

The Role of the Swiss national Bank

By Anisha – Winter 2013

The central bank is, also known as the “national bank” in some countries, is responsible for overseeing the monetary system of a country (online 2). In Switzerland this is the role of the Swiss National Bank (SNB). The main aim of this essay is to describe the role of the central bank in general and in particular of the SNB that it plays in the economy with reference to the recent crisis in Europe. The general framework of the essay follows the list of responsibilities stated by the SNB (online 2), albeit in a different order. Therefore I start by describing briefly the money the SNB provides the economy with. Second, I describe its monetary policy and then the bonds mechanism. Fourth I tackle the issue of price stability and the efforts made by the SNB in this respect. Finally make a brief description of additional roles.

Money

To start with, the SNB has the responsibility to issue notes and supply the economy with banknotes that are of high quality and secure – fiat money (online 3) as well as distributing coins (online 2). Since it is the SNB’s responsibility to supply money, we shall now examine its monetary policy as it is based on the interaction between demand and supply for money.

Monetary policy

Monetary policy refers to the process whereby the monetary authority, the central bank determines “the size and rate of growth of the money supply, which in turn affects interest rates” (online 4) depending on the “economic health” of the economy.

In other words, the monetary policy is based on the demand and supply for money relative to the financial needs of consumers and business organizations, as well as the demand and supply of the domestic (national) currency in the transnational markets – the details of the mechanism which will be developed in another essay.

On the one hand, “The money supply is the amount of financial instruments within a specific economy available for purchasing goods or services” (online 3). It is determined by the multiplier model of credit creation where the money supply is established by the monetary base (real cash and notes in circulation) x the money multiplier (the legal reserve that banks must keep so as to allow loans) (Online 5). The money supply in the short run is perfectly inelastic (online 6) meaning that the SNB cannot change the supply of money very quickly. On the other hand the demand for money is determined by the needs for financial transactions for consumption purposes of domestic goods and services (transactions demand for money), the savings given the employment and

financial risks in the market (precautionary balances) and the speculative purposes through the purchase and sale of bonds (speculative balances) (online 7).

The interaction between demand (L) and supply for money (M) determines a rate of interest (r) for money held by commercial banks and that loaned out. It is assumed that no risk factor is taken into account or other costs by the bank (which in fact make that interest to lenders is higher than that of depositors) – see figure 1.

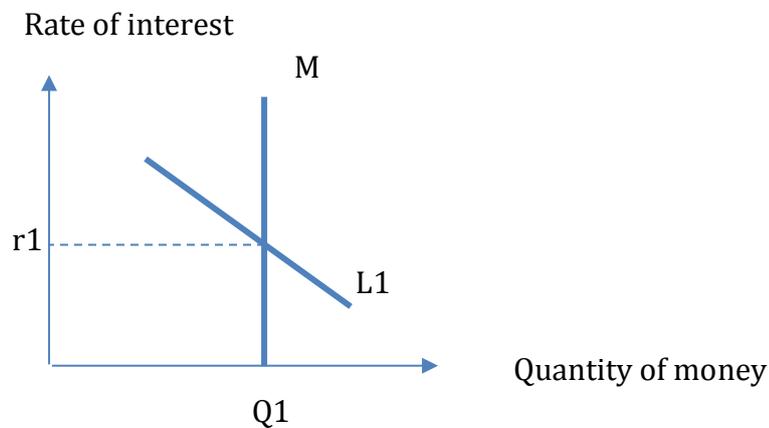


Figure 1

In order for the SNB to determine whether to increase/decrease the rate of interest (r) directly or indirectly by increasing/decreasing the supply of money (M), the SNB determines 1) the liquidity available on the money market by measuring the main money categories M1, M2, M3 (online 3) and 2) estimates the demand for money. Recently, the SNB has been using the London Interbank Offered Rate (Libor) (online 8) as its reference interest rate so as to follow the EU financial trends (online 2).

Bonds and securities

The SNB contributes to the stability of the financial system (online 2) by overseeing important payment and securities settlement systems. At the same time it “acts as banker to the Confederation” (Ibid.) since, on behalf of the Confederation, it can issue bonds to either finance debts or deficits (online 9) and/or to reduce the money in circulation.

This is an important mechanism because since the Swiss financial and banking sectors are often taken to be safe havens for investors, the capital inflow increases the supply of money beyond what the SNB has decided, bringing about the disequilibrium relative to the demand for money. This means that supply of money must be reduced so as to keep the same rate of interest (online 10).

