By publishing a medium-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 inflation forecast is normally based on the assumption that the reference interest rate will remain steady during the forecasting period.

Regular publication of an inflation forecast

Indicators of relevance to the inflation forecast

In the long term, price developments depend primarily on the course of the monetary aggregates. In particular, the money stock M_3 provides useful information. In the short term, other indicators are relevant; the most important are measures of economic activity and exchange rates. The National Bank comments on a regular basis the evolution of the most important economic indicators relevant to its inflation forecasts.

Review of monetary policy based on the inflation forecast

If the inflation forecast deviates from the range of price stability, monetary policy needs to be reviewed. Should inflation threaten to exceed 2% in the medium term, the National Bank will tend to tighten its monetary stance. On the other hand, it is ready to loosen the monetary reins if there is a danger of deflation.

As a rule, no smoothing of short-term price fluctuations

The National Bank must reckon with unexpected price fluctuations in the short term, for example as a result of marked swings in oil and other import prices or in exchange rates. It only reacts to such swings, however, if there is the danger of a protracted inflationary or deflationary development. The smoothing of short-term movements in the price level would be associated with the risk of stronger cyclical fluctuations, which would generate a significant burden on the economy.

Economic situation taken into account

A country's economy is subjected to numerous internal and external influences, leading to fluctuations in economic activity. Such fluctuations cannot be prevented. The National Bank's monetary policy, however, which aims at medium-term price stability, helps to limit these fluctuations. During a phase of underutilised production capacities, upward price pressures subside; conversely, they intensify during a period of economic overheating. The National Bank will thus tend to ease monetary policy in the first case and tighten it in the latter. In so doing, it takes account of the economic situation, promoting a balanced development of the economy.

Steering concept for the money market – target range for the three-month Libor rate

The National Bank implements its monetary policy by influencing the interest rate level on the money market. It sets a target range with a spread of one percentage point for the three-month Libor, the economically most significant money market rate for Swiss franc investments. The target range is published regularly. The National Bank reviews its monetary policy during its quarterly assessment of the economic situation. If circumstances so require, the National Bank also adjusts the target range for the three-month Libor rate between regular assessment dates. Explanations are given for any changes to the target range.

2000

2001

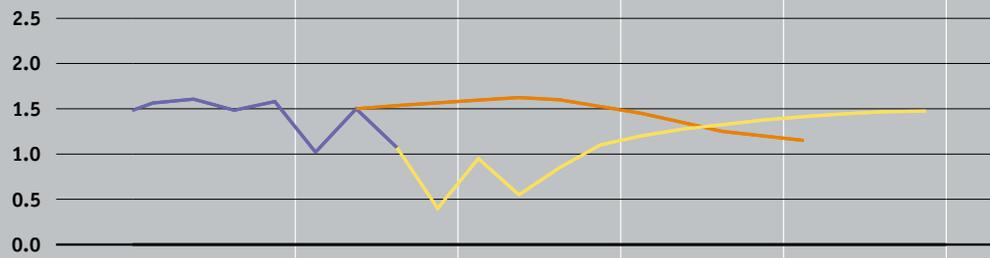
2002

2003

2004

Inflation forecast

— Inflation
— Forecast June 2001
(Libor 3.25%)
— Forecast December 2001
(Libor 1.75%)
Change in the national
consumer price index
in percent compared with
the previous year.



2000

2001

2002

2003

2004

Steering technique

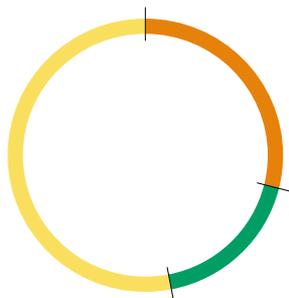
The National Bank influences the three-month Libor mainly through short-term repo transactions. It can prevent an undesirable rise in the three-month Libor rate by supplying the banks with additional liquidity through repo operations at lower repo rates (creation of liquidity). Conversely, by increasing repo rates, the National Bank induces an upward interest rate movement (absorption of liquidity). The liquid funds of commercial banks in Swiss francs consist largely of sight deposits held with the National Bank. The banks' demand for sight deposits derives mainly from statutory liquidity regulations; by contrast, since intraday liquidity has been introduced demand for sight deposits stemming from interbank payment transactions has all but ceased, notably in the case of the large banks. In normal circumstances, the maturity of repos ranges from one day to a few weeks. Short-term fluctuations in repo rates do not indicate a change in monetary policy. Rather, they reflect the National Bank's reaction to the uneven liquidity distribution in the banking system and other short-term influences.

Repo rates and the three-month Libor

Repo rates cannot be directly compared with the Libor. As a rule, the three-month Libor is higher for two reasons. First, maturities for repo transactions are usually shorter than three months and, therefore, have a lower maturity premium than the three-month Libor. Second, the Libor refers to an unsecured loan, whereas the repo rate is the price for a loan backed by securities. The Libor thus additionally contains a credit risk premium.

