Transcript of the video

Monetary policy: Implementation in the money market

Voiceover

Hello and welcome! Today we will explain how the Swiss National Bank, SNB for short, implements monetary policy – and why it's important for all of us.

As we have already explained in the "Monetary Policy" module, the SNB has an important mandate: to ensure price stability while taking into account the economic situation. Price stability means that prices should not rise too quickly. However, they shouldn't permanently fall either. To fulfill this mandate, the SNB can steer the interest rate using the SNB policy rate and, if necessary, influence the exchange rate directly.

If prices are rising too quickly, meaning there's a threat of high inflation, the SNB can raise the policy rate and slow down economic development. Conversely, if the economy is weak or prices are even falling, the SNB can lower the policy rate and press the accelerator.

The SNB hence announces the policy rate and thereby sets the course for monetary policy. Market interest rates, meaning the interest rates on financial markets, should remain close to the policy rate. However, merely announcing a change in the policy rate isn't enough to influence market interest rates and, consequently, the interest rates in our daily lives. To do this, the SNB conducts transactions with banks that are based on the SNB policy rate. The specifics of how this works will be explained here.

So, how does this mechanism work?

Banks must hold a minimum reserve of central bank money. The required reserve depends on how many customer deposits they have. They also need central bank money to process payments. If a bank has too little central bank money, it must borrow money from another bank on a short-term basis. This takes place on the so-called money market. The average interest rate at which this short-term transaction happens on a given day is called SARON. [SARON stands for Swiss Average Rate Overnight.]

The SARON is thus determined by the banks' transactions in central bank money. The SNB can directly influence how much central bank money is available to banks overall. Simply put, the SNB can steer the SARON by changing the supply of central bank money.

How does the SNB steer the supply of central bank money?

The SNB uses so-called open market operations to control the supply of central bank money.

Imagine the economy is booming, and prices are rising too quickly. This is when the SNB can apply the brakes. It raises the policy rate and withdraws money from the market through open market operations. This means that the SNB borrows money from the banks on a short-term basis and offers them a higher interest rate in return. This leaves the banks with less money to lend to other market participants. The money supply decreases, and this leads to higher market interest rates. The rising market

interest rates translate into higher loan interest rates, which increases the overall interest rate level. As a result, fewer loans are taken out, the economy slows down, and prices stabilize.

Conversely, if it becomes apparent that inflation is falling too sharply, the SNB lowers policy rate and makes more money available through open market operations. The additional central bank money leads to falling interest rates on the money market. With the increased money supply and lower interest rates, banks can issue more loans. This allows companies and households to invest and spend more easily, and the economy gets back on track.

What happened after the 2008 financial crisis?

At that time, the situation was particularly delicate. The policy rate was already very low, and further rate cuts were hardly possible. At the same time, the Swiss franc had appreciated significantly. The SNB lowered the policy rate to zero, but needed to find additional ways to implement monetary policy afterwards when conventional measures were no longer sufficient. It thus introduced negative interest rates to make the franc less attractive. For the same reason, The SNB hence bought foreign currencies, thereby increased the supply of Swiss francs to make the franc less attractive. For the same reason, the SNB also introduced negative interest rates. The increase in supply of Swiss franc led to a large amount of central bank money entering the market, which is still noticeable today.

And how does steering of interest rates work today, with a surplus of central bank money?

Today, banks are equipped with more than enough central bank money. To ensure that the policy rate continues to influence the general interest rate level, the SNB pays banks interest on their central bank money. Furthermore, using a tiered interest rate system allows the SNB to ensure that banks continue to lend to each other on the money market. A tiered interest rate system means that banks receive interest on part of their money held at the SNB, but not the same amount for all of it. This ensures that banks have sufficient incentive to lend money to each other so that the money market remains active and the SNB can continue to control the SARON.

In summary: The SNB policy rate is a kind of signpost, showing in which direction the SNB wants to steer monetary policy. The SARON is the actual market interest rate that results from transactions between banks. To keep the money market interest rate close to the policy rate, the SNB uses open market operations. After the 2008 financial crisis, these conventional measures were no longer sufficient to steer monetary policy and stabilize the Swiss Franc. The SNB therefore bought foreign currencies and introduced negative interest rates. Today, the SNB uses tiered interest rates to ensure the money market works even with a significantly increased money supply, and that it can continue to influence the SARON.