MONETARY POLICY

Knowledge sheet

Headlines on monetary policy

- **Central bank leaves monetary policy unchanged – economic outlook stable**
- **Change in interest rate expected – monetary policy to tighten the reins**
- **Economy headed for recession – rapid easing of monetary policy required**

Primary objective of a central bank

A central bank is no normal bank; it has a special core function in that it is charged with the task of pursuing a monetary policy that serves the interests of the country as a whole. This means that it simultaneously pursues two goals:

- The first is inflation, i.e. a sustained increase of the general level of prices over several periods. It is a central bank's job to avoid major fluctuations in the value of money, which is sometimes equated with an annual increase in the price level of between 0% and 2%. The term used to describe this is price stability, which is generally the primary objective of monetary policy.
- The second major goal is balanced economic activity. In other words, a country's economy should neither be allowed to overheat nor go into recession. This is generally an important secondary objective of monetary policy. Economic activity is often measured by the output gap, which is expressed as the percentage deviation between actual output and potential output. Potential output is the maximum level of output that is possible with existing capacities but without giving rise to any additional inflationary pressure. During boom times, output is greater than the potential (the output gap is positive). During a recession, output is less than the potential (the output gap is negative). If the output gap remains close to zero, economic activity is considered to be in equilibrium.

Monetary policy instrument

Most central banks – the Swiss National Bank included – pursue these goals by influencing economic developments. In normal circumstances, they do so by raising or lowering the price for the money they lend, in other words, by adjusting their key rate. Central banks use their interest rate policy to influence both inflation and economic activity.
If all other conditions remain unchanged, a higher key rate leads to a slowdown in the price rise (= lower inflation) and a weakening of economic activity (= reduced output gap). Conversely, when a central bank lowers the key rate, price rises and the economy accelerate.

The decision-making process

The central bank's management meets at regular intervals to make its interest rate decisions. The most important tool in the decision-making process is the analysis of economic data. The central bank analyses past and current economic developments as well as the forecasts for the coming quarters. Forecasts regarding the development of inflation and the economy are always determined by the applicable interest rate (since this rate systematically influences inflation and the economy).

The monetary policy process can be divided into two steps:

- Phase 1 (analysis, but with reference to the last interest rate decision): What is the assessment of the economic situation at present? Is the decision considered appropriate in retrospect? Is it still considered appropriate?
- Phase 2 (interest rate decision): What interest rate decision would be appropriate right now? Should the forecast point to a breach of price stability over the next few quarters for instance (on the assumption that interest rates remain unchanged), monetary policy action is required.

Challenges

The following reasons make it particularly difficult to steer monetary policy:

- Delayed effects: Economic growth, as measured by the target variables of inflation and the output gap, is a slow-moving process. This means that past events have an important role to play in current and future monetary policy. It also means that inflation may not react immediately to interest rate adjustments, but that its reaction is delayed.
- Unexpected occurrences: Besides past events and monetary policy influencing a country's economy, the element of chance also plays an important role. There will always be events that have an impact on the economy and that can never be properly forecast. Unexpected occurrences that have either a positive or negative impact on the economy and cannot be forecast with any degree of certainty are referred to as shocks or disruptions. A shock can, for instance, be a sudden decrease in export demand from abroad or a quick and substantial appreciation of the national currency.
- One instrument, two goals: Even if a central bank could steer the economy as it sees fit, discrepancies between

both objectives (low inflation and balanced economic activity) may arise. It can sometimes be difficult to pursue the two goals simultaneously with only one instrument. In cases like this, a central banker may have to make a difficult decision and choose the lesser of two evils, for example, settle for a temporarily higher-than-desired rate of inflation in favour of a lower risk of recession.

- Important economic data only become available after a lag: One of the difficulties concerning monetary policy is the lack of complete or correct information regarding economic developments. As the monetary policymakers are not aware of the precise economic situation and any underlying disruptions at the time the interest rate decision is made, it is necessary to be all the more careful when evaluating the available data. Moreover, the central bank thinks in terms of scenarios. Since extreme situations are not unheard of, a cautious central bank moves in small steps.

SUMMARY

A modern central bank pursues two goals:
Price stability as the most important objective and balanced economic activity as an important secondary objective.

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

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

The central bank's management makes regular interest rate decisions. It analyses the past and current developments of key variables, such as inflation and the output gap. Forecasts regarding the development of inflation and the economy are always determined by the applicable interest rate (since this rate systematically influences inflation and the economy).

A number of reasons make it particularly difficult to steer monetary policy:

- Inflation does not react immediately to interest rate adjustments.
- Besides monetary policy influencing economic developments, there will always be events that cannot be properly forecast (referred to as disruptions).
- The central bank only has access to fragmentary information on current economic developments.