Monetary policy of the Swiss National Bank

1 Concept

Significance of price stability

Stable prices are an important prerequisite for the smooth functioning of the economy, and they enhance prosperity. The National Bank's monetary policy aims to maintain price stability, i.e. to prevent both inflation and deflation. In so doing, it 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 interest rates are too low, the supply of money and credit to the economy is too high, 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 aggregate economic capacity will be overutilised, thus causing prices to rise. As a result, production conditions will deteriorate. By contrast, if interest rates are too high, this will reduce the supply of money and credit to the economy and, consequently, lead to a demand shortage. Prices for goods and services will come under pressure, hampering economic growth.

Economic situation taken into account

A country's economy is subject to numerous internal and external influences, leading to fluctuations in its economic activity. Such fluctuations are inevitable. The National Bank's monetary policy, however, which is aimed at medium-term price stability, helps to limit these fluctuations. If production capacities are underutilised, upward price pressures subside. During a period of economic overheating they intensify. The National Bank will thus tend to ease monetary policy in the former case and tighten it in the latter. In so doing, it takes account of the economic situation, promoting the balanced development of the economy.

Monetary policy concept

The National Bank needs indicators to determine whether or not its monetary policy course is appropriate in view of the goal of price stability. It 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: the definition of price stability, a medium-term inflation forecast and an operational target range for the National Bank's chosen reference interest rate, the three-month London interbank offered rate (Libor) for Swiss francs.

Definition of price stability

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, for example, arise when the quality of goods and services improves. Such changes tend to overstate the actual inflation rate slightly.

Regular publication of an inflation forecast

The National Bank publishes quarterly forecasts on the development of inflation for three subsequent years. The period of three years corresponds more or less to the time required for the transmission of monetary stimuli. Forecasts over such a long 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 based on the assumption that the reference interest rate will remain constant during the forecasting period. It thus illustrates future price trends on the assumption of an unchanged monetary policy environment and cannot be compared with the forecasts of other institutions.

Indicators of relevance to the inflation forecast

In the long term, the price trend depends primarily on the course of the monetary aggregates. These thus continue to play a significant role as monetary policy indicators. In particular, the money stock M_3 provides useful information. In the short term, other indicators are relevant, the most important being measures of economic activity and the exchange rate. The National Bank comments on a regular basis on the evolution of the most important monetary policy indicators that it uses in its inflation forecasts.

Review of monetary policy based on the inflation forecast

If the inflation forecast deviates from price stability, monetary policy needs to be reviewed. Should inflation threaten to exceed 2%, the National Bank will consider tightening its monetary stance. Conversely, it is ready to loosen the monetary reins if there is a danger of deflation. The National Bank does not, however, react mechanically to the inflation forecast.

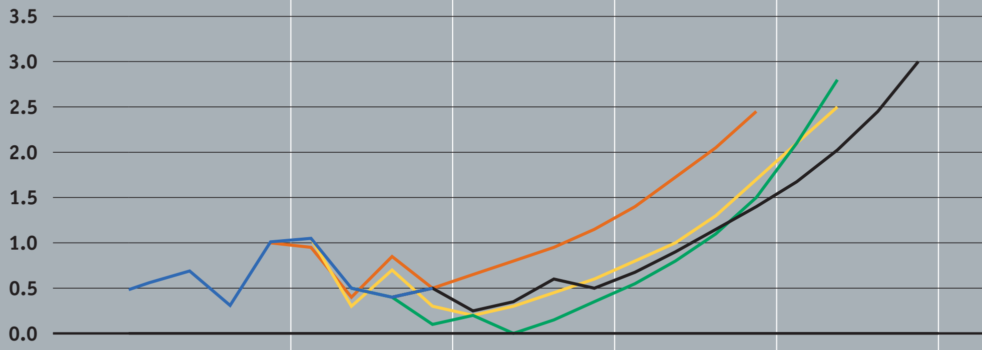
No smoothing of short-term price fluctuations

The National Bank must reckon with unexpected price fluctuations in the short term, for example as a result of 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 phase. Smoothing short-term movements in the price level would entail the threat of stronger cyclical fluctuations, which would place a significant burden on 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 interest rates on the money market. It sets a target range with a spread of usually 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. If circumstances so require, the National Bank also adjusts the target range for the three-month Libor rate between regular assessments. Explanations are given for any changes to the target range.