Monetary policy instruments

Repo transactions are the National Bank's major monetary policy instrument. In a repo transaction, the cash taker sells its 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. From an economic point of view, the repo is a secured loan. In exchange, the cash taker pays the cash provider interest. Apart from repo transactions, the National Bank can also employ foreign exchange swaps to regulate the money market. Furthermore, the National Bank has the possibility to place time deposits held with it by the Confederation at the banks for its own account but at the Confederation's risk. In this way, it can balance the shifts in liquidity between the banking system and the Confederation. The two latter instruments play no role in the current steering concept and are only resorted to in exceptional cases.



Collateral from repo transactions in percent

Swiss franc bonds of domestic borrowers 29

Swiss franc bonds of foreign borrowers 18

Euro bonds 53

Total: Sfr 26.2 billion.
End 2001

Instruments for money market operations in billions of Swiss francs

	2000		2001	
	Holding	Turnover	Holding	Turnover
	Average		Average	
Repo transactions (creation of liquidity)	18.9	768.7	17.1	923.5
less than 1 week	0.9	227.0	1.1	250.4
1 week	4.1	211.2	9.3	482.0
2 weeks	9.9	259.3	5.2	139.2
3 weeks	3.6	62.2	0.9	16.0
other	0.4	8.9	0.7	36.0
Repo transactions (absorption of liquidity)	0.2	40.0	0.0	12.4
less than 1 week	0.2	40.0	0.0	12.4
Confederation investments	11.4	112.8	4.9	72.8

By means of repo transactions, the National Bank puts interest-free liquidity at the commercial banks' disposal during the day to facilitate the processing of payment transactions. Intraday liquidity, provided exclusively during the day, however, may not be used to meet statutory liquidity requirements. Whether the liquidity requirements have been fulfilled is established from values resulting at the end of a business day, i. e. after repayment of the intraday liquidity. If a bank fails to repay the intraday liquidity on the same business day, it becomes liable to pay interest at a rate clearly in excess of the Lombard rate.

If a bank urgently needs liquidity which cannot be obtained in the money market, it may receive 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.

Intraday liquidity to facilitate payment transactions

Lombard loan as short-term source of refinancing in exceptional cases

2 Implementation

Background

The inflation forecast published by the National Bank in December 2000 predicted that, at an unchanged interest rate of 3.5%, inflation would increase somewhat in the course of 2001 and slightly exceed 2% for a limited period of time. This forecast was based on a background of robust economic growth in 2000 and the massive rise in oil prices. At the same time, the National Bank noted that the gradual tightening of Switzerland's monetary policy from autumn 1999 until summer 2000 and the anticipated economic slowdown in the US and Europe would help prevent an inflationary overheating of the Swiss economy. For 2001 and 2002, the National Bank projected real economic growth to slow to 2.2% and 1.6% respectively.

Subsiding inflationary pressures – lowering of the interest rate target range in March

In the course of the first quarter 2001, however, it became clear that price pressures were beginning to subside. This was due to the economic downturn in Switzerland and abroad as well as the faster-than-expected decline in oil prices. On 22 March, the National Bank reacted to this development by lowering the target range for the three-month Libor rate by 0.25 percentage points to 2.75%–3.75%. This was the first adjustment of the target range since mid-2000.

Interest rate target range left unchanged at the monetary policy assessment in June

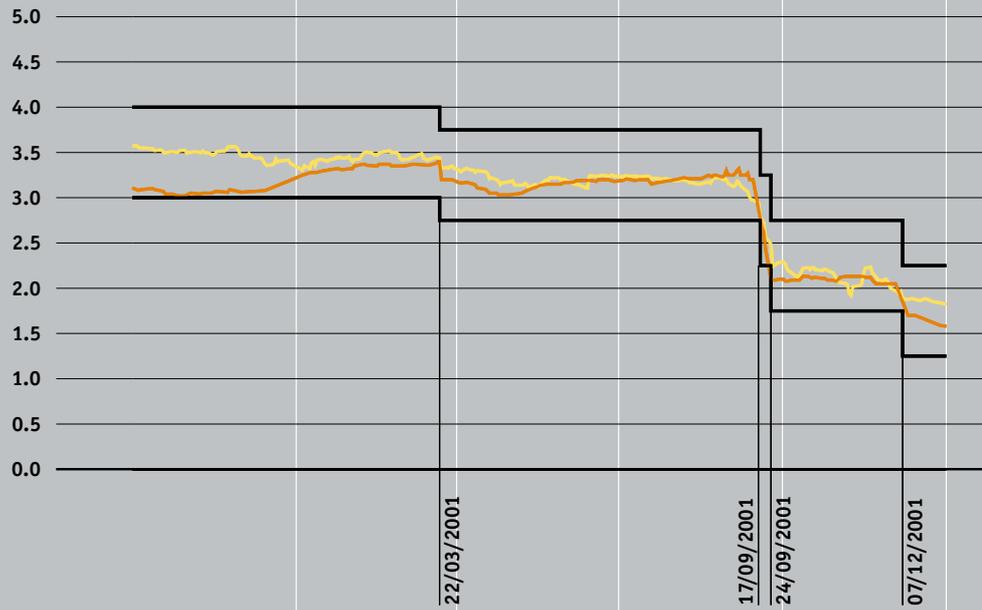
Although the economy lost momentum in the subsequent months, the decline was moderate and the overall economic capacities remained extremely stretched. The National Bank assumed, as most observers did, that the US economy would recover slightly towards the end of the year. Inflation measured by the national consumer price index, which had dropped significantly in the first quarter due to special factors, rose again in the two following months and, at 1.5%, roughly equalled the average recorded in 2000. The new inflation forecast presented at the news conference on 14 June showed that the National Bank, assuming a short-term interest rate of 3.25%, expected inflation to stabilise at around 1.5% in 2003. At its monetary policy assessment in June, the National Bank therefore decided to leave the interest rate target range unchanged.