Price stability

Having seen the fundamentals of monetary policy, we shall now examine how the monetary policy is put into use for keeping prices stable. As it is stated by the SNB, “price stability is an important condition for growth and prosperity. Inflation and deflation, by contrast, impair economic activity. They complicate decision-making by consumers and producers, lead to misallocations of labour and capital, result in income and asset redistributions, and put the economically weak at a disadvantage” (online 2). It is therefore important to understand the mechanism where monetary policy (together with fiscal policy) is considered to be an automatic stabiliser (online 11).

Suppose the Confederation seeks to offset an inflationary surge (such as in 2009 with 3% - online 12). It will first need to understand its nature since inflation according to Blink & Dorton (2007: 205ff) can either be demand-pull, cost-push or due to an excess of money supply.

In the case of a demand-pull inflation shown as a shift from AD1 to AD2 – see figure 2, it will need to contract the aggregate demand (AD) by discouraging mainly consumption expenditure by increasing the rate of interest since consumption expenditure accounts for almost 2/3 GDP (online 13). However, higher interest rates will hurt those who have made borrowings from the banking system for mortgages or for debt-financing firms (Blink & Dorton, 2007: 208). For international investors higher interest rates can be seen to be a good investment opportunity, thereby increasing the capital inflow and the money supply in the Swiss markets.

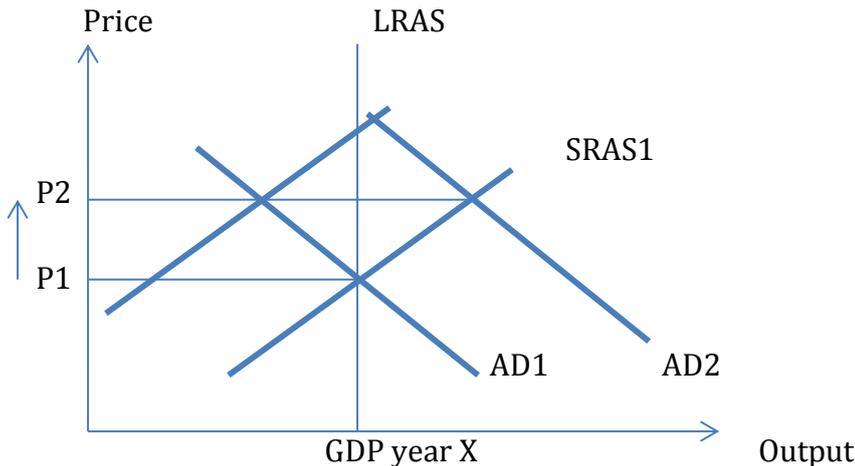


Figure 2

In the case of a cost-push inflation shown as a leftward shift of the SRAS1 to SRAS2 – see figure 2, mainly due to raises in wages and increased prices of imported factors of production (Blink & Dorton, 2007: 208) may lead to unemployment if the firms want to keep the prices of their goods/services unchanged. In this case the SNB can also seek to use its monetary policy to deal with the issue in a similar fashion to demand-pull inflation. However, since demand-side policies are likely to cause unemployment to rise

(Blink & Dorton, 2007: 210), it is supply-side policies that are preferred in that they involve lowering corporate taxes, union power and removing minimum wages legislations (Blink & Dorton, 2007: 183).

In case inflation is due to an excess of money supply either because of demand-side policies or increased capital inflows, the SNB can intervene to reduce it through open market operations (Blink & Dorton, 2007: 210).

Additional roles

Having looked at the way monetary policy is used to combat inflation we can conclude the list of roles by mentioning that the SNB provides services for payments between banks through the interbank payment system (SIC system) (online 2). Additionally, the SNB manages the currency reserves, which is the most important component of its assets as they are used for defending the value of the Swiss franc on the foreign markets – the details of the mechanism will be explained in another essay. Finally the SNB compiles statistical data on banks and financial markets as well as on the balance of payments, direct investment and the Swiss financial accounts (Ibid).

Concluding notes

Overall, it is quite clear that the SNB seeks to maintain the financial and economic stability in Switzerland which together with stable politics contribute to its success as an economy. In particular it is the SNB's strategy to keep inflation at less than 2% per annum while avoiding deflationary moves (online 2) and to achieve this it resorts to an expansionary/contractionary monetary policy. However, a monetary policy has its limitations. To start with, since it is based on the confidence that the SNB is able to use its monetary policy to combat inflation (Blink & Dorton, 2007: 208ff), it may not actually achieve it – this situation is referred to as “liquidity trap” (online 14) – bringing about a confidence crisis as in 2008 (online 15). Another limitation is that it is “difficult to control many objectives with one tool” (online 14) especially that in an open economy changing interest rates affect exchange rates. In spite of these limitations, monetary policies are much preferred that fiscal policies because the latter are unpopular (Blink & Dorton, 2007: 210) and ineffective as they often “crowd out” the positive effects of the monetary policies.

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