Quarterly Bulletin, 1, March 1999

Contents

Abstracts

1. Conclusions for monetary policy

Given the development of the economic and monetary indicators, it seems feasible to continue pursuing a generous monetary policy in the coming months. The slowdown in growth is likely to intensify in the first half of the year and make way for an economic rebound only during the second half. The forecasts for the money stock M3, which the National Bank increasingly consults as a monetary indicator, still point to a slow growth of this aggregate. The prospects for inflation remain favourable. In January and February, prices went up slightly due to the increase in VAT. As expected, the cyclically sensitive service prices rose more significantly than the prices for goods. The latter continue to be strongly influenced by falling oil prices.

2. Economic and monetary policy developments

The National Bank strove to maintain liquidity on the money market also in the fourth quarter of 1998. In October, it supplied the banks with additional liquidity to counteract an excessive appreciation of the Swiss franc. As a result, the gap between the monetary base and the medium-term target path widened markedly. The situation returned to normal in November and December. As a result of the generous supply of liquidity, short-term interest rates remained low both in the fourth quarter and at the beginning of the new year. Since the real, export-weighted exchange rate lost ground somewhat, monetary conditions were slightly more favourable than in the fourth quarter.

Economic recovery continued to lose momentum in the fourth quarter of 1998. Real gross domestic product still rose by 1.2% year-on-year. Flagging growth is mainly attributable to a cooling down in the export sector as a consequence of the Asian crisis and weaker economic growth in Europe. Private consumption and corporate investment, however, remained important pillars of support for the economy.

3. On monetary policy in 1999

In this speech, delivered at the University of St Gallen on 21 January 1999, Hans Meyer, Chairman of the Governing Board of the Swiss National Bank, examines the fundamentals of Swiss monetary policy. The National Bank pursues a flexible monetary policy strategy. It strives to achieve the goal of price stability, orienting itself to the development of monetary aggregates as well as to other indicators. Monetary policy decisions are discretionary decisions to a large degree. This is precisely why it is important that the National Bank's mandate is clear. The new law on currency and payment instruments gives the National Bank the mandate to pursue a monetary policy which will benefit the country as a whole, with the goal of price stability taking precedence. In the interest of achieving an optimal overall effect, each economic policy instrument is to be applied taking into account its particular characteristics. A long-term connection tends to exist between the supply of money and price stability. In adequately planning and coordinating the supply of money with real economic trends, the National Bank ensures price stability. This is not an end in itself but a significant contribution toward achieving a balanced economic development.

4. The optimal capital ratio of a bank

The historic development of banks' capital ratios and a comparison with other industries indicate that the capital ratios are not selected randomly. This observation is inconsistent with the hypothesis of Modigliani and Miller (1958), according to which a company is indifferent to its capital structure. In this article, the bank is considered as a depositors' insurance against unpredictable shortages of liquidity. The model shows that in determining its capital structure the bank is faced with a trade-off. On the one hand, it tries to generate as many deposits and loans as possible, thereby increasing revenue. On the other hand, as deposits and loans expand, so do production costs as well as the risk of insolvency and illiquidity. The simulations show that the bank cannot operate with any solvency or liquidity ratios, but that it can only achieve the return on equity given by a CAPM equilibrium within the framework of a specific balance sheet structure.

5. Chronicle of monetary events

— § —

1. Conclusions for monetary policy

With export demand levelling off, the economic recovery lost considerable momentum in the course of last year. As a consequence, the Swiss economy also felt the difficult adjustment process, which was bound to occur on the heels of the financial and economic crises in the different regions of the world. Sustained and robust domestic demand marked a bright spot. Private consumption grew substantially through the end of the year, and consumer sentiment remained optimistic. This was mainly attributable to the steady improvement of the labour market. Corporate investment also continued to develop at a dynamic pace, with the most important stimuli emanating from the services sector. By contrast, construction spending had only a very insignificant effect on economic growth, with the result that an important driving force behind economic recovery is still lacking.

Consumer prices remained stable last year; in the fourth quarter, due to lower oil prices, they were even slightly below the corresponding level in the previous year. As expected, prices rose somewhat in January and February 1999 due to the increase in VAT. The most significant price surge occurred in the private and public services sector.

At the end of 1998, the National Bank announced that it intends to continue conducting a basically generous monetary policy. In so doing, it took into account both the cyclical risks and the insecurities stemming from the launch of the euro at the beginning of 1999. The steadily low short-term interest rates in January and February were in conformity with the announced monetary policy.

The introduction of the single European currency on 1 January 1999 passed smoothly. While it is true that the euro has decreased in value considerably against the dollar since the beginning of the year, this is a reflection of the different economic development rather than a weakness of the euro itself. Its exchange rate versus the Swiss franc fluctuated within stable limits. As a result of a markedly stronger dollar, the real, export-weighted exchange rate lost ground somewhat during the first quarter. Along with lower interest rates, this amounted to a slight easing of monetary conditions compared to the fourth quarter of 1998.

The development of the cyclical and monetary indicators seems to favour adherence to the generous monetary policy in the months ahead.

The National Bank expects the growth of real GNP to slow down to an average of 1.5% this year. Flagging growth is likely to intensify in the first half of the year and make way for an economic rebound only during the second half. The global economic situation continues to be fraught with considerable risks. While there have been signs of some stabilisation in East Asia in the immediate past, the situation in Japan remains difficult. In Europe, economic activity cooled down as a result of distinctly weak exports. For the time being, this sector will therefore have a dampening effect.

During the course of this year, the seasonally-adjusted monetary base has grown at a much slower pace than in the fourth quarter. After the vigorous expansion of liquidity, with which the National Bank had counteracted the appreciation of the Swiss franc in the autumn of 1998, the situation returned to normal again. The forecasts for the money stock M3, which the National Bank increasingly consults as a monetary indicator, still point to a slow growth of the aggregate. This is a reflection of the economic downturn, the high level of price stability as well as domestic lending activity, which continues to be flat.

The prospects for inflation remain favourable. The National Bank reckons that this year's average increase in consumer prices will be 1% - partly due to higher VAT. The rise in prices during the first two months of this year was modest overall. As anticipated, it was especially the cyclically sensitive service prices that went up while commodity prices continued to be strongly influenced by falling oil prices. This is expected to be an enduring trend in the months ahead. It is not a threat to the goal of price stability.

In spite of the existing cyclical risks, the National Bank does not fear that there will be another recession. Particularly sustained economic growth in the United States and the favourable monetary conditions in Europe, which are underpinning domestic demand, make for an optimistic outlook. If, however, the development of the Swiss economy were to deviate significantly from the National Bank's current expectations during the coming months, the course of monetary policy would have to be adjusted. The same applies in the event of disruptions in the foreign exchange markets.

5. Chronicle of monetary events

The Federal Parliament deals with the new monetary article

The National Council dealt with the Federal Council's proposal for a new monetary article in the Federal Constitution on 17 December 1998, and the Council of States on 17 March 1999 (cf. 2/1998 Quarterly Bulletin, in German and French). Both councils 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 new formulation of the central bank's mandate and specified the National Bank's accountability. Moreover, they decided in favour of a regulation requiring 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, both the National Council and the Council of States 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. While the National Council, for this reason, added a relevant paragraph to the constitutional article proposed by the Federal Council, the Council of States decided to include a transitional provision in the Federal Constitution. Accordingly, the Federal law governs the use of those currency reserves which, at the time this provision enters into force, are no longer required for the conduct of monetary policy. Similarly, the law provides for the allocation of the profits from those reserves, with the option to deviate from the profit distribution regulation contained in the monetary article.