Advanced text

Monetary policy: Application

Core task of a central bank

A central bank is no ordinary bank; it is charged with the fulfilment of a specific core task, namely to conduct a monetary policy that serves the overall interests of the country. This involves pursuing two important goals simultaneously:

- The first goal centres on inflation, i.e. a sustained increase in the general price level over several periods. The central bank's aim is to prevent major fluctuations in the value of money; this is often equated with an increase in price level of 0% to 2% per year. The term used to describe this goal is price stability. It is generally considered the primary objective of monetary policy.
- The second goal centres on the balanced development of a country's economy, ensuring that it neither overheats nor cools down significantly. This is usually an important secondary objective of monetary policy, but it is closely related to the development of inflation.

Measure of economic performance

Economic developments can be assessed using various indicators, such as consumer confidence, gross domestic product (GDP) or the unemployment rate. In Mopos, the output gap serves as a measure of economic performance. It shows how well existing production capacity is being utilised. More specifically, the output gap measures the percentage deviation of actual output from potential output, i.e. the maximum output that can be achieved without causing additional inflationary pressure. If production capacity utilisation is high, inflationary pressure tends to rise; if production capacity is underutilised, this has a dampening effect on inflation.

Monetary policy instrument

Most central banks – the Swiss National Bank included – pursue their monetary policy goals by influencing the economy in a targeted manner. Under normal circumstances, this is primarily achieved by adjusting the key interest rate. [1] Central banks thus provide clear guidance on the direction monetary policy should take. They also take supplementary measures to ensure that short-term money market interest rates remain close to the key interest rate.

Central banks use their interest rate policy to influence both inflation and economic activity. A higher key interest rate tends to slow price rises (= lower inflation) and weaken economic activity (= narrower output gap), while a lower rate has an expansionary effect, accelerating both price rises and economic activity.

What is an output gap?

The actual output of an economy fluctuates around its long-term potential output. Potential output is the output that can be achieved at full capacity utilisation without causing additional inflationary pressure.

If actual output exceeds potential, inflation tends to rise. If it is lower than potential, inflation tends to fall.

Decision-making process

The central bank's board meets at regular intervals to make its interest rate decision. The most important tool in this process is the analysis of economic data. The central bank examines how this data performed in previous quarters as well as in the current quarter. In addition, it prepares forecasts on future developments in inflation and economic activity. These forecasts also always depend on the applicable interest rate, which influences both variables. Based on this comprehensive analysis, the central bank decides whether a monetary policy adjustment is necessary.

The monetary policy process can be divided into two phases:

- **Analysis of current situation:** The first phase focuses on examining the current economic situation. This involves assessing how the situation has changed since the last monetary policy assessment.
- **Forecast and interest rate decision:** The second phase concentrates on the future. Since the effect of interest rate changes is delayed, a forward-looking approach to monetary policy is necessary. Should the forecasts indicate a threat to price stability or a boom or recession if interest rates remain unchanged, monetary policy action is required.

Challenges

A number of factors complicate the conduct of monetary policy:

- **One instrument, two goals:** Conflicts may arise between the two objectives of price stability and balanced economic development. In such cases, it can be difficult to achieve both goals simultaneously with just one monetary policy instrument. The central bank must then strike a balance between the two objectives, for example by temporarily accepting higher inflation in order to ensure a milder recession.
- **Time lag:** Economic development, as measured by the target variables of inflation and the output gap, is a slow process. Changes often take time to become apparent. This means that both past developments and delayed economic responses to interest rate changes are crucial for current and future monetary policy.
- **Unexpected events:** In addition to past events and monetary policy, the element of chance also plays an important role. Unexpected events that have either a positive or negative impact on the economy and cannot be foreseen with any degree of certainty are referred to as shocks or disruptions. One example of this is a sudden and substantial appreciation of the national currency.

Summary

A modern central bank pursues two goals: price stability as the primary objective and balanced economic development as an important secondary objective.

The central bank uses its key interest rate as an instrument to achieve both goals:

- An increase in the key interest rate usually leads to lower inflation and weaker economic activity.
- Meanwhile, a decrease in the key interest rate results in higher inflation and stronger economic activity.

The central bank's board makes interest rate decisions at regular intervals. For this purpose, it analyses the past and current course of key economic variables, such as inflation and the output gap. Forecasts on future developments in inflation and economic activity are always determined by the applicable interest rate, since this rate influences both variables.

A number of factors complicate the conduct of monetary policy:

- Inflation reacts with some delay to interest rate adjustments.
- In addition to monetary policy, events that cannot be foreseen with any degree of certainty (known as shocks) influence the economy.
- Conflicts may arise between the objectives of low inflation and balanced economic development, requiring the central bank to weigh up different priorities.

Footnotes:

[1] The Mopos simulation is limited to conventional monetary policy, which is achieved by steering the key interest rate. Unconventional measures, such as negative interest rates or foreign exchange market interventions, are not taken into account.