Inflation forecast



Inflation

Forecast March 2003
(three-month Libor: 0.25%)

Forecast June 2003
(three-month Libor: 0.25%)

Forecast September 2003
(three-month Libor: 0.25%)

Forecast December 2003
(three-month Libor: 0.25%)

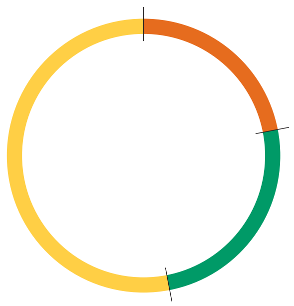
Change in the national
consumer price index
from previous year,
in percent.

Steering technique

The National Bank influences the three-month Libor mainly through short-term repo transactions, its chief monetary policy instrument. 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 (creating liquidity). Conversely, by injecting less liquidity or increasing repo rates the National Bank induces an upward interest rate movement (absorbing 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 requirements. By contrast, since intraday liquidity has been introduced, interbank payment transactions hardly influence the demand for sight deposits anymore. In normal circumstances, the maturity of repos ranges from one day to a few weeks. The repo rate depends on both monetary policy and the maturity of a transaction. Imbalances in the distribution of liquidity within the banking system may cause short-term fluctuations.

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, the Libor refers to an unsecured loan, whereas the repo rate is the price for a loan backed by securities. The Libor thus contains a credit risk premium. Second, maturities for repo transactions are usually shorter than three months and therefore have a lower maturity premium than the three-month Libor.



Collateral from repo business
in percent

Swiss franc bonds of domestic borrowers 22

Swiss franc bonds of foreign borrowers 25

Euro bonds 53

Total: CHF 27.1 billion.
End 2003

Instruments for money market operations in billions of Swiss francs

		2002		2003	
		Holding Average	Turnover	Holding Average	Turnover
Repo transactions; liquidity-creating		21.7	967.6	23.6	1,017.9
maturity	less than 1 week	0.8	213.5	1.4	236.4
	1 week	8.5	445.6	8.4	436.4
	2 weeks	10.2	258.6	11.1	286.4
	3 weeks	1.7	36.6	2.3	39.8
	others	0.5	13.3	0.3	18.9
Repo transactions; liquidity-absorbing		0.0	0.5	0.0	0.0
maturity	less than 1 week	0.0	0.5	0.0	0.0

Repo operations

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.

Other monetary policy instruments

Apart from repo transactions, the National Bank can also employ foreign exchange swaps to regulate the money market. Furthermore, the National Bank has the option of placing time deposits held with it by the Confederation with the banks for its own account but at the Confederation's risk. In this way, it can balance shifts in liquidity between the banking system and the Confederation. The two latter instruments play no role in the current monetary policy concept of the National Bank; since 2000, repo transactions exclusively have been used for regulating the money market.

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

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 collateral provided in the form of securities and granted only at the official Lombard rate. The National Bank always keeps this rate at two percentage points above the call money rate to discourage banks from using the Lombard loan as a permanent source of refinancing. In the course of 2004, instead of the traditional Lombard loan, the banks will be given the possibility of concluding repo transactions at the Lombard rate. This results in a more efficient collateral management for the banks.

Intraday liquidity to facilitate payment transactions

By means of repo transactions, the National Bank, during the day, makes interest-free liquidity (intraday liquidity) available to the commercial banks and to PostFinance to facilitate the processing of payment transactions in the Swiss Interbank Clearing (SIC) system and foreign exchange transactions in the Continuous Linked Settlement (CLS) system. The liquidity available exclusively during the day may not be used to meet statutory liquidity requirements. Whether the liquidity requirements have been fulfilled is established from figures calculated 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 exceeding the Lombard rate by two percentage points.

2 Implementation

Background

At its quarterly assessment of the situation in December 2002, the National Bank had expected economic growth in Switzerland to be around 1% in 2003 and that a sustained upswing would not set in before the second half of the year. On the assumption that the three-month Libor rate would remain steady at 0.75%, it forecast inflation rates between 0.7% (annual average 2003) and 1.6% (2005) in the next few years. It therefore seemed appropriate to leave the target range for the three-month Libor rate unchanged at the level of 0.25% to 1.25% applicable since 26 July 2002.

