Switzerland's Approach to Monetary Policy

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Monetary policy as conducted by the Swiss National Bank is aimed at maintaining price stability in the medium term. Between 1980 and 1999, the Bank used the seasonally adjusted monetary base as monetary target and as indicator.[1] Given the continually distorted indicator value of the monetary base after 1996, the Bank fundamentally reviewed its modus operandi. As of the beginning of 2000, the Swiss National Bank (SNB) considers price stability to be achieved with an annual inflation (CPI) rate of less than 2 percent. The Bank bases its monetary policy decisions on a medium-term (three-year) inflation forecast.[2] Despite similarities to inflation targeting, the new framework differs from it in one important respect, namely, it does not contain an *institutional* commitment to an inflation target as the *overriding* objective of monetary policy.

Swiss National Bank's Main Monetary Policy Instruments

In the new monetary policy framework, the Bank sets a target range for the three-month Libor, with a width of 100 basis points. The three-month Libor is the economically most important money market rate for Swiss franc investments. While the 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. As a rule, the Bank

Table 1
Criteria for Securities Eligible as Collateral for SNB Basket Repos

Currency	Must be denominated in Swiss francs
Liquidity	Only securities listed on a recognized stock exchange or traded on an organized market that can be delivered through SIS SegaIntersettle
	Volume of issue must be at least SFr 100m
Types	Straight bonds
	Floating-rate bonds
	Bonds with embedded options, without the option
	Money market debt register claims
Minimal Ratings (for foreign debtors only)	S&P: A
	Moody's: AA/A2
Ineligible Securities	Subordinated debt
	Convertible bonds
	Cash taker may not use company's own securities or the securities of a firm forming part of the same economic unit
	Securities with the lowest minimal rating that are under review for downgrading are not eligible

Source: Article 14 of the Swiss National Bank Law.

influences the Libor indirectly via short-term repo transactions.[3] Maturities of repos are between one day and several weeks. Longer-maturity repos provide the markets with base liquidity. The average maturity of repos in the year 2000 was nine days. The 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 fluctuations in market rates.

Open Market Operations

Repo transactions are the Swiss National Bank's main tool for market operations. The Bank is in principle prepared to purchase any securities from several collateral baskets, which contain Bank-eligible securities. In its auctions, the Bank invites tenders for the SNB basket, the German GC-basket, and the German Euro Jumbo Pfandbrief-basket. The composition of the SNB basket is determined largely by legal restrictions.[4] These restrictions, listed in Table 1, concern currency, liquidity, type of eligible securities, minimal ratings, and ineligible securities. Article 14 of the National Bank Law also restricts the debtors of eligible securities, listed in Table 2, and the maturity of securities eligible for repo transactions. All domestic securities eligible for repos must have a maturity of six months or less. Bills drawn on payees abroad must have a maturity of six months or less. Easily marketable debt securities of foreign states, international organizations, and foreign banks must have a maturity of 12 months or less. The Swiss National Bank's own interest-bearing debt certificates must have a maturity of two years or less. In 2000, the collateral from repo transactions was distributed as follows: 39 percent of CHF bonds of domestic borrowers, 39 percent of CHF bonds of foreign borrowers, and 22 percent of euro bonds.

The German GC-basket includes German federal government paper and some World Bank issues. The owner of this basket is the Swiss Exchange. The third basket—the German Euro Jumbo Pfandbrief-basket—

[1] At the end of 1996, the indicator value of the monetary base began to lose its significance, with banknote circulation rising considerably faster than anticipated. This induced the Bank to devote more attention to other indicators. It particularly set its sights on the exchange rate and M3.

[2] M3 remains an indicator in the long run. In the short run, by contrast, other indicators of the development of inflation are significant, such as economic developments and exchange rates.

[3] Liquid funds of commercial banks in Swiss francs consist largely of sight deposits held with the Swiss National Bank. The banks' demand for sight deposits derives from statutory liquidity regulations; since intraday liquidity has been introduced, demand for sight deposits stemming from cashless payment transactions has all but ceased. 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 SNB operates in the money market almost daily.

[4] The Bank applies the principles listed next in the main text in defining the basket of securities eligible for its repo transactions. It reserves the right, however, to diverge without explanation from these principles in individual cases. The cash taker in a repo transaction may not use the company's own securities or the securities of a firm forming part of the same economic unit. With 20 percent or more of share capital held, a firm qualifies as part of the same economic unit. This rule, however, does not apply to participations in mortgage-bond institutes.

consists of German mortgage bonds with a minimum issue volume of 1 billion euros. This instrument has not been used since 1999.

The Swiss National Bank, like all other participants in the market, accepts borrowed securities as collateral for repo transactions. In principle a number of options are available to reduce risk in repo transactions. Several central banks have a system that involves haircuts, which takes into account the interests of the cash provider but not those of the cash taker. The Bank does not apply haircuts; securities are transferred at their market value. They are also priced daily to their market value, and deviations are compensated by margin transfers. The real-time gross-settlement system in use (SIS) also guarantees a delivery-versus-payment transaction that eliminates settlement risk.