Interest rate cuts following the terrorist attacks in the US

In the second half of the year, it became increasingly clear that the US economy would not rebound as quickly as had first been anticipated. In addition, the economic downturn in Europe and, particularly, in Germany, proved to be more pronounced than expected. This also clouded growth prospects for Switzerland. At the same time, current inflation decreased. Therefore, even before the terrorist attacks of 11 September, the ground was prepared for a further reduction in money market rates. When the Federal Reserve and the European Central Bank (ECB) cut their interest rates by half a percentage point on 17 September, the National Bank moved forward its monetary policy assessment scheduled for 20 September and also lowered the target range by 0.5 percentage points to 2.25%–3.25%. Since the other central banks reduced their key interest rates by the same margin, the interest rate differential to other countries did not change. In the subsequent days, the Swiss franc came under strong upward pressure, especially against the euro. On 21 September, the National Bank indicated to the markets that it was extremely concerned about the development on the foreign exchange markets, and on 24 September, it reduced the interest rate target range by another 0.5 percentage points to 1.75%–2.75%. With this cut the National Bank acted in response to the appreciation of the Swiss franc, which threatened to aggravate the monetary conditions in a manner that was undesirable given the flagging economy.

Money market rates

- Three-month Libor
- Repo rate 1 week
- Target range
- Market prices.



Further reduction in the interest rate target range in December

At the monetary policy assessment in December, the National Bank decided to lower the target range for the three-month Libor rate by another 0.5 percentage points to 1.25%–2.25%. It acted in response to the further deterioration of the economic outlook and the associated decrease in inflationary pressure. The inflation forecast published at the news conference on 7 December is based on a three-month Libor of 1.75% and anticipates an average inflation rate of 0.9% for 2002, 1.3% for 2003 and 1.5% for 2004. At the same time, the National Bank based its forecast on an increase in real GDP of 1.5% in 2001 and around 1% in 2002.

Short-term increase of repo rates within the target range

With these four rate cuts, the National Bank reduced the target range for the three-month Libor rate by a total of 1.75 percentage points in 2001. Every time it lowered its interest rate – except on 24 September – the National Bank informed the markets that the three-month Libor rate would be kept in the middle of the target range for the time being. Since the markets had been anticipating a downtrend in interest rates since the beginning of the year, this meant that the National Bank had to let short-term repo rates climb temporarily. This was particularly the case in March, September and November, when there was the growing expectation that rates would be adjusted – possibly even ahead of schedule. In these cases, however, the National Bank was willing to make use of the flexibility offered by the target range and let the three-month Libor temporarily slip considerably below the middle of the applicable target range.

No signs of a long-term rise in prices

The substantial reduction in short-term interest rates effected during 2001 was facilitated in that the growth rates of the monetary aggregates did not signal a threat to long-term price stability. The money stock M_3 , which – overall – had grown only marginally from 1997 to mid-1999, increased steadily during 2001, but growth remained moderate. In the fourth quarter, M_3 exceeded the previous year's level by 4.8% on average.

Expansion of monetary base due to rising demand for banknotes

The seasonally-adjusted monetary base, which measures the liquidity supplied directly to the economy by the National Bank, registered a much stronger expansion. This increase is mainly attributable to the massive rise in banknote circulation, which was influenced by special factors such as the forthcoming introduction of euro banknotes and coins. The second component of the monetary base, the banks' sight deposits at the National Bank, also rose while experiencing heavy fluctuations. These fluctuations were most likely triggered by the interaction between the markets' interest rate expectations and the National Bank's efforts to keep the three-month Libor rate near the middle of the interest rate target range.

Monetary aggregates

— Monetary base
— M₁
— M₂
— M₃
 Change from previous year in percent.



Money and capital market rates

— Three-month Libor
— Yield on federal bonds
- - - Spread in percentage points