Lowering of the target range in March

In the first few months of 2003 it became clear that the economic upswing would be delayed. The impending war in Iraq strengthened this trend. In this situation, the National Bank strove to head off the tightening of monetary conditions that would arise from an appreciation of the Swiss franc. On 6 March the National Bank therefore lowered the target range for the three-month Libor rate by half a percentage point to 0%–0.75%. At the same time, the National Bank announced that for the time being, the three-month Libor was to be kept at the lower end of the target range at 0.25%. For technical reasons (zero lower bound for nominal interest rates), the target range has temporarily been reduced from 100 to 75 basis points. At the quarterly assessment of the situation of 20 March, this policy was confirmed, and at the same time a new inflation forecast was published (cf. also table Inflation forecasts).

Monetary conditions relaxed due to weakening of the Swiss franc

Following the lowering of the target range for the three-month Libor rate in March, the Swiss franc depreciated markedly. This led to a welcome further easing of monetary conditions. Nevertheless, the economic data were at first somewhat weaker than expected. The National Bank had already reduced its forecast for economic growth in 2003 to just under one percent in March; by mid-year it was expecting a stagnation and a little later a moderate decline of GDP. Inflation again decreased slightly.

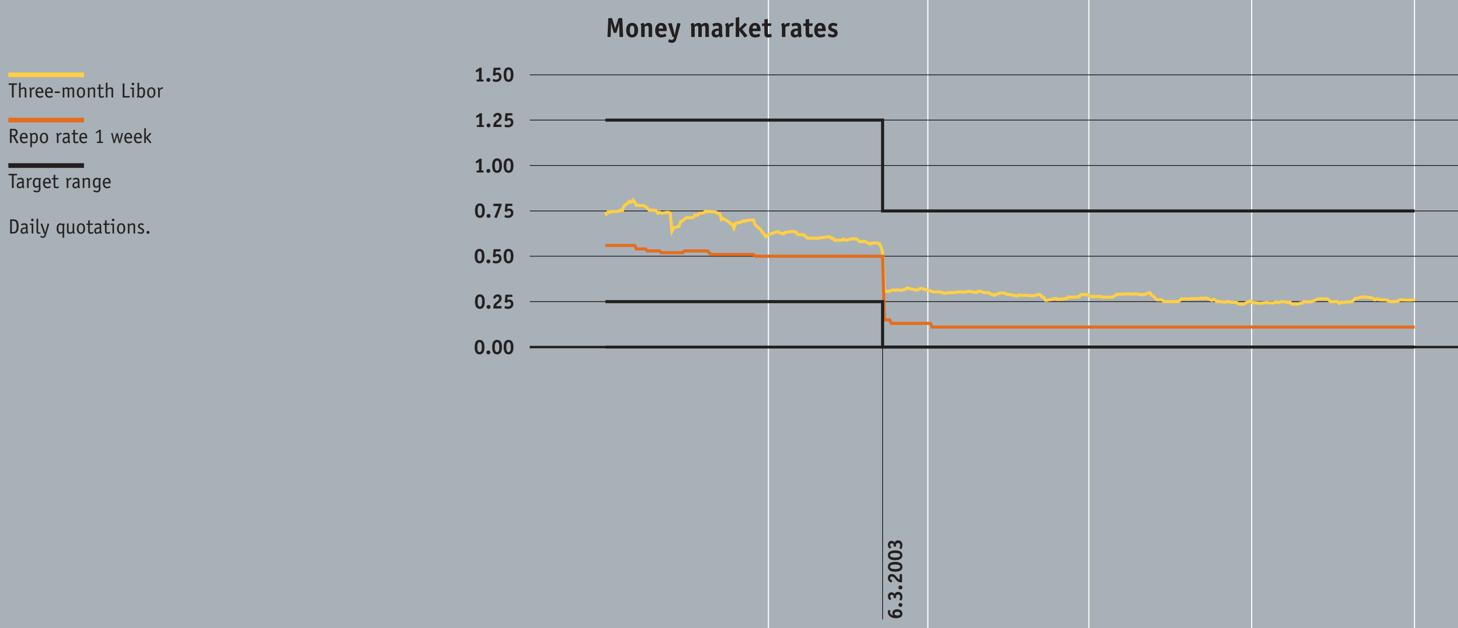
No further adjustments to the target range until year-end

At the quarterly assessments of 11 June, 18 September and 11 December, the target range was left unchanged at 0.0%–0.75%. The inflation forecasts published on these three dates differed only in minor respects (cf. table).