Table 2
Issuers of Securities Eligible as Collateral for SNB Basket Repos

Swiss Confederation
Swiss cantons
Other debtors with explicit guarantee of the Confederation or of a canton
Swiss municipalities as well as their bond-issuing institute
Swiss mortgage-bond institutes
Foreign states (central administrators) meeting minimum rating criteria
Other debtors with explicit guarantee of a foreign state and minimal rating
International organizations with a minimal rating
Foreign banks with a minimal rating

Source: Article 14 of the Swiss National Bank Law.

Before the introduction of repos in 1998, foreign exchange swaps were the chief monetary instrument of the Bank. Since the 1980s, they had served to fill the banking system's basic liquidity needs. Until 1997, the Bank completed swaps exclusively against dollars. Since June 1998, it has been transacting swaps against deutsche marks on a regular basis (and since 1999 against euros). A swap had a term of between one and six months. The Bank fixed the terms and conditions based on market prices.

For the short-term steering of liquidity, the Swiss National Bank also has the option of placing time deposits held with it by the Confederation at the banks to the account of the Confederation. In this way, it can balance the shifts in liquidity between the banking system and the Confederation. This instrument is rarely used. The SNB usually balances such shifts in the context of its repo transactions with the banks.

At the beginning of October 1999, the 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. The liquidity provided during the day may not be used to meet statutory liquidity requirements.

Standing Facilities and Other Monetary Policy Instruments

The use of repo transactions by the Swiss National Bank has some advantages over Lombard loans. In a Lombard loan (advance against securities) the securities serving as guarantee are pledged and the ownership is not conveyed. The provisions of the Swiss Banking Law (Article 17) are an impediment insofar as pledged securities are not easily marketable. Pledged securities cannot be transferred to other parties for use. Lombard loans are now used by the Swiss National Bank only when a bank has urgent liquidity needs that it cannot meet in the money market. Loans are granted against full collateral at the official Lombard rate, which is constantly at 2 percentage points above the call money rate in order to discourage banks from using the Lombard loan as a permanent source of refinancing.

The discount credit has lost its practical significance. The Bank, however, retains the right to discount securities in special circumstances in which it is willing to extend credit to the banks on a broad basis.

In addition to the instruments currently in use for steering the money market, the National Bank Law lists a number of other monetary policy instruments. Spot exchange transactions are now concluded only in connection with interventions in the foreign exchange market—which have become rare—or for commercial purposes. Domestic securities are purchased primarily for diversifying Swiss National Bank assets. Prior to the introduction of repo transactions in 1998, the Bank had employed money market debt register claims of the Confederation for open market operations. Finally,

the Bank still has the legal option of calling in minimum reserves (non-interest-bearing deposits). The use of this instrument, however, has been discontinued since 1977.

Investment of Assets

At the end of 2000, gold and foreign exchange reserves accounted for about 30 and 40 percent of the Swiss National Bank assets, respectively. The Bank uses a modest proportion of its gold holdings for lending. The Bank invests the bulk of its foreign exchange reserves in safe and liquid securities, and a small proportion in time deposits at prime foreign banks.[5] The Governing Board issues investment policy guidelines in conformity with which an internal investment committee determines the detailed currency allocation and the permissible interest rate risk. The Bank's portfolio managers are guided by a reference portfolio for each individual currency.

The Bank also keeps a small fraction of its assets in Swiss franc bonds.[6] It manages this portfolio subject to the condition that the investment decisions may neither disrupt monetary policy nor profit from it. The investment policy is bound by rules. Specifically, the Bank now has an investment strategy that reproduces an index for Swiss franc bonds that is representative of the market.

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Selected Fiscal Issues

In the past few years, fiscal policy has been guided by a constitutional requirement to balance the federal budget by 2001. Cantons and communes have also been trying to reduce high debt levels accumulated during the low growth of the 1990s. The fiscal framework has already helped to reduce the general government debt/GDP ratio from a peak of over 54 percent in 1998 to under 49 percent at the end of 2000. Recently, the Council of States approved a proposal to strengthen the framework for fiscal policy at the Confederation level after 2001, although approval by the National Council and a referendum are required before the proposal can be implemented. The guiding principle of this amendment is a balanced budget over the cycle, with the automatic stabilizers allowed to operate. To this end, a medium-term path of expenditure limits consistent with the goal of budget balance would be specified, and revenues and the deficit would be allowed to fluctuate over the cycle.[7]

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[5] At the end of 2000, roughly 80 percent of the reserves were invested in government securities and securities with indirect government guarantee.

[6] At the end of 2000, the market value of the Swiss franc bonds portfolio was SFr 5.2 billion, which amounted to about 4 percent of the Bank's total assets.

[7] As with most other OECD countries, there are concerns regarding long-run spending pressures associated with population aging.