Inflation forecasts Annual averages in percent

Month	Libor[1]	2003	2004	2005	2006
December 2002	0.75	0.7	0.9	1.6	–
March 2003	0.25	0.7	0.9	1.9	–
June 2003	0.25	0.6	0.4	1.2	–
September 2003	0.25	0.5	0.2	1.0	–
December 2003	0.25	0.6	0.4	1.0	2.3

1 Based on a constant three-month Libor rate



Q4 2002 Q1 2003 Q2 Q3 Q4

Inflation forecast signals interest rate rise in the medium term

Seen over the whole year, the National Bank endeavoured to underpin the economic recovery and to keep Swiss franc investments fairly unattractive. It considered its monetary policy to be expansionary. This is reflected in the inflation forecasts, which rose markedly near the end of the forecasting period and topped 2.0% in 2006, thus underscoring the fact that the low interest rate cannot be maintained in the long run.

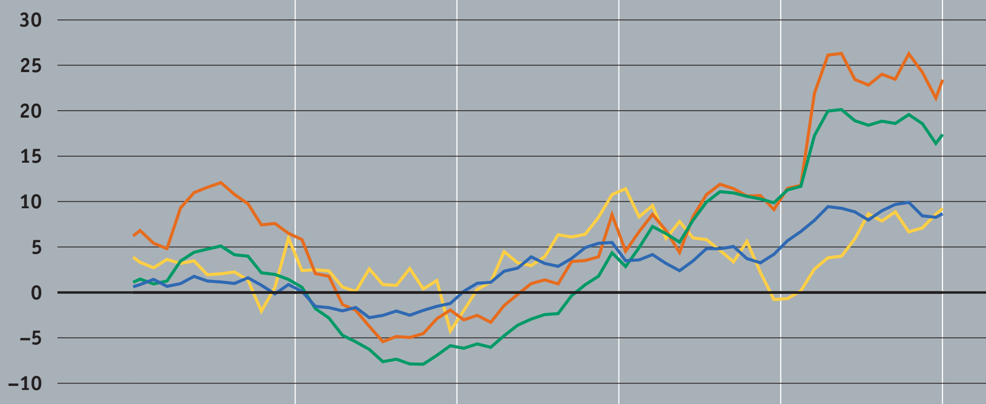
Strong money supply growth

The expansionary monetary policy was accompanied by growing monetary aggregates. The strong money supply growth, however, overstated the risk to price stability. For one thing, credit creation by the banks continued to be slow-moving. For another, increasing liquidity was also a sign of insecurity on the part of investors, who had a preference for liquidity after the negative stock market experience and given the uncertain economic situation. The preference for liquidity is particularly marked whenever the interest rate level on the money market approaches 0%. In this case, interest income no longer covers the commission charged to investors on the conclusion of certain money market transactions. Thus in 2003, in particular fiduciary Swiss franc investments abroad flowed back into sight deposits in Switzerland. This inflow of capital additionally expanded the monetary aggregates.

Adhering to an expansionary monetary policy despite a strong increase in money supply growth

The National Bank held the view that monetary policy only needs to be tightened once the economic upswing is certain. Given the unused production capacities, a pickup in demand does not immediately put upward pressure on prices, leaving sufficient time to adjust monetary policy.

Monetary aggregates



Monetary base

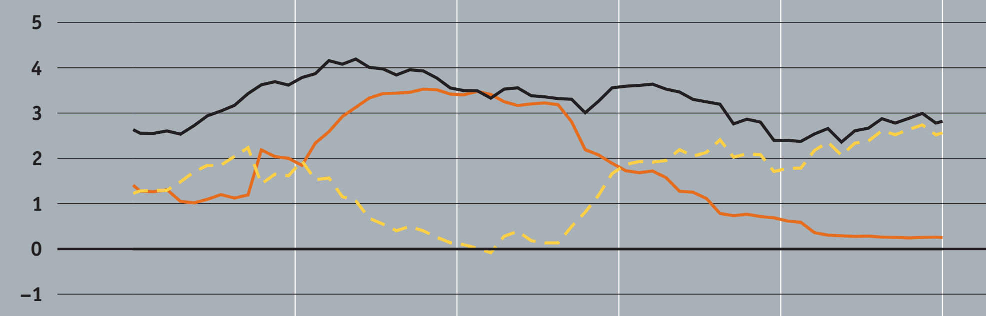
M_1

M_2

M_3

Change from previous year in percent.

Money and capital market rates



Three-month Libor

Yield on Confederation bonds

Spread in percentage points.

1999 2000 2001 2002 2003